2022/23 Federal and California Tax Update

www.spidell.com | E-mail: cpe@spidell.com | Phone: 800-277-2257

2022/2023 Federal and California Tax Update

Version 3

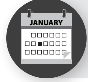
Course slides

Use the following link to access the slideshow presentation for this course:

www.caltax.com/files/2022/fedcal-slides.pdf

Updated manual and follow-up letter

We will e-mail you a link to download an updated PDF version of the manual along with your follow-up letter in:



February 2023

CPE certificates and more

Log in to Spidell CPE with your e-mail address and password (your license number) to access your CPE certificates and more. Go to:

cpe.spidell.com

Spidell's Flash E-mail

To sign up for Spidell's free Flash E-mail service, go to www.caltax.com and log in (or create a new account). Go to "My Account" and then "Account Details" and check the box to subscribe. Or to access our archive, click on "News" and then "Flash E-mail."

Spidell's Podcasts

Spidell offers two podcasts, Spidell's California Minute® and Spidell's Federal Tax Minute™. Both are weekly audio shows led by Editorial Director Kathryn Zdan, EA, and are designed to provide tax news snippets while bringing you tips and hot topics that will save you time and save your clients tax.

Send an e-mail to AnthonyA@spidell.com to subscribe, or go to www.caltax.com/news/podcast or www.caltax.com/news/fedtaxminute to access the archive of past episodes.

Your Presenters:

Mike Giangrande, J.D., LL.M.
Tim Hilger, CPA
Alan Pinck, EA
Stan Pollock, CPA
Renée Rodda, J.D.

Federal Editor:
Mike Giangrande, J.D., LL.M.

California Editor:
Renée Rodda, J.D.

Contributing Editor:
Sandy Weiner, J.D.

Contributing Staff:
Ana Cervantes
Austin Lewis
Kathryn Zdan, EA

Spidell Publishing, LLC

P.O. Box 61044
Anaheim, CA 92803-6144

Phone: (800) 277-2257
Fax: (714) 776-9906

Website: www.caltax.com
E-mail: subscriptions@spidell.com

© Spidell Publishing, LLC
Third Edition
February 2023

This publication is distributed with the understanding that the authors and publisher are not engaged in rendering legal, accounting or other professional advice and assume no liability in connection with its use. Tax laws are constantly changing and are subject to differing interpretation. In addition, the facts and circumstances in your particular situation may not be the same as those presented here. Therefore, we urge you to do additional research and ensure that you are fully informed before using the information contained in this publication. Federal law prohibits unauthorized reproduction of the material in Spidell's **2022/2023 Federal and California Tax Update** manual. All reproduction must be approved in writing by **Spidell Publishing, LLC.**®

This is not a free publication. Purchase of this electronic publication entitles the buyer to keep one copy on his/her computer and to print out one copy only. Printing out more than one copy — and any electronic distribution of this publication — is prohibited by international and United States copyright laws and treaties. Illegal distribution of this publication will subject the purchaser to penalties of up to $100,000 per copy distributed.

2022/2023 FEDERAL AND CALIFORNIA TAX UPDATE
PART I — CHAPTERS 1-5

Course objectives: Be prepared for the upcoming 2022-2023 filing season with this comprehensive review and critical analysis of essential issues in federal tax law and practice that have come up during the past year. Topics discussed include: filing requirements; name, image, likeness (NIL) income; student loan forgiveness exclusion; alternative minimum tax and credits; individual tax credits; Inflation Reduction Act energy incentives for individuals and businesses; Affordable Care Act; HOMES retrofit rebates; Treasury bonds; taxation of cryptocurrency; estate, trust, and gift taxes; traditional IRAs; inherited IRAs and proposed RMD regulations; Roth IRAs; Social Security and Medicare; proposed SECURE Act 2.0 legislation; Paycheck Protection Program and Employee Retention Credit lingering issues; research and development; IRC §179 and depreciation; business interest expense limitation; SALT workaround; business start-up expenses; centralized partnership audit regime (CPAR); sale of real estate; real estate professionals; Schedule E reporting issues; Delaware statutory trusts; new domestic filing exception to Schedules K-2/K-3; IRS audits; foreign tax issues; and much more.

After completing this course, you will be able to:

- Recall the transition relief for the Clean Vehicle Credit for taxpayers who purchased a car before the Inflation Reduction Act was enacted
- Identify the types of property that qualify for the Residential Clean Energy Credit
- Recall how taxpayers should make repayments of deferred Social Security taxes
- Determine the calculation of required minimum distributions when the taxpayer owns multiple IRA accounts
- Recall the effect on the distribution ordering rules when a taxpayer makes a qualified charitable distribution
- Identify the wage and apprenticeship requirements applicable to the Energy Efficient Commercial Building deduction
- Identify what needs to be included in a valid R&D Credit refund claim
- Determine periods of nonqualified use for purposes of claiming the IRC §121 exclusion
- Recall differences between a Delaware statutory trust and a TIC 1031
- Identify directives under the new beneficial ownership reporting requirement enacted by the Corporate Transparency Act of 2019

Category: Taxes

Recommended CPE Hours: CPAs — 6 Tax
EAs — 6 Federal Update
CRTPs — 6 Federal Update

Level: Update

Prerequisite: General tax preparation knowledge is required.

Advance Preparation: None

Expiration Date: December 2023

2022/2023 FEDERAL AND CALIFORNIA TAX UPDATE
PART II — CHAPTERS 6-10

Course objectives: Be ready for the upcoming 2022-2023 filing season with this exhaustive review and analysis of important issues in California tax law and practice that have come up during the past year. Topics discussed include: middle class tax refunds; first-time penalty abatement; California's individual health care mandate; calculating the Other State Tax Credit (OSTC); California's PPP loan forgiveness partial conformity; student loan forgiveness; nonconformity issues; passthrough entity elective tax and credit; interplay between the OSTC and the Passthrough Entity Elective Tax Credit; net operating losses; cannabis businesses; remote workers; market-based sourcing rules; Public Law 86-272; CalSavers; tax basis capital account reporting; reporting unclaimed property on California tax returns; California like-kind exchanges; property tax; worker classification updates; CalKIDS college savings program; and much more.

After completing this course, you will be able to:

- Identify differences between the federal and California first-time penalty abatement programs
- Determine taxable wages when one spouse lives in California and the other spouse lives in another state
- Recall where adjustments are made on the California return for taxpayers who don't meet the 25% gross receipts reduction threshold for PPP loans
- Recall how payment of the passthrough entity tax may effect mandatory e-pay requirements
- Identify the new reporting requirements for cannabis businesses
- Choose who must file an unclaimed property report

Category: Taxes

Recommended CPE Hours: CPAs — 2 Tax
CRTPs — 2 CA Tax

Level: Update

Prerequisite: General tax preparation knowledge is required.

Advance Preparation: None

Expiration Date: December 2023

Table of Contents

List of Chapters

Chapter 1: Individuals

Chapter 2: Retirement

Chapter 3: Business

Chapter 4: Real Estate

Chapter 5: Practice and Procedures

Chapter 6: California Legislation and Filing Issues

Chapter 7: California Conformity

Chapter 8: California Individuals

Chapter 9: California Business

Chapter 10: California Miscellaneous

Chapter 11: Practitioner Aids

Chapter 1 — Individuals

Filing deadline is April 18, 2023....................1-1
Personal exemptions and dependents....................1-1
No personal exemption deduction....................1-1
Filing issues....................1-4
Filing requirements....................1-4
Gross income....................1-6
Name, image, likeness (NIL) income....................1-6
Dependent care assistance....................1-7
Capital gains....................1-8
Hobby activities....................1-10
Exclusions from income....................1-12
COD exclusion....................1-12
Adjustments to gross income....................1-13
Unreimbursed expenses of K–12 educators....................1-13
Alimony....................1-14
Student loan interest....................1-14
Health savings accounts....................1-15
Standard deduction and itemized deductions....................1-16
Standard deduction....................1-16
Itemized deduction phaseout....................1-17
Medical expenses....................1-17
Taxes....................1-19
Casualty and theft losses....................1-20
Home mortgage interest....................1-21
Charitable contributions....................1-22
Miscellaneous itemized deductions....................1-23
Qualified business income deduction....................1-23
Tax calculation....................1-24
Alternative minimum tax and credits....................1-24
Self-employment tax....................1-26
Net investment income tax (NIIT)....................1-26
Individual tax credits....................1-27
Child Tax Credit....................1-27
Child and Dependent Care Credit....................1-28
Adoption Credit....................1-30
Earned Income Credit....................1-31
Education credits....................1-32
Saver's Credit....................1-33
Inflation Reduction Act energy incentives....................1-34
Clean Vehicle Credit....................1-35
Previously Owned Clean Vehicle Credit....................1-41

Energy Efficient Home Improvement Credit (aka Nonbusiness Energy Credit) 1-43
Residential Clean Energy Credit 1-47
Affordable Care Act (ACA) 1-49
ACA individual mandate 1-49
Premium Tax Credit 1-49
Expanded affordability exemption 1-52
Nanny tax threshold 1-54
College savings 1-55
Expiring tax provisions 1-56
Other Inflation Reduction Act provisions 1-57
HOMES retrofit rebates 1-57
High-efficiency electric home rebates 1-59
2022–2023 phaseout chart 1-61
Investments 1-62
Series I Treasury bonds 1-62
Taxation of cryptocurrency/NFTs/DeFi 1-64
Estate, trust, and gift taxes 1-74
Unified exclusion amount 1-74
DSUE portability election 1-78
Annual gift tax exclusion 1-79

Chapter 2 — Retirement

Traditional IRAs 2-1
IRA contribution amounts 2-1
Taxpayer active in employer-sponsored plans 2-1
Taxpayer is not an active participant, but spouse is 2-2
Form 5498 2-2
Excess IRA contributions 2-2
IRA distributions 2-4
Early withdrawal penalty/additional tax 2-13
Coronavirus-related distributions 2-13
IRA distributions subject to 10% tax 2-15
Inherited IRAs 2-15
Proposed RMD regulations 2-15
Roth IRAs 2-24
Roth IRA contribution amounts 2-24
Roth conversions 2-25
Allowable rollovers 2-31
Plan limitation amounts 2-32
Social Security 2-33
Social Security (FICA) 2-33

Medicare **2-34**
High-income individuals 2-34
Medicare-related provisions of the Inflation Reduction Act **2-36**

Chapter 3 — Business

PPP and ERC lingering issues **3-1**
Employee Retention Credit penalty relief 3-1
Improperly forgiven PPP loans are taxable income 3-2
ERC fraud 3-2
Inflation Reduction Act provisions for businesses **3-3**
"Base" and "bonus" credits 3-3
Qualified Commercial Clean Vehicle Credit 3-6
Energy efficient commercial building deduction 3-8
Alternative Fuel Vehicle Refueling Property Credit 3-10
New Energy Efficient Home Credit 3-11
Energy Investment Tax Credit 3-12
Renewable Electricity Production Tax Credit 3-14
Clean electricity property classified as five-year property 3-18
Monetizing specified energy credits 3-18
Additional changes to energy credits 3-21
Excise tax on stock buybacks 3-21
Corporate minimum tax 3-22
New excise tax on drug manufacturers 3-23
Research and development **3-23**
Research expenses 3-23
R&D credits 3-28
Research Credit against small business payroll taxes 3-30
IRC §179 and depreciation **3-32**
IRC §179 expensing 3-32
Bonus depreciation 3-32
Correcting depreciation errors 3-35
Automobile expenses **3-38**
Standard mileage rate 3-38
Accountable versus nonaccountable plans 3-39
Trade or business expenses **3-41**
Meals and entertainment 3-41
Net operating losses 3-43
Excess business losses 3-45
Business interest expense limitation 3-46
Reporting SALT workaround on business return 3-50
Business start-up expenses 3-52

Hemp businesses not subject to IRC §280E 3-54
Corporations 3-54
Correcting inadvertent S corporation terminations without a private letter ruling 3-54
Constructive dividends and reasonable compensation 3-56
IRS targeting C corporations that zero-out profits 3-58
Accumulated earnings tax 3-59
Partnerships 3-61
CPAR: partner-level adjustments 3-61
IRC §754 election 3-65

Chapter 4 — Real Estate

Sale of residence 4-1
Nonqualified use 4-1
Counting periods of nonqualified use 4-2
Depreciation recapture 4-3
Inherited residence 4-4
Sale of real estate: ordinary income or capital gain 4-5
Musselwhite v. Comm. 4-5
Home office 4-7
Real estate professionals 4-9
Sezonov v. Comm. 4-9
Passive activity 4-10
Material participation 4-10
The single-activity election 4-11
Schedule E reporting issues 4-13
Active participation 4-13
Average rental period 4-14
Personal property rentals 4-14
Schedule 1 reporting 4-15
Passive activity rules 4-15
Delaware statutory trusts 4-16
What is a DST? 4-16
Eligible investors 4-17
Income tax reporting 4-17
Benefits of a DST investment 4-17
Like-kind exchanges 4-17
TIC versus DST like-kind exchange 4-18

Chapter 5 — Practice and Procedures

PTINs...**5-1**
PTIN renewal...5-1
Forms and filing update...**5-1**
1099-K reporting threshold...5-1
1099-NEC and 1099-K double reporting...5-2
Information Returns Intake System...5-3
Corporate Transparency Act...5-4
Schedules K-2/K-3...5-11
Practitioner issues...**5-21**
E-signatures extended through October 31, 2023...5-21
Entity changes requiring new EIN...5-22
E-file rejects due to name control matching...5-25
IRS audits...5-28
Superseding returns can now be e-filed...5-31
IRS issues...**5-32**
Increased IRS funding...5-32
Understanding IRS transcript codes...5-33
Tax Pro Account...5-35
IRS refund tool now includes prior two years...5-35
Foreign tax issues...**5-36**
Foreign-earned income exclusion...5-36
Withholding requirements...5-36
Foreign reporting...5-37
FBAR penalties...5-37
Foreign Tax Credit...5-38
Disaster relief...**5-43**
Local disaster relief provisions...5-43
Planning checklists...**5-43**

Chapter 6 — California Legislation and Filing Issues

Legislation...**6-1**
New legislation of interest...6-1
November 2022 tax-related ballot initiatives...**6-7**
Tax basis capital account reporting...**6-8**
How to recreate California tax basis...6-8
Reporting unclaimed property on California tax returns...**6-9**
New tax return questions...6-9
Who must file unclaimed property reports?...6-9

Unclaimed Property Voluntary Disclosure Program....6-10
FTB disclosures....6-10
Cost of noncompliance....6-10
Voluntary compliance program....6-11
Wildfire settlement exclusion....6-11
Turf replacement rebate exclusion....6-12
Water and utility payment exclusion....6-12
ABLE account contribution limits....6-12
College Access Tax Credit extended....6-13
Applying for the credit....6-14
Claiming the credit....6-14
COVID-19 paid supplemental sick leave....6-14
Main Street Small Business Tax Credit requirements eased....6-14
California Competes Tax Credit extended....6-15
Homeless Hiring Tax Credit....6-15
California Historic Rehabilitation Tax Credit has been funded....6-16
Workers' Tax Credit....6-16
Qualified taxpayer....6-16
Workers' Tax Credit adjustment factor....6-17
Top reasons for FTB e-file rejections....6-17
Business entities....6-17
Individuals and fiduciaries....6-17
New personal income tax return checkboxes....6-18
SDI benefit amounts and tax base expanded....6-18

Chapter 7 — California Conformity

Student loan forgiveness....7-1
California's exclusion....7-1
PPP loan forgiveness partial conformity....7-2
Post-March 2021 loans....7-2
When do we measure gross receipts?....7-3
What documentation is required?....7-3
When are deductions reduced?....7-4
Where are the adjustments made?....7-4
What if we already filed?....7-5
Are Schedule C borrowers required to reduce deductions?....7-5
What about multistate taxpayers?....7-5
Conformity to PPP loan forgiveness basis adjustments....7-5
Continuing nonconformity....7-6
Additional pandemic relief conformity....7-6
Restaurant Revitalization Fund grants....7-6

Shuttered Venue Operator Grants 7-6
Excess business loss limitation 7-7
Excess business loss 7-7
Loss carryovers 7-7
Other nonconformity issues 7-9
Quick Guide to California Nonconformity for Taxable Year 2022....................7-11

Chapter 8 — California Individuals

Middle Class Tax Refunds 8-1
Refund amounts 8-1
Gross income exclusion 8-1
Qualifications 8-2
Check is not in the mail 8-3
Erroneous payments 8-3
FTB assistance 8-3
Collection-proof 8-3
First-time penalty abatement enacted 8-4
Eligibility 8-4
Application 8-4
California's individual health care mandate 8-5
Covered California may be a better deal than private insurance 8-6
Selling a nonresident's interest in an entity 8-7
Nonresident partners' sale of a partnership interest 8-7
S corporation shareholders: The California two-step analysis 8-8
Spouses working in different states: Which states get to tax? 8-11
Split it down the middle 8-11
Method to the madness 8-12
Other State Tax Credit requires double-taxed income 8-12
Credit overview 8-13
Calculation of credit 8-14
Additional tax relief provided to low-income taxpayers 8-15
Foster Youth Tax Credit 8-16

Chapter 9 — California Business

Passthrough entity elective tax 9-1
How the passthrough entity elective tax and credit work 9-1
Qualified entity 9-2
Qualified taxpayer 9-3
Qualified net income 9-4

The federal deduction ... 9-7
Making the election ... 9-8
Paying the tax ... 9-9
How the payment is made ... 9-13
Confirm payments on MyFTB ... 9-14
Interplay with mandatory e-pay ... 9-14
California credits to owners ... 9-16
Credit ordering rules ... 9-19
Nonresident withholding ... 9-22
Client letter ... 9-23
Frequently asked questions ... 9-23
Net operating loss suspension repealed ... 9-23
Business credit limitation repealed ... 9-24
Cannabis businesses receive major tax relief ... 9-24
Excise tax changes ... 9-24
New reporting requirements ... 9-25
Equity Licensee Excise Tax Credit ... 9-25
High Road Cannabis Tax Credit ... 9-25
Cannabis Equity Tax Credit ... 9-26
Remote workers ... 9-27
Hidden cost to employers ... 9-27
Hidden costs for employees ... 9-27
Market-based sourcing rules: FTB reverses interpretation ... 9-30
Subcontractor services ... 9-31
Bait and switch ... 9-31
What does this mean? ... 9-31
Other situations addressed ... 9-32
Penalty relief ... 9-32
Out-of-state entities beware ... 9-33
Beware those 1099s ... 9-33
Preparer ignorance is no excuse ... 9-33
Per-owner penalties add up ... 9-34
Other recent traps ... 9-34
P.L. 86-272 protections may no longer be available ... 9-35
MTC reexamines P.L. 86-272 protections ... 9-35
California takes the lead ... 9-36
Protected activities ... 9-36
Impact on California businesses ... 9-37
Taxation of nonresident sole proprietors ... 9-37
All is not lost ... 9-38
Sales of real estate and LLC gross receipts fee ... 9-40
Dealer versus investor ... 9-40

Payroll tax increases coming in January **9-40**
How the FUTA rate is determined 9-41
CalSavers **9-42**
Most nonexempt businesses must register by 2026 9-42
Registering with CalSavers 9-43
New businesses 9-43
CalSavers penalties 9-43

Chapter 10 — California Miscellaneous

FTB **10-1**
FTB form changes for 2022 tax year 10-1
FTB "outreach" campaigns 10-2
Accounting for real estate withholding 10-3
FTB settles some LLC fee protective refund claims 10-4
Dishonored payment penalty for rejected duplicate payment 10-5
Partial interest abatement 10-5
Faster access to MyFTB account 10-6
Changes to MyFTB password expiration 10-6
Board settlement approval threshold increased 10-7
Certificates of mailing procedures for large tax deficiencies 10-7
Collection and filing enforcement fees 10-7
Filing extensions for wildfire victims 10-7
Property tax **10-7**
Solar property new construction exclusion 10-7
Emergency Proposition 19 rules adopted 10-8
Property tax increases for partial transfers 10-10
2023 Disabled Veterans' Exemption 10-12
EDD **10-13**
Worker classification updates 10-13
Simplified application process for Work Sharing Program 10-15
Credit for withholding when no withholding sent to EDD 10-16
CDTFA **10-17**
Exemption for thrift store on military bases 10-17
State of emergency extensions 10-17
Offers-in-compromise 10-18
Used car dealers 10-18
Excess sales tax reimbursements 10-18
Subsidiary doing work for parent is a separate entity 10-19
Calculating overpayment percentage on audit 10-20
Sales tax medical exemption: Packaging is everything 10-20

SOS **10-21**
SOS filing fees suspended 10-21
Corporate conversions 10-21
SOS entity numbers 10-21
Inflation-adjusted minimum wage starting in 2023 .... **10-21**
CalKIDS college savings program launches **10-22**

Chapter 11 — Practitioner Aids

1040 Engagement Letter **11-1**
Client Letter (May Be Organizer Letter) **11-3**
Other Client Letters and Resources **11-5**
Expiring Tax Provisions **11-6**
Charitable Contribution Substantiation **11-7**
Transportation Fringe Benefits **11-8**
Foreign Activity Reporting Forms **11-9**
FATCA and FBAR Requirements **11-10**
California Nonresident Withholding Chart **11-12**
Roth Conversion Checklist **11-13**
Spidell's California Refund Grabber Checklist **11-15**
Checklist for a Trouble-Free Tax Return **11-18**
Tips to Prepare Yourself and Your Office For Tax Season **11-21**
Identity Theft Victim Checklist **11-23**
Checklist to Help Determine California Residency/Nonresidency **11-25**
California Taxation of Nonresident income **11-27**
Walking Away From a Corporation/LLC Qualifier **11-28**
Audit-proofing Disaster/Casualty Losses **11-29**
California Itemized Deductions Conformity Worksheet **11-30**
Other Practitioner Aids **11-32**
2022 California Tax Rates, Exemptions, and Credits **11-34**
2022 California Tax Rate Schedules **11-35**
2022 Federal Tax Rate Schedules **11-36**
2023 Federal Tax Rate Schedules **11-37**

 ©2022

Chapter 1

Individuals

INDIVIDUALS

FILING DEADLINE IS APRIL 18, 2023

The filing deadline for 2022 personal income tax returns is Tuesday, April 18, 2023.

Emancipation Day in Washington, D.C., is observed the weekday closest to April 16, which is a Sunday in 2023. So, Emancipation Day will be observed on Monday, April 17, and the filing deadline will be Tuesday, April 18. Any general reference to April 15 in these materials can be interpreted as April 18, 2023, for this filing season.

California conformity

California conforms to the April 18, 2023, filing deadline for individuals.

PERSONAL EXEMPTIONS AND DEPENDENTS

NO PERSONAL EXEMPTION DEDUCTION

The Tax Cuts and Jobs Act (TCJA) suspended the personal and dependent exemption deduction for taxable years 2018 through 2025. For tax year 2022, it remains at zero. (IRC §151(d)(5))

Even though the personal exemption deduction is suspended, the personal exemption amount is still adjusted annually for inflation for other purposes:

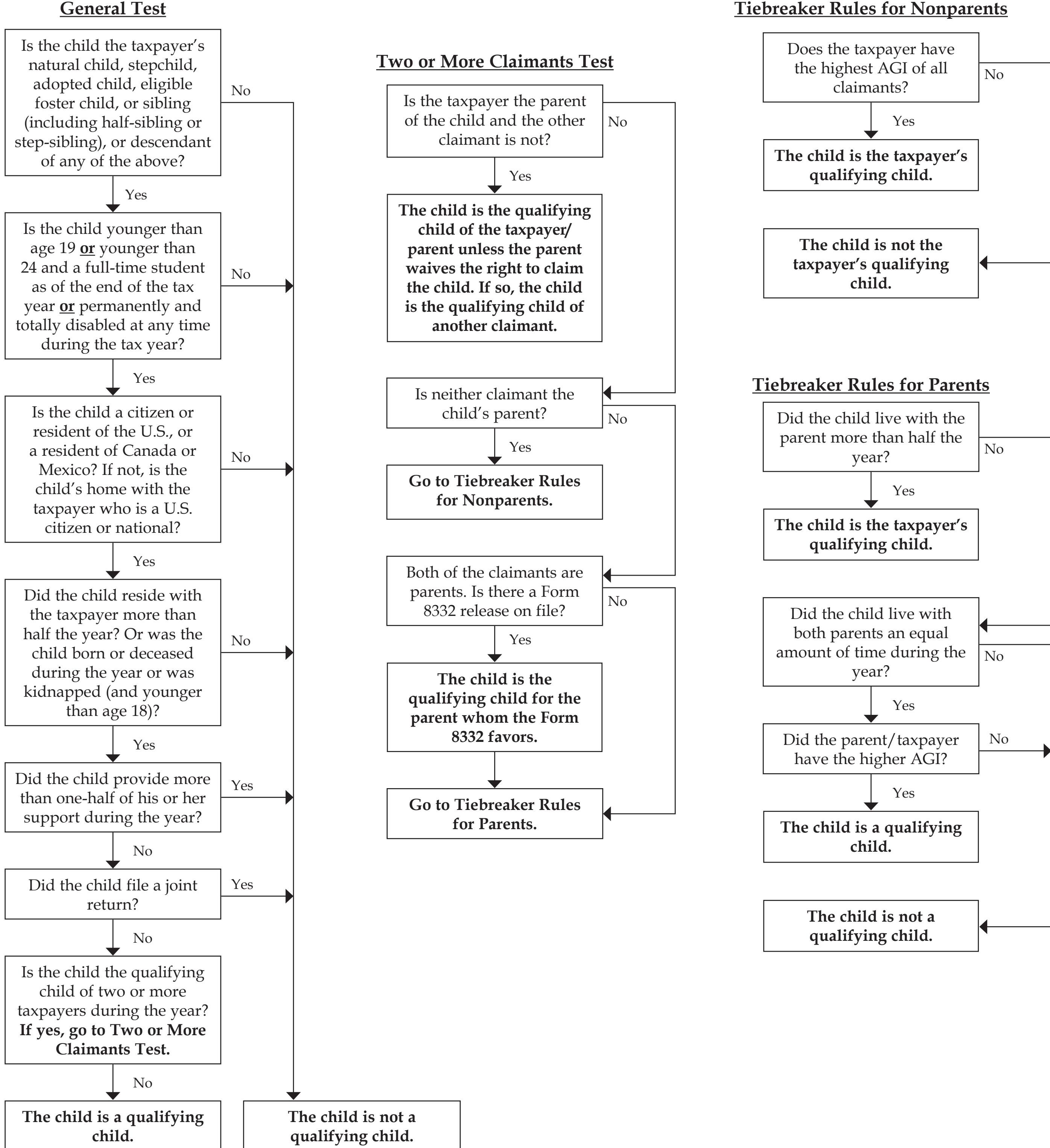
- It is utilized as part of the gross income test when determining whether a qualifying relative can be claimed as a dependent (IRC §152(d)(1)); and
- For purposes of the maximum $500 credit for an "other dependent" under the Child Tax Credit (see discussion beginning on page 1-27). (IRC §24(h)(4))

Personal Exemption Amount	
2022 (Rev. Proc. 2021-45)	**2023 (Rev. Proc. 2022-38)**
$4,400	$4,700

California nonconformity

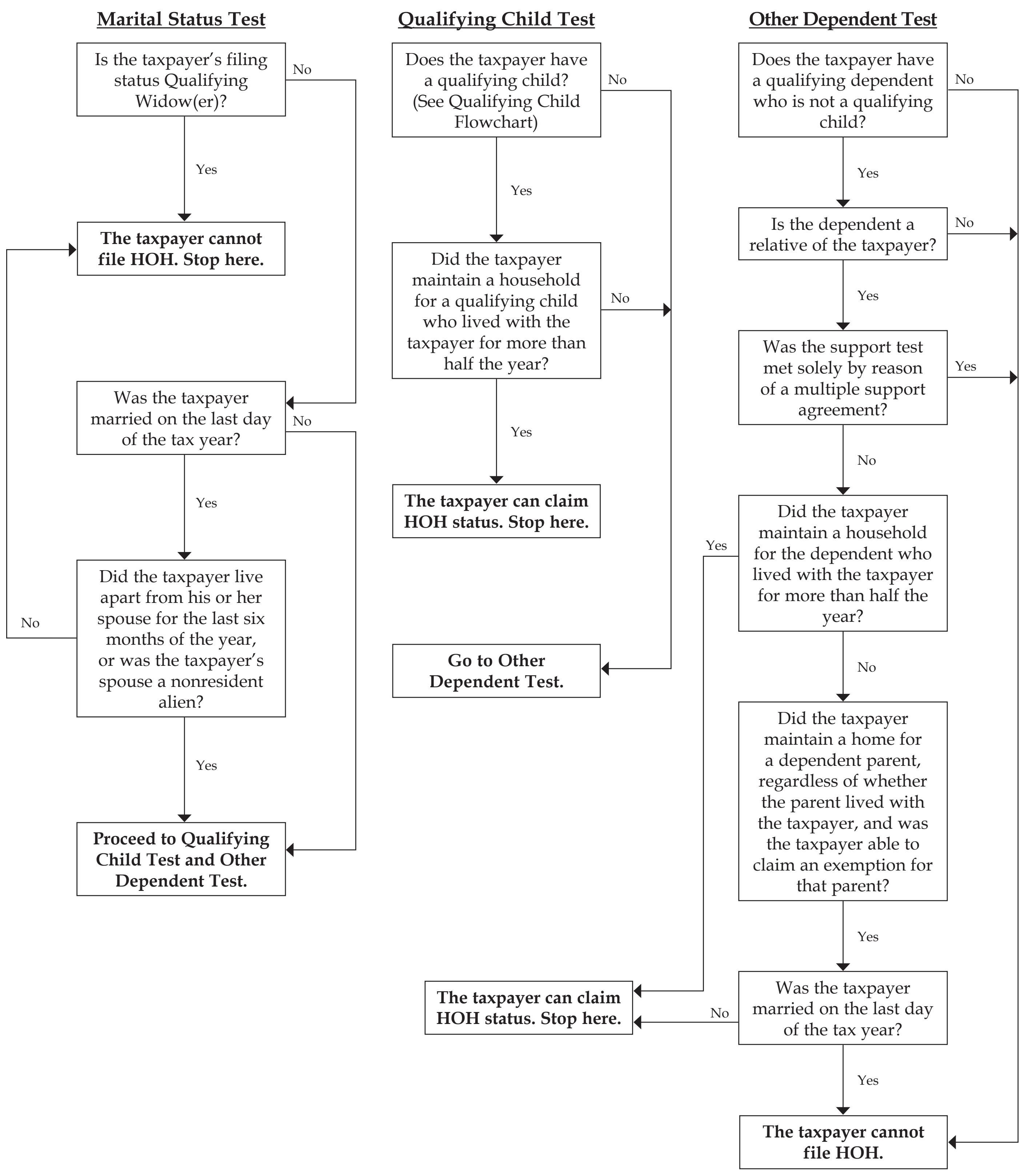
California provides personal exemption credits rather than a deduction. (R&TC §17054) These credits are phased out when a taxpayer's federal AGI exceeds a threshold amount (see page 11-34). (R&TC §17054.1)

Qualifying child flowchart: California conforms



 ©2022

Head of household flowchart: California conforms



FILING ISSUES

FILING REQUIREMENTS

Taxpayers who *must* file

A taxpayer must file an income tax return if their gross income is greater than their applicable standard deduction. (IRS Publication 501, Table 1) However, in the case of a married taxpayer filing separately, a return must be filed if the taxpayer's gross income is at least $5.

If a taxpayer's gross income is not greater than their standard deduction (or $5 in the case of a married taxpayer filing separately), then the taxpayer must nevertheless file a return if any of the following applies:

- The taxpayer owes any special taxes reported on Schedule 2 (if any line on Schedule 2 applies);
- The taxpayer (or spouse if filing jointly) received Archer medical savings account (MSA), Medicare Advantage MSA, or health savings account (HSA) distributions;
- The taxpayer had net earnings from self-employment of at least $400;
- The taxpayer had wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer Social Security and Medicare taxes;
- Advanced payments of the Premium Tax Credit were made for the taxpayer, spouse, or dependent who enrolled in coverage through the Health Insurance Marketplace; or
- The taxpayer has a net tax liability under the TCJA's IRC §965 transition tax (applicable to U.S. shareholders of controlled financial corporations (CFCs) that they are paying in installments under IRC §965(h) or deferred by making an election under IRC §965(i). (IRS Publication 501, Table 3)

Taxpayers who *should* file

Taxpayers who are not required to file an income tax return should still file if they are entitled to claim a refund or a refundable credit. (IRS Publication 501) Taxpayers who don't have to file but should file include those who:

- Had income tax withholding;
- Made estimated tax payments for the year or had overpayments applied from the prior year; or
- Qualify for the:
    - Earned Income Credit;
    - Refundable Child Tax Credit;
    - Refundable American Opportunity Tax Credit;
    - Health coverage tax credit;
    - Credit for federal tax on fuels;
    - Premium Tax Credit; or
    - Credit for child and dependent care expenses.

Filing requirements for dependents

A dependent must file an income tax return if their 2022 gross income is more than the amounts shown in the following table.

Filing Requirements for Dependents		
Filing status	**Dependent's income consists of …**	
	(A) Only earned income	**(B) Only unearned income**
Single		
Under age 65 and not blind	$12,950	$1,150
Either age 65 or older or blind	$14,700	$2,900
Age 65 or older and blind	$16,450	$4,650
Married*		
Under age 65 and not blind	$12,950	$1,150
Either age 65 or older or blind	$14,350	$2,550
Age 65 or older and blind	$15,750	$3,950
* If a dependent's spouse itemizes deductions on a separate return, then the dependent must file a return if the dependent has $5 or more of gross income (earned and/or unearned)		

Dependents whose income is made up of both earned income and unearned income must file a return if any of the following applies:

- Their **unearned** income is greater than the amount shown in Column (B) of the chart above;
- Their **earned** income is greater than the amount shown in Column (A) of the chart above; or
- Their total gross income was more than the larger of:
  - The amount shown in Column (B) of the chart above; or
  - Their earned income plus $350 (but not more than the amount shown in Column (A) of the chart above).

Kiddie tax rules

Children who meet the following listed requirements must attach Form 8615, Tax for Certain Children Who Have Unearned Income, to their income tax return. If the requirements are met, the child's unearned income is taxed at their parents' highest marginal income tax rate. All of the following conditions must be met:

- The child's unearned income was more than $2,300 in 2022 ($2,500 for 2023);
- The child meets one of the following age requirements:
  - Under age 18 at the end of the tax year;
  - At least age 18 at the end of the tax year and didn't have earned income that was more than one-half of the child's support; or
  - Was a full-time student at least age 19 and under age 24 at the end of the tax year and didn't have earned income that was more than one-half of the child's support;
- At least one of the child's parents was alive at the end of the tax year;
- The child is required to file a tax return for the year; and
- The child didn't file a joint return for the year.
  (IRC §1(g)(2))

Which parent's tax rate applies?

In the case of parents who are not married, the tax rate of the custodial parent is used to determine the kiddie tax. (IRC §1(g)(5)(A))

In the case of married taxpayers filing separately, the parent with the greater taxable income is the one whose tax rate applies to determine the kiddie tax. (IRC §1(g)(5)(B))

Parents' election to report child's interest and dividends

Instead of filing Form 8615 and attaching it to their child's income tax return, parents can elect to report their child's income on their own return using Form 8814, Parents' Election to Report Child's Interest and Dividends. Parents are eligible to make the election if their child meets all of the following conditions:

- At the end of the tax year the child was under age 19 (or under age 24 if a full-time student);
- The child's gross income was less than $12,500 for the 2022 tax year;
- The child had income only from interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends);
- No estimated tax payments were made for the child for the tax year, and no overpayments from the previous tax year (or from any amended return) were applied to the current tax year under the child's name and Social Security number;
- No federal income was withheld from the child's income under the backup withholding rules;
- The child is required to file a federal return unless this election is made;
- The child does not file a joint return for the tax year; and
- The parent is qualified to make the election because they are either the custodial parent, the parent with higher taxable income when the parents' filing status is married filing separate, or both the child's parents file a joint return.

California conformity

California conforms to the kiddie tax rules currently in effect. (R&TC §17041)

GROSS INCOME

NAME, IMAGE, LIKENESS (NIL) INCOME

On June 21, 2021, the U.S. Supreme Court handed down its decision in ***National Collegiate Athletic Association (NCAA) v. Alston*** (141 S.Ct. 2141 (2021)), thus changing the economic landscape of college sports. In a nutshell, a number of NCAA Division I athletes sued the NCAA in a class action lawsuit. The Supreme Court ruled unanimously in favor of the student athletes.

Soon after the Supreme Court decision, the NCAA approved a name, image, and likeness (NIL) policy that allows student athletes to earn money from endorsements, sponsorships, social media, etc. Based on the NCAA's new NIL policy, a new industry is springing up within the sports world of student athletes looking to profit from their personal brand.

©2022

NIL income can come from sources such as:

- Endorsements;
- Social media advertising dollars;
- Autograph signings;
- Paid public appearances; and
- Licensing deals.

NIL income is taxable to the recipient and is unlikely to be reported on a W-2 because the sources of income listed are not typically paid to people who are employees. NIL income will be reported on Form 1099-NEC, 1099-K, or may not be reported on any IRS forms.

Don't assume that these revenue streams are only for the elite college athletes playing for the biggest colleges and universities. Even small businesses, especially those in and around bustling college towns, are rushing to endorsement deals with college athletes. (https://talkbusiness.net/2021/09/small-business-owners-see-new-opportunities-with-nil-era-in-college-athletics/)

Example of NIL endorsement deal

Joe is the owner/operator of a bar and restaurant in a small town with an NCAA Division III school. There are four other bars in the downtown area that compete to attract the college business. Joe has made endorsement deals with the captains of the football, basketball, baseball, and soccer teams and pays each of them $400 per month to wear his apparel and make appearances at his establishment to drive more business.

Joe must issue 1099-NECs to the student athletes because he pays them more than $600 per year.

Laura is the captain of the women's soccer team and is one of the students paid by Joe ($400 per month × 12 months = $4,800). Laura also receives about $5,000 per year to make appearances at local youth soccer camps and is paid another $5,000 by a popular shoe company to wear their shoes around campus.

Between the camps and endorsement deals, Laura will make $14,800 this year in nonwage income that is also subject to self-employment taxes.

☑ Planning Pointer

Clients with children often provide their child's tax information to the parent's tax preparer each year. The trend often continues into adulthood after the child turns age 18 and heads off to college.

Tax professionals should be sure that any client over the age of 18 signs their own engagement letter, and the tax professionals should communicate directly with them if there are any questions or concerns about the information provided. Doing so will help alleviate any miscommunication as it is relayed through the parents.

DEPENDENT CARE ASSISTANCE

Taxpayers can exclude up to $5,000 of employer-provided dependent care assistance from their gross income ($2,500 for married taxpayers filing separately). (IRC §129(a)(2))

Practice Pointer

The American Rescue Plan Act (ARPA) provided an enhanced exclusion of up to $10,500 for the 2021 tax year *only*. Many employers increased the dependent care assistance available to their employees to conform to the ARPA's increased amount and have kept the higher benefits in place.

Taxpayers who receive dependent care assistance from their employers in excess of $5,000 ($2,500 for married taxpayers filing separately) in 2022 will have additional taxable income reported on their W-2s.

California partial conformity

California conforms to the federal dependent care exclusion prior to its amendment by the ARPA. (R&TC §17131) California did not conform to the 2021 temporary increase. As such, taxpayers can only exclude up to $5,000 of employer-provided dependent care assistance from their gross income ($2,500 for married taxpayers filing separately) in all years.

Carryovers of flexible spending and dependent care benefits are not taxable

Because of the pandemic, many taxpayers were unable to use the money they set aside in their employer's dependent care assistance programs (flexible spending accounts) in 2020 and 2021. Generally, carryovers of unused dependent care assistance program amounts are not permitted.

If these dependent care benefits would have been excluded from income if used during taxable year 2020 (or 2021, if applicable), the benefits remain excludible from gross income and are not considered wages of the employee in 2021 and 2022 if they were carried over pursuant to the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA; P.L. 116-260). (IRS Notice 2021-26)

Other flexible spending account rule changes made by the TCDTRA softened the "use it or lose it" treatment for flexible spending accounts by allowing:

- Plans to extend the annual grace period to 12 months after the plan year ending in 2020 or 2021;
- Health care flexible spending accounts to provide post-termination reimbursements for anyone terminated in 2020 or 2021 throughout the end of the plan year (including the 12-month grace period);
- Dependent care flexible account payments for children under age 14 (increased from age 13) during the plan year if there were unused amounts from the preceding year;
- Participants in either a health or dependent care flexible spending arrangement to prospectively modify their employee contribution amounts for the 2021 plan year; and
- Employers to retroactively amend their cafeteria plans as long as the amendment is consistent with how the plan was operated. Plans can only be retroactively amended to the beginning of the previous calendar year.
  (TCDTRA §214)

CAPITAL GAINS

Gain or loss from the sale of capital gain property (such as investments) held more than one year is treated as a long-term capital gain or loss. (IRC §1222(3) and (4)) Property held one year or less is treated as short-term. (IRC §1222(1) and (2))

 ©2022

Long-term capital gains (as well as qualified dividends) are taxed at preferential tax rates that are lower than the ordinary income tax rates and detailed in the following chart. Short-term capital gains are taxed at ordinary income rates.

Individual Long-Term Capital Gains Rates (IRC §1(h))		
Rate	**Taxable income breakpoint (2022) (Rev. Proc. 2021-45)**	**Taxable income breakpoint (2023) (Rev. Proc. 2022-38)**
0%	Single: $41,675 MFS: $41,675 MFJ: $83,350 HOH: $55,800 Estates and trusts: $2,800	Single: $44,625 MFS: $44,625 MFJ: $89,250 HOH: $59,750 Estates and trusts: $3,000
15%	Single: $459,750 MFS: $258,600 MFJ: $517,200 HOH: $488,500 Estates and trusts: $13,700	Single: $492,300 MFS: $276,900 MFJ: $553,850 HOH: $523,050 Estates and trusts: $14,650
20%	No breakpoint	No breakpoint

Capital losses

Stocks rallied in 2021 and produced larger than usual gains for many taxpayers. The S&P 500, one of the most closely followed stock market indices, gained nearly 27% in 2021 but has produced large losses in 2022. Tax professionals should expect many clients who sold securities in 2022 to have capital losses.

When calculating capital gain or loss, taxpayers must first net short-term capital gains and losses together to determine total net short-term capital gain or loss. Likewise, long-term capital gains and losses are netted together to determine total net long-term gains or losses. The following items are treated as long-term capital gains or losses for netting purposes:

- Undistributed long-term capital gains from mutual funds (or other regulated investment company) or real estate investment trusts (REITs); and
- Capital gain distributions from mutual funds and REITs.

The total net capital gains and losses are then netted together. Noncorporate taxpayers that have an overall capital loss can deduct up to $3,000 ($1,500 if married filing separately) against their ordinary income. (IRC §1211(b)) Any excess capital losses must be carried over to the next year. Capital loss carryovers maintain their character as short-term or long-term.

Taxpayers who have both short-term capital losses and long-term capital losses that carry over to the next year must first use their short-term losses.

Example of capital loss carryovers

Leticia reports net short-term capital losses of $2,500 (Schedule D, line 7) and net long-term capital losses of $6,000 (Schedule D, line 15) on her 2022 income tax return ($8,500 of total net capital losses). Leticia deducts $3,000 of her overall capital losses against her ordinary income, leaving $5,500 of capital losses to carry forward to 2023.

Leticia's $3,000 of capital losses used to offset her ordinary income is first used to reduce her short-term capital loss carryovers. Because she only has $2,500 of short-term capital losses, there are no short-term capital loss carryovers into 2023.

This leaves $500 of long-term capital losses that were used to offset ordinary income. Leticia's long-term capital loss carryovers are $5,500 ($6,000 - $500).

☑ Planning Pointer

Stock market downturns are prime opportunities for Roth IRA conversions. See page 2-28 for a discussion of this Roth IRA conversion strategy.

Capital loss carryovers in year of death

Capital loss carryovers expire upon the taxpayer's death and can only be used in the year of death. (Rev. Rul. 74-175) A taxpayer's unused capital loss carryovers cannot be transferred to his or her estate, nor can they be transferred to the decedent's spouse. Where taxpayers have capital loss carryovers that are classified as community property, only the surviving spouse's one-half of the capital loss carryovers will carry to the year after the deceased spouse's death.

Example of capital loss carryovers in year of death

Bill and Jean are married taxpayers filing jointly. Bill died in 2022 and on their final income tax return, Bill and Jean have $120,000 of capital loss carryovers.

Jean can only carry over her one-half of the capital loss carryovers to a year after Bill's death. As such, her capital loss carryovers are limited to $60,000.

California partial conformity

California does not have a reduced rate for capital gains or qualified dividends. Capital gains and qualified dividends are taxed at ordinary income rates on the California return. (R&TC §§17041, 17062.5) California conforms to the $3,000 ($1,500 MFS) capital loss deduction limitation. (R&TC §18151)

HOBBY ACTIVITIES

Gross income from hobby activities are includable in taxable income, but expenses are not deductible. (IRC §183) This is because expenses associated with a hobby activity are typically deductible to the extent of gross income from the activity as 2% miscellaneous itemized deductions. Under the TCJA, all 2% miscellaneous itemized deductions are suspended for taxable years 2018 through 2025.

Even though taxpayers cannot deduct expenses associated with their hobby activities through 2025, taxpayers are permitted to factor in cost of goods sold when determining their hobby activity gross income. (Treas. Regs. §1.183-1(e))

Example of hobby activity COGS

Ani buys and sells antique furniture as a hobby activity. In 2022, Ani purchased 12 pieces of furniture for $10,000 and resold them for $12,000. She also incurred $3,000 of other general expenses, such as renting space in an antique mall, supplies, etc.

Ani has gross hobby income of $2,000 ($12,000 revenue minus $10,000 cost of goods sold). Because Ani's activity is a hobby activity, she cannot deduct the $3,000 of other expenses.

☑ Planning Pointer

Taxpayers, such as Ani from the previous example, will be subject to the lower 1099-K filing threshold starting for payments received in 2023. Be sure to remind your clients who receive alternative sources of income, such as from hobby activities, that they can expect to receive a 1099-K if they received at least $600 through credit card or payment app transactions. See page 5-1 for a complete discussion of 1099-K issues.

Hobby versus trade or business

The IRS defines a hobby as any activity that a person pursues because they enjoy it and have no intention of making a profit. Taxpayers who intend to make a profit, therefore, are engaged in a trade or business. (Treas. Regs. §1.183-2(a)) The courts and the IRS consider nine factors when trying to determine whether a taxpayer intends to make a profit:

- Business-like manner of carrying on the business;
- Taxpayer's expertise or that of their advisors;
- Time and effort expended;
- Expectation that assets used in the activity may appreciate in value;
- Success in similar or dissimilar activities;
- History of income or loss;
- Amount of occasional profits;
- Financial status; and
- Elements of personal pleasure.
  (Treas. Regs. §1.183-2(b))

Presumption that activity is a trade or business

Taxpayers whose activity is profitable for three out of the five years ending with the tax year at issue are presumed to be engaged in an activity for profit. (IRC §183(d)) In the case of an activity that consists in major part of the breeding, training, showing, or racing of horses, taxpayers must be profitable for two out of the seven years ending with the tax year at issue in order for the presumption to apply.

EXCLUSIONS FROM INCOME

COD EXCLUSION

Gross income does not include cancellation of debt if:

- The debt was discharged in bankruptcy;
- The debt was discharged when the taxpayer was insolvent;
- The discharged debt was qualified farm indebtedness;
- The discharged debt is qualified real property business indebtedness (only if the taxpayer is not a C corporation); or
- The discharged debt is qualified principal residence indebtedness discharged prior to January 1, 2026 (but limited to $750,000 of acquisition debt ($375,000 for MFS)).
  (IRC §108)

California partial conformity

California has not allowed the principal residence exclusion since 2013 but conforms to the other COD provisions. (R&TC §§17024.5, 17131, 17144)

Student loan forgiveness exclusion

Under President Biden's Student Loan Debt Relief Plan announced on August 24, 2022, the Department of Education is seeking to forgive up to $20,000 of federal student loan debt for borrowers who have received Pell Grants and $10,000 for all others.

The relief is limited to individuals with income of less than $125,000 ($250,000 for MFJ or HOH filers). The plan does not forgive private student loan debt, only those loans held by the Department of Education. (www.ed.gov/policy/gen/leg/foia/secretarys-legal-authority-for-debt-cancellation.pdf)

Pell Grants

A federal Pell Grant is only given to undergraduate students who "display exceptional financial need." Pell Grants typically do not have to be repaid, but they only cover about one- third of the cost of a four-year public college degree, which means Pell Grant recipients still have to take out other loans to cover their education expenses. It's these additional loans that will be forgiven for Pell Grant recipients, up to the $20,000 cap.

Waiting on Supreme Court ruling

President Biden's Student Loan Debt Relief Plan has been challenged in the courts, and the U.S. Supreme Court will hear oral arguments on the case in February, 2023 The Supreme Court will issue its ruling sometime in the spring. If the Student Loan Debt Relief Plan goes forward at all, it will do so in 2023.

Taxability of loan forgiveness

Any loans forgiven under the President's executive order are not includable in the borrower's gross income due to changes made by the American Rescue Plan Act (ARPA). The ARPA provides a cancellation of debt (COD) exclusion to certain student loans forgiven during the 2021 through 2025 calendar years. (ARPA §9675; IRC §108(f)(5)) This exclusion is for federal income tax purposes and applies to:

- Federal loans;
- State education loan programs;
- Loans made by a college or university; and
- Private educational loans.

The exclusion applies whether the loan was provided through the educational institution or directly to the borrower. In some states the forgiven student loans may be taxable income.

Taxpayers don't have to meet any other criteria to be eligible for the COD exclusion as long as the loan is a qualified loan. The IRS stated that lenders of these discharged loans should not issue Forms 1099-C to the borrowers. (IRS Notice 2022-01)

California nonconformity

California does not currently conform to the new COD exclusion for student loan forgiveness enacted by the ARPA but does allow a more expansive exclusion than the pre-ARPA federal exclusion. (R&TC §§17131, 17132.11, 17134, 17144.6, 17144.8) See page 7-1 for a discussion of California's nonconformity.

ADJUSTMENTS TO GROSS INCOME

UNREIMBURSED EXPENSES OF K–12 EDUCATORS

The maximum above-the-line deduction for eligible educator expenses is $300 ($600 if both taxpayers on a joint return are eligible educators) for 2022. (IRC §62(a)(2)(D)) The deduction remained at $250 from 2002 through 2021.

California nonconformity

California has never conformed to the above-the-line educator expenses deduction. (R&TC §17072) Because California does not conform to the suspension of the miscellaneous itemized deductions enacted by the TCJA, teachers may be able to claim an itemized deduction for unreimbursed employee expenses on their California return.

ALIMONY

Alimony is not deductible by the payor spouse nor included in the recipient spouse's gross income if the divorce or written separation agreement is executed after December 31, 2018. (IRC §§71, 215) In California, a separation or property settlement agreement can be executed and effective before a divorce becomes final.

Alimony paid pursuant to a divorce or written separation agreement in place on or before December 31, 2018, remains deductible by the payor spouse and included in the income of the recipient spouse (grandfathered agreements). This is also true for grandfathered agreements that are modified after December 31, 2018. However, if the modified agreement expressly provides that the TCJA applies to the modification, then the agreement will lose its grandfathered status.

California nonconformity

Alimony is deductible by the payor and included in the recipient's income no matter the date of the divorce or separation agreement for California income tax purposes. (R&TC §17024.5)

STUDENT LOAN INTEREST

A taxpayer may deduct up to $2,500 of interest on debt incurred solely to pay qualified higher education expenses. (IRC §221)

For 2022, the deduction begins to phase out for taxpayers with modified adjusted gross income (MAGI) between $70,000 and $85,000 and MAGI between $140,000 and $175,000 for joint returns. (Rev. Proc. 2021-45) For 2023, the MAGI phaseout range is $75,000–$90,000 ($155,000–$185,000 for joint returns). (Rev. Proc. 2022-38)

California conformity

California fully conforms to the student loan interest deduction. (R&TC §§17024.5, 17201)

Exclusion for student loan payments made by employer

Payments made by an employer on an employee's student loan that are made after March 27, 2020, and before January 1, 2026, may be excluded from the employee's gross income. (IRC §127(c))

The employer student loan payments are treated as an employer educational assistance program under IRC §127, which is subject to a $5,250 maximum per calendar year.

Practice Pointer

Educational assistance programs must be written plans containing specific requirements set forth in IRC §127, including employee notification requirements. To download a sample plan, go to:

Website
www.caltax.com/files/2022/sample127plan.doc

The employer can deduct the payments as a business expense and is not required to pay payroll tax and workers' compensation expenses on the payments (as would be required if paid as wages). The employee essentially receives $5,250 in "free" income.

The exclusion applies to payments made either directly to the lender or to the employee on any qualified education loan (as defined in IRC §221(d)(1)) incurred by the employee for the employee's education. The payments are not excluded if the student loan was for a family member, including the spouse of the employee.

No double benefit

A taxpayer cannot claim a student loan interest deduction for loan payments made with excluded employer benefits. Tax professionals should be sure to ask their clients who paid student loan interest in 2022 if any of their student loans were repaid by their employer.

California nonconformity

California provides for an exclusion from income for a qualified education assistance program. The maximum exclusion is $5,250. California law mirrors federal law prior to its amendment by the CARES Act. (IRC §127; R&TC §17151)

California does not follow the CARES Act amendment that allows employers to include payments on student loans made after March 27, 2020, and prior to January 1, 2026, as part of their educational assistance program. Any loans paid as part of the employer's educational assistance program will be treated as taxable wages for California purposes. However, taxpayers may be able to claim a student loan interest deduction on their California return for interest paid with these benefits.

Employers providing this benefit must make sure the benefits are reported as taxable wages on the California W-2, even though they are excluded on the federal W-2.

HEALTH SAVINGS ACCOUNTS

The inflation-adjusted limitations for health savings accounts (HSAs) under IRC §223(g) are listed in the following table:

Inflation-Adjusted Limitations for HSAs

	2021 (Rev. Proc. 2020-32)		**2022 (Rev. Proc. 2021-25)**		**2023 (Rev. Proc. 2022-24)**	
	Family	**Self only**	**Family**	**Self only**	**Family**	**Self only**
Contribution limit	$7,200	$3,600	$7,300	$3,650	$7,750	$3,850
Additional catch-up contribution for taxpayer age 55 or older	$1,000 per qualifying spouse	$1,000	$1,000 per qualifying spouse	$1,000	$1,000 per qualifying spouse	$1,000
Minimum health insurance deductible	$2,800	$1,400	$2,800	$1,400	$3,000	$1,500
Maximum out of pocket	$14,000	$7,000	$14,100	$7,050	$15,000	$7,500

California nonconformity

California does not conform to HSAs. (R&TC §§17131.4, 17131.5) Thus, a taxpayer with an HSA must:

- Include annual income or loss from investments in HSA accounts in California AGI;
- Increase the medical expense deduction for any qualified expenses paid out of the HSA account; and
- Reduce California income by any taxable distributions from an HSA.

Caution

California W-2 wages must be increased by the amount of the employer's federal HSA contribution. This is one more reason it's important to always check the California wages box on the W-2 when preparing personal returns, in addition to reporting amounts that contain a code W in box 12 on the Form W-2. Verify that your software has made the adjustment on Schedule CA (540).

STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

STANDARD DEDUCTION

Standard Deductions (IRC §63)			
Filing status	**2021 (Rev. Proc. 2020-45)**	**2022 (Rev. Proc. 2021-45)**	**2023 (Rev. Proc. 2022-38)**
Married filing joint and qualifying widow(er)	$25,100	$25,900	$27,700
Head of household	$18,800	$19,400	$20,800
Single	$12,550	$12,950	$13,850
Married filing separate	$12,550	$12,950	$13,850

Additional Standard Deductions for Elderly and Blind			
Filing status	**2021**	**2022**	**2023**
Unmarried			
Elderly or blind	$1,700	$1,750	$1,850
Elderly and blind	$3,400	$3,500	$3,700
Married			
Elderly or blind (per taxpayer)	$1,350	$1,400	$1,500
Elderly and blind (per taxpayer)	$2,700	$2,800	$3,000

 ©2022

California nonconformity

California does not increase standard deductions for the elderly or blind. (R&TC §17073.5(b)) Instead, California allows an additional exemption credit for age and blindness. (R&TC §17054) See page 11-34 for California standard deduction amounts.

ITEMIZED DEDUCTION PHASEOUT

The overall limitation on itemized deductions is suspended through December 31, 2025. (IRC §68)

California nonconformity

California continues to phase out itemized deductions using 6% of federal AGI as reported on the federal return. (R&TC §17077) Generally, a taxpayer's itemized deductions are reduced by the lesser of:

- 6% of the excess federal AGI over the threshold amount (see page 11-34); or
- 80% of the itemized deductions otherwise allowable.

MEDICAL EXPENSES

Out-of-pocket medical expenses that are not reimbursed by insurance are deductible as an itemized deduction to the extent they exceed 7.5% of the taxpayer's adjusted gross income. (IRC §213(a))

Eligible expenses

Eligible medical expenses are those paid for:

- The diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body;
- Transportation primarily for and essential to medical care;
- Qualified long-term care services; or
- Insurance.
  (IRC §213(d)(1))

Medicine and drugs are only classified as eligible medical expenses if they are prescribed by a doctor or are insulin. (IRC §213(b))

Practice Pointer

Tax professionals should review W-2s and pay stubs for clients who receive health insurance through an employer plan. Many employer plans do not cover all of a taxpayer's health insurance (or they only cover the worker but not family members) as a pre-tax benefit. Any health insurance paid through post-tax payroll deductions are deductible as medical expenses on Schedule A.

Assisted care expenses

If the taxpayer, spouse, or a dependent is living in an assisted care home, such as a nursing home, primarily for and essential to medical care, then the entire cost of the assisted living (including meals and lodging) is deductible as a medical expense. (IRS Publication 502)

If the individual is in a home primarily for nonmedical reasons, then only the cost of the actual medical care is deductible as a medical expense, not the cost of meals and lodging. Determining whether a person is in a home primarily for and essential to medical care is based on the facts and circumstances of each individual.

Home improvements and car modifications

Taxpayers who make capital improvements to their home for the main purpose of medical care can deduct the full cost of the improvement if it does not increase the value of the home. If the capital improvement does increase the value of the home, then the cost of the improvement is reduced by the increase in the value of the property. The difference is a medical expense deduction. (IRS Publication 502)

Medical expense deductions include the cost of special hand controls and other special equipment installed in a car for the use of a person with disabilities.

Medical expenses of children of divorced parents

Taxpayers are generally allowed to account for medical expense deductions of themselves, their spouse, and dependents only when calculating the allowable itemized deduction for medical expenses. (IRC §213(a)) However, medical expenses paid for a minor child are deductible as a medical expense for the parent who pays such expenses, even if the child is a dependent of the other parent. (IRC §213(d)(5))

Special rule for decedents

Expenses paid for the medical care of the taxpayer which are paid out of their estate during the one-year period beginning with the day after the decedent's date of death are treated as if paid by the taxpayer at the time the expense was incurred and is deductible on the taxpayer's final income tax return. (IRC §213(c)(1))

However, if medical expenses paid after the taxpayer's date of death from their estate are deducted on an estate tax return, then the expenses are not deducted on the taxpayer's final income tax return. (IRC §213(c)(2))

California conformity

California conforms to the 7.5% of AGI threshold. Remember, California uses **federal** AGI to compute this threshold. (R&TC §17241)

Medical mileage rates

The medical mileage rate for 2022 increased halfway through the year. For January 1, 2022, through June 30, 2022, the medical mileage rate was 18 cents. (IRS Notice 2022-03) For July 1, 2022, through December 31, 2022, the medical mileage rate was 22 cents. (IRS Announcement 2022-13).

The medical mileage rate for 2023 is 22 cents. (IRS Notice 2023-03)

California conformity

California automatically conforms to the federal medical mileage rates. (R&TC §§17024.5, 17201)

 ©2022

Long-term care insurance

For 2022, up to $5,640 in premiums paid for long-term care insurance, per person, can qualify as a deductible medical expense. (IRC §213; Rev. Proc. 2021-45) The maximum deduction for 2023 is $5,960. (Rev. Proc. 2022-38)

Self-employed individuals may include their qualified long-term care insurance premiums in the self-employed health insurance deduction, subject to the maximum deduction limits listed here. (IRC §162(l)(1))

Keep two things in mind:

- The deduction is limited based on the taxpayer's age; and
- Only premiums paid for "qualified long-term care" plans are deductible.

Long-Term Care Premium Deduction Limits		
Age of individual before close of tax year	**Maximum deductible premium for 2022 (Rev. Proc. 2021-45)**	**Maximum deductible premium for 2023 (Rev. Proc. 2022-38)**
40 or less	$450	$480
More than 40 but not more than 50	$850	$890
More than 50 but not more than 60	$1,690	$1,790
More than 60 but not more than 70	$4,510	$4,770
More than 70	$5,640	$5,960

California conformity

California automatically conforms to the federal long-term care limitations. (R&TC §§17024.5, 17201)

TAXES

For taxable years 2018 through 2025, taxpayers may claim an itemized deduction of up to $10,000 ($5,000 in the case of married taxpayers filing separately) for the aggregate of state and local income taxes and property taxes (the "SALT" limitation). (IRC §164(b)(6))

Taxpayers may still make an election to deduct sales and use tax rather than income tax (also subject to the $10,000 limit).

California nonconformity

Although California does not allow a deduction for state and local income taxes, it does allow an unlimited deduction for real and personal property taxes. (R&TC §17220)

California SALT cap workaround

California enacted AB 150 (aka the passthrough entity elective tax), which is its version of the SALT cap workaround allowable by IRS Notice 2020-75. See page 9-1 for a discussion of California's AB 150.

CASUALTY AND THEFT LOSSES

The itemized deduction for personal casualty and theft losses is limited for tax years 2018 through 2025 to losses attributable to Presidentially declared disasters. (IRC §165) FEMA's updated list of Presidentially declared disasters can be found at the following website:

Website
www.fema.gov/disasters

California nonconformity

California does not conform to the TCJA regarding casualty and theft losses. Therefore, taxpayers can still claim casualty losses on their California return without regard to whether the casualty or theft loss occurred in a Presidentially declared disaster. (R&TC §§17024.5, 17201)

Non-personal use property

The casualty and theft loss limitation under the TCJA for taxable years 2018 through 2025 does not apply to casualty and theft losses on:

- Business property;
- Income-producing property; and
- Ponzi-type investment schemes.

Ponzi losses

In order to deduct theft losses from a Ponzi-type scheme, the loss must result from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss:

- The lead figure (or one of the lead figures) was charged by indictment or criminal information (that has not been withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for purposes of IRC §165; or
- The lead figure (or one of the lead figures) was the subject of a state or federal complaint (that has not been withdrawn or dismissed) alleging the commission of fraud, embezzlement or a similar crime, and either:
  - The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or
  - A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

Detailed guidance regarding Ponzi losses can be found in Rev. Rul. 2009-9 and Rev. Proc. 2009-20.

 ©2022

Ponzi losses and cryptocurrencies

Cryptocurrency investments are still an emerging industry. With promises of getting rich quickly, investors are losing billions of dollars to Ponzi schemes revolving around cryptocurrencies. (www.washingtonpost.com/business/2022/07/22/crypto-ponzi-scheme-eminifx/; www.ftc.gov/business-guidance/blog/2022/06/reported-crypto-scam-losses-2021-top-1-billion-says-ftc-data-spotlight)

Taxpayers should be skeptical of any cryptocurrency investments making promises of guaranteed returns or too-good-to-be-true returns. Other cryptocurrency issues are discussed beginning on page 1-64.

Employee business losses

Taxpayers who are employees can have business property and income-producing property that technically could be subject to the exceptions listed above. However, such deductions are classified as 2% miscellaneous itemized deductions and are disallowed under the separate TCJA provision that disallows all 2% miscellaneous itemized deductions for taxable years 2018 through 2025.

Example of casualty and theft losses

Carmen had a terrible year in 2022. She had the following casualty and theft losses during the year:

- She lost her Schedule C business (a retail business) when her leased space was burned in a fire (not a Presidentially declared disaster). Her losses included inventory, cash on-hand, and fixed assets.
- She also lost $50,000 of valuable family heirlooms that were contained in her office in the burned down business space.
- Carmen owns a single-family residential rental property. Her tenants failed to pay rent for six months, forcing her to pay attorney fees to evict them. When the tenants vacated the property, they stole everything that wasn’t bolted down and smashed all the windows and mirrors.
- Lastly, Carmen’s financial planner absconded with $100,000 she invested. He was running a Ponzi scheme and left town abruptly when his scheme was discovered and he was indicted.

All of Carmen’s losses are deductible except for the $50,000 of family heirlooms that were lost in the fire at her business. Schedule C losses and the rental property theft and destruction are reported on Form 4684, Casualties and Thefts, Section B, and the Ponzi loss is reported on Form 4684, Section C.

HOME MORTGAGE INTEREST

For tax years 2018 through 2025, taxpayers may treat no more than $750,000 as deductible acquisition indebtedness ($375,000 for married taxpayers filing separately). (IRC §163(h)(3))

Interest on home equity debt is not deductible for tax years 2018 through 2025 no matter when the debt was incurred under additional changes made by the TCJA.

Grandfathered debt

In the case of acquisition indebtedness incurred on or before December 15, 2017, the $1 million limitation ($500,000 for married taxpayers filing separately) is grandfathered in. Grandfathered debt includes refinanced grandfather debt, but only to the extent of the balance of the debt prior to refinancing. (IRC §163(h)(3)(F)(iii)(I))

Equity indebtedness is not grandfathered.

Second homes

Mortgage interest on acquisition indebtedness continues to include mortgage interest on a second home, within the lower dollar caps. Taxpayers with more than two homes can only deduct interest on their principal residence, plus one additional home.

California nonconformity

California does not conform to the TCJA limits on mortgage interest, so taxpayers may continue to claim a deduction for interest on acquisition debt of $1 million and equity debt of $100,000, regardless of the date of the loan. (R&TC §§17024.5, 17201) California does not allow a deduction for mortgage insurance premiums. (R&TC §17225)

Mortgage insurance premiums

The itemized deduction for mortgage insurance premiums expired on December 31, 2021. (IRC §163(h)(3)(E))

Comment

For the last few years, the deduction for mortgage insurance premiums has been retroactively extended one additional year at the end of each year as part of an extended bill.

CHARITABLE CONTRIBUTIONS

Taxpayers who itemize their deductions may deduct charitable contributions to qualified charities of up to 60% of their "contribution base." A taxpayer's contribution base is their adjusted gross income computed without regard to any net operating loss carryback. (IRC §170(b)(1)(H))

Net operating loss carryforwards to the current tax year are computed as part of the taxpayer's contribution base.

The temporary changes to the charitable contribution deduction rules in effect for 2020 and 2021 through COVID-19 legislation are no longer in effect for 2022. As such, the TCJA rules for charitable contributions that applied in 2019 are the same rules that apply for 2022. As such, the following items are not available in 2022:

- The 100% of AGI charitable contribution limit; and
- The limited deduction for cash charitable contributions for those who claim the standard deduction.

California nonconformity

California conforms, with modifications, to the IRC §170 charitable contributions deduction prior to the any COVID-19 legislation. (R&TC §§17024.5, 17201, 17275.5)

 ©2022

MISCELLANEOUS ITEMIZED DEDUCTIONS

All 2% miscellaneous itemized deductions, without exception, are disallowed for tax years 2018 through 2025. (IRC §67(g)) Generally, miscellaneous itemized deductions not subject to the 2% floor remain fully deductible. Some of the most common non-2% miscellaneous itemized deductions include:

- **Casualty and theft losses from income-producing property:** This includes property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art (see page 1-20 for disallowance of casualty losses for loss of personal property);
- **Federal estate tax on income in respect of a decedent**;
- **Impairment-related work expenses of persons with disabilities:** This includes expenses paid for attendant care in connection with the taxpayer's place of work, such as a blind taxpayer engaging the services of a reader to be able to perform his or her work duties;
- **Loss from other activities from Schedule K-1 (Form 1065-B), box 2 (large partnerships)**;
- **Unrecovered investment in an annuity:** In the event of a retired taxpayer who dies before the entire investment in an annuity is recovered tax-free, any unrecovered amount is deducted on the retiree's final income tax return;
- **Claim of Right deductions**; and
- **Gambling losses**.

California nonconformity

California does not conform to the suspension of the 2% miscellaneous deductions. These deductions may still be claimed on the California return. (R&TC §§17024.5, 17076)

QUALIFIED BUSINESS INCOME DEDUCTION

IRC §199A allows taxpayers to claim a deduction of up to 20% against qualified business income (QBI). Taxpayers whose taxable income is above a phaseout threshold may have their QBI deduction limited or completely phased out.

✐ **Practice Pointer**

When reviewing prior-year income tax returns for new clients, be sure to pick up IRC §199A loss carryovers.

Picking up all prior-year carryovers is important, but tax professionals have reported a trend that the IRC §199A loss carryovers are overlooked more often than other carryovers.

Taxpayers whose income is below the phaseout range receive a QBI deduction of 20% of the lesser of:

- QBI; or
- Taxable income before the IRC §199A deduction and after reduction for net capital gains (this is referred to as the taxable income limitation).

How much of a taxpayer's QBI deduction is phased out depends on many factors, including whether a taxpayer's qualified business income is deemed to be from a specified service trade or business (SSTB) and/or the amount of the W-2 wages paid by the taxpayer's business and the unadjusted basis of assets immediately before acquisition (UBIA).

IRC §199A Phaseout Range		
Filing status	**2022 (Rev. Proc. 2021-45)**	**2023 (Rev. Proc. 2022-38)**
Married filing joint	$340,100–$440,100	$364,200–$464,200
Married filing separate	$170,050–$220,050	$182,100–$232,100
Single and HOH	$170,050–$220,050	$182,100–$232,100
Note: The above are taxable income amounts immediately before the IRC §199A deduction and are not reduced for net capital gains		

California nonconformity

California does not conform to IRC §199A, so there is no QBI deduction. (R&TC §§17024.5, 17201)

TAX CALCULATION

ALTERNATIVE MINIMUM TAX AND CREDITS

AMT exemption

The AMT exemption amount is adjusted annually for inflation.

AMT Exemption Amounts		
Filing status	**2022 (Rev. Proc. 2021-45)**	**2023 (Rev. Proc. 2022-38)**
Single, HOH	$75,900	$81,300
MFJ, surviving spouse	$118,100	$126,500
MFS	$59,050	$63,250
Estates and trusts	$26,500	$28,400

The AMT exemption phaseout threshold is adjusted annually for inflation.

AMT Exemption Phaseout		
Filing status	**2022 (Rev. Proc. 2021-45)**	**2023 (Rev. Proc. 2022-38)**
Single, HOH	$539,900–$843,500	$578,150–$903,350
MFJ, surviving spouse	$1,079,800–$1,552,200	$1,156,300–$1,662,300
MFS	$539,900–$776,100	$578,150–$831,150
Estates and trusts	$88,300–$194,300	$94,600–$208,200

 ©2022

California nonconformity

California law provides for an annual inflation adjustment of AMT phaseout and exemption numbers. California's numbers are different than federal (see page 11-34). (R&TC §17062(b)(5)(A)–(C) and (b)(6)(A)–(C))

Incentive stock options

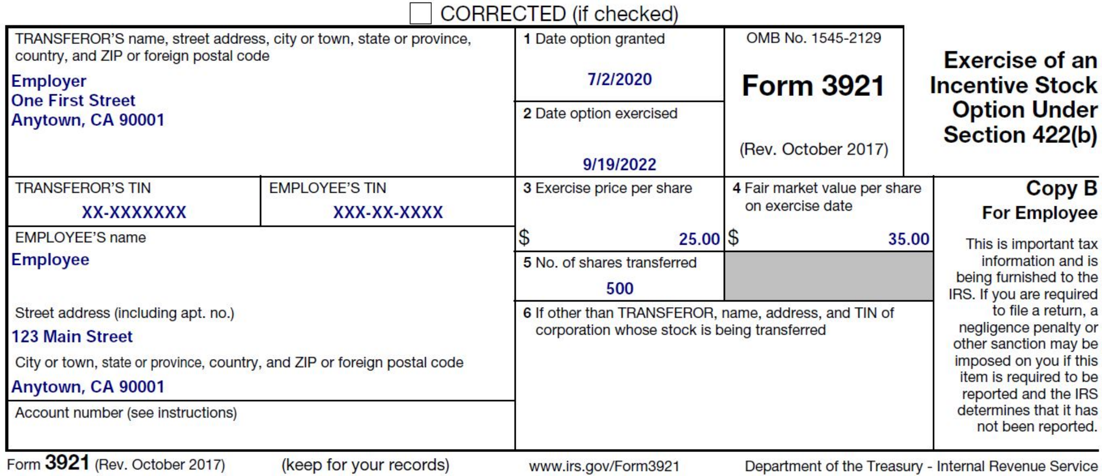
An employee does not recognize income when an incentive stock option is granted (the grant date). (IRC §83) The grant date is the date the employee is first granted the option to purchase, at some point in the future, shares of their employer stock at a stated exercise price. However, the employee typically must wait a period of time (defined in the ISO plan documents) before they can exercise their option to purchase the stock. The waiting period is also referred to as the vesting period for the ISO.

An employee also does not recognize income (for regular tax purposes) when an incentive stock option is exercised (the exercise date). (IRC §421(a)) However, the amount by which the fair market value (on the exercise date) of the purchased shares exceeds the exercise price paid for those shares constitutes a preference item for alternative minimum tax purposes and must be reported on line 2i of Form 6251, Alternative Minimum Tax – Individuals. (IRC §56(b)(3))

Practice Pointer

Employers must issue Form 3921, Exercise of an Incentive Stock Option Under §422(b), by January 31 of the calendar year following the calendar year in which an employee exercises an incentive stock option.

Form 3921 provides the relevant information that is used to calculate the employee's AMT adjustment on the exercise date as well as taxable gain when the stock is ultimately disposed of by the employee. A sample Form 3921 is reproduced here:



☐ CORRECTED (if checked)

TRANSFEROR'S name, street address, city or town, state or province, country, and ZIP or foreign postal code
Employer
One First Street
Anytown, CA 90001

1 Date option granted: 7/2/2020

2 Date option exercised: 9/19/2022

OMB No. 1545-2129

Form 3921 (Rev. October 2017)

Exercise of an Incentive Stock Option Under Section 422(b)

TRANSFEROR'S TIN: XX-XXXXXXX

EMPLOYEE'S TIN: XXX-XX-XXXX

3 Exercise price per share: $ 25.00

4 Fair market value per share on exercise date: $ 35.00

EMPLOYEE'S name: Employee

5 No. of shares transferred: 500

Street address (including apt. no.): 123 Main Street

City or town, state or province, country, and ZIP or foreign postal code: Anytown, CA 90001

Account number (see instructions)

6 If other than TRANSFEROR, name, address, and TIN of corporation whose stock is being transferred

Copy B For Employee

This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.

Form 3921 (Rev. October 2017) (keep for your records) www.irs.gov/Form3921 Department of the Treasury - Internal Revenue Service

On the Form 3921 shown, the $10 price difference per share (box 4 minus box 3) × the 500 shares exercised (box 5) in 2022 = $5,000, which represents the employee's AMT adjustment in 2022.

AMT adjustment and AMT credit

Taxpayers who must pay the alternative minimum tax due to the exercise of incentive stock options can file Form 8801, Credit for Prior Year Minimum Tax — Individuals, Estates and Trusts, in subsequent years and claim an AMT credit. The AMT credit is claimed in taxable years when the taxpayer is not subject to AMT and is essentially a refund of alternative minimum taxes paid in prior years.

Additionally, due to the AMT adjustment, the stock's basis for AMT purposes is higher, resulting in lower gain for AMT purposes when the stock is ultimately sold.

SELF-EMPLOYMENT TAX

Repaying 2020 Social Security deferral

In 2020, self-employed individuals (as well as household employers) could have elected to defer 50% of their employer's share of Social Security taxes. (CARES Act §2302) Of the amount deferred, one-half had to be repaid by December 31, 2021, and the other one-half must be paid by December 31, 2022.

The IRS has stated that taxpayers can make their Social Security repayments through:

- The Electronic Federal Tax Payment System® (EFTPS);
- Credit card;
- Money order; or
- Check.

Taxpayers should make their repayments of deferred Social Security taxes separate from other tax payments, and they should designate the payments as "deferred Social Security tax."

Failure to timely repay

In a memorandum issued by the IRS's Office of Chief Counsel on June 21, 2021, the IRS confirmed that if a taxpayer fails to repay any portion of the deferred taxes timely, then the deferral is disallowed, and the entire amount of deferred taxes are subject to failure-to-deposit penalties under IRC §6656. (PMTA 2021-07) In other words, the entire amount of deferred taxes are automatically charged the 10% penalty for failure to deposit payroll taxes for more than 15 days under IRC §6656(b)(1)(A)(iii).

Additional information can be found at the following IRS website:

Website
www.irs.gov/newsroom/irs-reminder-for-many-employers-and-self-employed-people-deferred-social-security-tax-payment-due-jan-3

NET INVESTMENT INCOME TAX (NIIT)

The 3.8% net investment income tax is imposed on an individual for the lesser of:

- Net investment income; or
- The excess of modified adjusted gross income for the taxable year, over the threshold amount. (IRC §1411(a)(1))

 ©2022

The threshold amounts are:

NIIT Threshold Amounts	
Filing status	**NIIT threshold**
MFJ and qualifying widow(er)	$250,000
MFS	$125,000
Single and HOH	$200,000
Note: The NIIT thresholds are not adjusted annually for inflation	

For estates and trusts, the net investment income tax is imposed on the lesser of:

- The undistributed net investment income; or
- The excess of modified adjusted gross income over the dollar amount at which the highest tax bracket begins for an estate or trust for the tax year ($13,451 for 2022 and $14,450 for 2023).

Modified adjusted gross income, for purposes of the NIIT, is generally defined as the taxpayer's adjusted gross income for regular income tax purposes increased by the foreign-earned income exclusion (but also adjusted for certain deductions related to the foreign-earned income).

IRC §1411(c)(1) defines "net investment income" as gross income from interest, dividends, annuities, royalties, and rents, other than such income that is derived in the ordinary course of a trade or business not described in IRC §1411(c)(2). The IRS has held that all dividends paid by a C corporation, even those paid by a closely held C corporation where the shareholder was a material participant, are subject to the net investment income tax. (CCA 202118009)

For taxpayers who haven't excluded any foreign-earned income, their modified AGI is generally the same as their regular AGI.

IRC §1411(c)(2) provides that the net investment income tax applies to income derived in the ordinary course of business if that business is a passive activity with respect to the taxpayer.

A passive activity is described as any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate. (IRC §469(c)(1)) To qualify for the ordinary course of business exception, the taxpayer must directly conduct the trade or business through a disregarded entity owned by the taxpayer or through a passthrough entity such as a partnership or S corporation. (Treas. Regs. §1.1411-4(b)) Since a C corporation is neither, the dividend income received by a taxpayer is classified as investment income.

INDIVIDUAL TAX CREDITS

CHILD TAX CREDIT

For taxable years 2018 through 2025, the Child Tax Credit is $2,000 per child. (IRC §24(h))

Comment

The American Rescue Plan Act (ARPA) increased the credit by $1,000 per child ($1,600 for children under the age of six) for the 2021 tax year only and provided an advanced credit payment. Neither of these provisions was extended into 2022.

Qualifying children must have a Social Security number that is issued by the due date of the taxpayer's income tax return, including extensions. Taxpayers who fail to obtain an SSN for their qualifying child by the due date of their income tax return, for whatever reason, are still eligible for the $500 credit available for other dependents under IRC §24(h)(4)(A).

Qualifying child

A qualifying child is an individual who has not reached age 17 during the taxable year. Under the ARPA, a qualifying child was defined as an individual who has not reached the age of 18 during the taxable year, but the ARPA change was applicable for the 2021 tax year **only**. (ARPA §9611; IRC §24)

Phaseouts of the credit

The $2,000 per-child credit is phased out, but not below zero, by $50 for each $1,000, or fraction thereof, by which the taxpayer's modified AGI exceeds the following thresholds:

- $400,000 if MFJ;
- $200,000 if single, HOH, or surviving spouse; and
- $200,000 if MFS.

Refundable credit

Up to $1,500 of the Child Tax Credit is refundable in 2022. (Rev. Proc. 2021-45; IRC §24(h)(5)) The refundable portion is $1,600 for 2023. (Rev. Proc. 2022-38)

Credit for other dependents

In addition to the Child Tax Credit for qualifying children, taxpayers may also claim a Child Tax Credit of $500 for each dependent who is not a qualifying child (i.e., a qualifying relative), none of which is refundable. (IRC §24(h)(4)) In order to qualify for the $500 nonrefundable credit, the dependent must be a U.S. citizen, U.S. national, or U.S. resident alien. (IRC §24(h)(4)(B))

California nonconformity

California has no comparable Child Tax Credit but continues to allow a personal exemption credit for dependents. (R&TC §17054) In addition, beginning with the 2022 tax year, taxpayers are no longer required to have earned income to claim the Young Child Tax Credit. (R&TC §17052.1) See page 8-15 for more details.

CHILD AND DEPENDENT CARE CREDIT

The nonrefundable Child and Dependent Care Credit is available to taxpayers who paid expenses for the care of a qualifying individual to enable the taxpayer (and their spouse, if filing a joint return) to work, actively look for work, or attend school full time, or the qualifying individual was disabled. (IRC §21)

Generally married taxpayers must file a MFJ return to claim the credit unless the couple is:

- Legally separated; or
- Married and living apart, and the taxpayer's home is the qualifying person's home for more than half the year, the taxpayer pays more than half the cost of keeping up the home for the year, and the spouse doesn't live in the home for the last six months of the year.
(IRC §21(e)(3) and (4))

A qualifying individual is:

- A dependent qualifying child who was under age 13 when the care was provided;
- A spouse who was physically or mentally incapable of self-care and lived with the taxpayer for more than half of the year; or
- An individual who was physically or mentally incapable of self-care, lived with the taxpayer for more than half of the year, and either:
  - Was the taxpayer's dependent; or
  - Could have been the taxpayer's dependent except that they received gross income equal to or greater than the personal exemption amount ($4,400 for 2022), or filed a joint return, or the taxpayer (or taxpayer's spouse, if filing jointly) could have been claimed as a dependent on another taxpayer's return.

(IRC §21(b)(1))

Only the custodial parent may claim the Child and Dependent Care Credit, even if the child is a dependent of the noncustodial parent. The custodial parent must actually pay the child care expenses to claim the credit.

Calculation of the credit

The Child and Dependent Care Credit is equal to the applicable percentage of the total care expenses paid by the taxpayer, up to $3,000 if there is one qualifying individual or $6,000 if there are two or more qualifying individuals. The applicable percentage is:

Child and Dependent Care Credit Applicable Percentages						
Adjusted gross income		Applicable percentage		Adjusted gross income		Applicable percentage
Over	But not over			Over	But not over	
$0	$15,000	35%		$29,000	$31,000	27%
$15,000	$17,000	34%		$31,000	$33,000	26%
$17,000	$19,000	33%		$33,000	$35,000	25%
$19,000	$21,000	32%		$35,000	$37,000	24%
$21,000	$23,000	31%		$37,000	$39,000	23%
$23,000	$25,000	30%		$39,000	$41,000	22%
$25,000	$27,000	29%		$41,000	$43,000	21%
$27,000	$29,000	28%		$43,000	No limit	20%

Example of Child and Dependent Care Credit

Jane is divorced and is the custodial parent for her two children, but under her divorce agreement, her ex-husband is entitled to claim one of the children as a dependent. Jane's annual eligible child care costs are $4,000 per child, and her AGI is $41,500 for 2022.

Even though Jane only claims one of her children as a dependent, she is the custodial parent for both and is therefore the parent who is eligible to claim the Child and Dependent Care Credit for both children. Her Child and Dependent Care Credit is calculated as follows:

Eligible expenses for child #1	$3,000*
Eligible expenses for child #2	+3,000*
Total eligible expenses	6,000
Applicable percentage (from table)	× 21%
Child and Dependent Care Credit	$1,260

* Eligible expenses are limited to $3,000 per child, up to $6,000 maximum (even if there are more than two children)

California partial conformity

California conforms to the Child and Dependent Care Expenses Credit, with modifications. (R&TC §17052.6)

ADOPTION CREDIT

Federal law provides for an Adoption Credit and exclusion from gross income for adoption benefits furnished under an employer's qualified adoption assistance program. (IRC §§23, 137) Generally taxpayers may take the credit when they pay the adoption expenses out of their own funds, and amounts paid to them by their employer under a qualified adoption assistance program are excludable.

Adoption Credit		
	Maximum credit (IRC §23(b)(1))	**Maximum exclusion (IRC §137(b)(1))**
2021 (Rev. Proc. 2020-45)	$14,440	$14,440
2022 (Rev. Proc. 2021-45)	$14,890	$14,890
2023 (Rev. Proc. 2022-38)	$15,950	$15,950

Phaseout amounts

For 2022, both the Adoption Credit and the exclusion are phased out ratably when modified AGI is $223,410–$263,410. (Rev. Proc. 2021-45) The same phaseout amounts apply for all filing statuses.

For 2023, the phaseout range is $239,230–$279,230. (Rev. Proc. 2022-38)

 ©2022

The credit

A credit for 100% of qualified adoption expenses, up to the maximum, may be claimed for each eligible child, including a special needs child. (IRC §23) Any unused credit may by carried forward for five years.

California partial conformity

California has its own Adoption Credit, which is different from federal. (R&TC §17052.25) However, California fully conforms to the federal exclusion from income for employer-reimbursed adoption expenses. (R&TC §17131)

EARNED INCOME CREDIT

Eligible low-income workers are able to claim a refundable Earned Income Credit (EIC). (IRC §32) The amount depends upon the taxpayer's income and whether the taxpayer has qualifying children and how many. In addition, no EIC is allowed if an eligible individual is the qualifying child of another taxpayer.

The credit is based on a percentage of earned income up to a "plateau" amount of earned income.

Earned Income Plateau Amounts

Qualifying children	Credit Percentage	2022 (Rev. Proc. 2021-45)	2023 (Rev. Proc. 2022-38)
None	7.65%	$7,320	$7,840
One	34%	$10,980	$11,750
Two	40%	$15,410	$16,510
Three or more	45%	$15,410	$16,510

Beginning point of phaseout range for joint filers

The EIC is reduced by a percentage of the amount by which earned income (or AGI, if higher) exceeds a phaseout amount.

EIC Phaseout Ranges

		2022 (Rev. Proc. 2021-45)		2023 (Rev. Proc. 2022-38)	
Qualifying children	Phaseout percentage	Other than joint returns	Joint returns	Other than joint returns	Joint returns
None	7.65%	$9,160–$16,480	$15,290–$22,610	$9,800–$17,640	$16,370–$24,210
One	15.98%	$20,130–$43,492	$26,260–$49,622	$21,560–$46,560	$28,120–$53,120
Two	21.06%	$20,130–$49,399	$26,260–$55,529	$21,560–$52,918	$28,120–$59,478
Three or more	21.06%	$20,130–$53,057	$26,260–$59,187	$21,560–$56,838	$28,120–$63,398

California conformity

California's Earned Income Tax Credit (EITC) is available for the 2022 taxable year. The credit is only available to individuals who have a qualifying principal place of abode in California.

EDUCATION CREDITS

The above-the-line deduction for higher education expenses was repealed for expenses paid after 2020. Taxpayers can still take advantage of the two long-standing education credits: the American Opportunity Tax Credit and the Lifetime Learning Credit. Both credits begin to phase out when modified AGI reaches $80,000 ($160,000 for MFJ).

Prior to the Tax Certainty and Disaster Tax Relief Act (TCDTRA), passed into law on December 27, 2020, the phaseout range for the Lifetime Learning Credit was adjusted annually for inflation, but the American Opportunity Tax Credit was not. In order to bring the phaseout range for both of these credits into parity, the TCDTRA eliminated the Lifetime Learning Credit's inflation adjustment for taxable years after 2020. (TCDTRA §104(a)(2))

Comparison of Education Tax Benefits (IRC §25A)		
Feature	**American Opportunity Tax (Hope) Credit**	**Lifetime Learning Credit**
Type of benefit	Refundable tax credit (up to 40% refundable)	Nonrefundable tax credit (cannot exceed tax liability)
Maximum benefit	$2,500 (100% of first $2,000 in qualified expenses, 25% of second $2,000) per student	$2,000 (20% of first $10,000 in qualified expenses) per return
Number of tax years credit is available	Available only for four tax years per eligible student (not four school years, which typically span five tax years)	Available for an unlimited number of years
Income limit	Credit begins to phase out at $80,000 modified AGI and is fully phased out at $90,000 ($160,000 and $180,000 thresholds for joint returns); phaseout is not adjusted for inflation	
Postsecondary education expenses qualifying for benefit	Tuition, fees, computers, and course materials required for enrollment	Tuition and fees required for enrollment
Type of postsecondary education	First four years of undergraduate education when enrolled on at least a half-time basis in a program leading to a degree, credential, or certificate	For any year of undergraduate or graduate enrollment for one or more courses

California nonconformity

California has no comparable credits.

SAVER'S CREDIT

Eligible taxpayers can claim a nonrefundable tax credit for contributions they make to a qualified retirement plan. (IRC §25B) The credit offsets both regular tax and AMT and is in addition to any applicable deduction.

The maximum annual contribution eligible for the credit is $2,000. An eligible taxpayer must be:

- Age 18 or over; and
- Not a full-time student or claimed as a dependent on another's return.

The rate of credit is determined by modified AGI.

The credit is available for elective contributions to any of these plans:

- 401(k) plan;
- 403(b) annuity or eligible deferred compensation arrangement of a state or local government (457 plan);
- SIMPLE IRA;
- Traditional IRA;
- Roth IRA; or
- Voluntary after-tax contributions to a qualified retirement plan.

Practice Pointer

The IRS classifies California's CalSavers program as a Roth IRA. As such, taxpayers who have withholding from their employer and participate in the CalSavers program are eligible for the Saver's Credit under IRC §25B if the taxpayer meets the AGI requirements listed below. CalSavers is discussed in more detail at page 9-42. For more information, see:

Website
https://saver.calsavers.com/home/savers/program-details.html

Taxpayers who elect to have withholding from their paycheck placed into a CalSavers account but who do not qualify to contribute to a Roth IRA can have their contributions recharacterized as traditional IRA contributions if the recharacterization is made prior to the due date of the tax return, not including extensions.

With limited exceptions, the qualified contribution is reduced by distributions from the plan made:

- During the year the credit applies;
- During the two preceding years; or
- Prior to the due date of the return for the year in which the credit applies. (IRC §25B(d)(2)(B))

Saver's Credit Rate Chart				
	AGI			
Year	**Joint**	**Head of household**	**All other filers**	**Credit %**
2022 2023	$0–$41,000 $0–$43,500	$0–$30,750 $0–$32,625	$0–$20,500 $0–$21,750	50%
2022 2023	$41,001–$44,000 $43,501–$47,500	$30,751–$33,000 $32,626–$35,625	$20,501–$22,000 $21,751–$23,750	20%
2022 2023	$44,001–$68,000 $47,501–$73,000	$33,001–$51,000 $35,626–$54,750	$22,001–$34,000 $23,751–$36,500	10%
2022 2023	Over $68,000 Over $73,000	Over $51,000 Over $54,750	Over $34,000 Over $36,500	0%
2022: IRS Notice 2021-61; 2023: IRS Notice 2022-55				

2022 credit for 2023 action

The credit pertains to the year for which the contribution is made. Because a contribution may be made for a tax year up to the due date of the return, this credit may be the only one available that will provide a credit for action taken after the end of the taxable year. For example, a taxpayer may make an IRA, SEP IRA, SIMPLE IRA, or pension contribution for the 2022 taxable year up until April 18, 2023, and be entitled to a 2022 credit.

California nonconformity

California has no comparable credit.

INFLATION REDUCTION ACT ENERGY INCENTIVES

Below is a chart summarizing the various Inflation Reduction Act of 2022 energy efficiency-related tax/rebates available to individuals.

Inflation Reduction Act Energy Incentives for Individuals		
Topic	**Rebate/credit**	**More information**
Appliance purchases	Rebates from the state (credit for certain items such as water heaters)	Page 1-59
Energy efficiency improvements such as windows, insulation, appliances, water heaters, etc.	Energy Efficient Home Improvement Credit and rebates from the state	Page 1-43
Clean energy vehicles (e.g., electric vehicles, plug-in hybrids, fuel cell vehicles)	Clean Vehicle Credit	Page 1-35
Purchases of used clean energy vehicles	Previously Owned Clean Vehicles Credit	Page 1-41
Purchases of clean energy vehicles for business use	Qualified Commercial Clean Vehicle Credit	Page 3-6
Solar panels/battery storage	Residential Clean Energy Credit	Page 1-47
In-home electric charging stations	Alternative Fuel Refueling Property Credit (beginning with 2023 tax year, only available if property placed in service in low-income or rural census tracts)	Page 3-10

CLEAN VEHICLE CREDIT

The Inflation Reduction Act (IRA ’22) replaces the New Qualified Plug-in Electric Drive Motor Vehicles Credit with the Clean Vehicle Credit, which generally applies to vehicles with at least four wheels that are placed in service after December 31, 2022, and sunsets at the end of 2032. (IRA ’22 §13401; IRC §30D) The credit can be claimed for each qualifying vehicle placed in service during the tax year but can only be claimed once per vehicle. Taxpayers are not limited as to the amount of times they may claim the credit.

While the 200,000-unit (per manufacturer) phaseout of the credit is repealed applicable to vehicles sold after December 31, 2022, as discussed below, going forward manufacturers must ensure that the key components of the vehicle are produced in or manufactured in the U.S. or U.S. “friendly” countries if their vehicles are to remain eligible for the credit.

The revised credit may be claimed for vehicles propelled primarily by electricity, including hybrid plug-ins and hydrogen fuel cell electric vehicles.

However, for vehicles placed in service after 2022, the credit can only be claimed:

- For vehicles that have a manufacturer’s suggested retail price below specified levels; and
- By taxpayers below specified modified AGI levels.

Beginning with vehicles purchased in 2024, taxpayers will be able to assign the credit to the dealer, which will result in a lower out-of-pocket cost to the taxpayer, rather than having to wait to claim the credit when they file their tax return.

Transition relief

Contracts prior to August 16, 2022: Taxpayers who purchased, or entered into a binding written agreement to purchase, a new qualified plug-in electric drive motor vehicle (as defined prior to the enactment of IRA ′22) after 2021 and before August 16, 2022 (the IRA ′22 enactment date) and placed the vehicle in service on or after August 16, 2022, may elect to treat the vehicle as having been placed in service prior to August 16, 2022, for purposes of qualifying for the credit. (IRA ′22 §13401(l))

This is welcome relief for those taxpayers who purchased a car before IRA ′22 was enacted but won't receive the car until a later date due to supply chain issues. This includes taxpayers who:

- Purchase a vehicle that was not assembled in North America;
- Are above the new modified AGI limits;
- Purchased a vehicle above the new retailer's suggested retail price limit; or
- Whose new vehicle does not meet the more stringent efficiency and manufacturing standards.

Purchases August 16, 2022–December 31, 2022: Taxpayers who purchase and take possession of a new qualifying electric vehicle after August 16, 2022, and before January 1, 2023, apply the pre-IRA ′22 rules to determine their credit, with the exception that the car's final assembly point must be in North America.

What constitutes a binding written contract?

The IRS has stated:

"In general, a written contract is binding if it is enforceable under State law and does not limit damages to a specified amount (for example, by use of a liquidated damages provision or the forfeiture of a deposit). While the enforceability of a contract under State law is a facts-and-circumstances determination to be made under relevant State law, if a customer has made a significant non-refundable deposit or down payment, it is an indication of a binding contract.

For tax purposes in general, a contract provision that limits damages to an amount equal to at least 5% of the total contract price is not treated as limiting damages to a specified amount. For example, if a customer has made a non-refundable deposit or down payment of 5% of the total contract price, it is an indication of a binding contract. A contract is binding even if subject to a condition, as long as the condition is not within the control of either party. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions."

For more information, go to:

Website
www.irs.gov/credits-deductions/individuals/plug-in-electric-drive-vehicle-credit-section-30d

Credit amount

The maximum amount of the Clean Vehicle Credit is $7,500 per qualified vehicle if the vehicle meets both the critical materials and battery component requirements, which essentially require that a specified percentage (which increases each year) of the critical components and battery minerals be

manufactured, processed, extracted or produced in the U.S. or in countries with which the U.S. has entered a free trade agreement. (IRC §30D(b))

If it only meets one of the requirements, then the credit is limited to $3,750.

These new credit amount provisions will go into effect on the date the Secretary of the Treasury issues proposed guidance regarding the critical mineral and battery component requirements, which must be issued no later than December 31, 2022. (IRA ’22 §13401(k)(3))

Comment

We assume that the IRS will post on their website a listing of which cars qualify for what amount of credit.

For vehicles placed in service in 2022, taxpayers can claim up to $7,500 per vehicle. The base amount is $2,500, and an additional $5,000 is available based on the battery capacity.

The credit is nonrefundable, and unused credits cannot be carried over.

Qualifying vehicles

Beginning with vehicles purchased after August 16, 2022, in order to qualify for either the current or the new version of the credits, the final assembly of the vehicle must occur within North America. (IRA ’22 §13401(b)) The U.S. Department of Energy has published on its website the list of vehicles with final assembly points in North America. The list contains a limited number of eligible vehicle models for 2022 and only currently lists a handful of eligible vehicles for 2023 (although it is likely this list will grow). The list can be found at the following website:

Website
https://afdc.energy.gov/laws/inflation-reduction-act

Caution

The IRS has updated its website to provide updated guidance regarding the Clean Vehicle Credit and has cautioned taxpayers that even if they purchase one of the eligible car models listed on the U.S. Department of Energy website linked above, some car models from the same manufacturer may have final assembly points in North America while other cars of the same model may have their final assembly point overseas.

For this reason, taxpayers must look up the vehicle identification number (VIN) for the exact car they are purchasing to verify whether it qualifies for the Clean Vehicle Credit. The U.S. Department of Energy website linked above contains a VIN lookup tool.

As before (with changes noted for vehicles placed in service after 2022), a qualified vehicle means a vehicle:

- Whose original use must commence with the taxpayer;
- That is acquired for use or lease but not for resale;
- Is made by a manufacturer, although IRA '22 requires the manufacturer to be a "qualified" manufacturer;
- Is treated as a motor vehicle for purposes of Title II of the Clean Air Act;
- That has a gross vehicle weight rating of less than 14,000 pounds;
- That is propelled to a significant extent by an electric motor that draws electricity from a battery that:
    - Has a capacity of not less than four kilowatt hours (increased to seven kilowatt hours for vehicles placed in service after 2022); and
    - Is capable of being recharged from an external source of electricity; and
- New for vehicles placed in service after 2022, for which the seller provides the requisite information to the IRS including:
    - The taxpayer's name and taxpayer identification number;
    - The vehicle identification number (the credit can only be claimed once per vehicle, which will be tracked by the VIN);
    - The vehicle's battery capacity;
    - Verification that the original use commences with the taxpayer; and
    - The maximum amount of credit allowed for the vehicle.

Comment

The credit is only allowed if the taxpayer includes the VIN on the return for the taxable year.

Nonqualifying vehicles

The following vehicles are ineligible for the credit:

- Any vehicle placed in service after December 31, 2024, if any of the applicable critical minerals contained in the vehicle's battery were extracted, processed, or recycled by a foreign entity of concern (as defined in 42 U.S.C. §18741(a)(5)); or
- Any vehicle placed in service after December 31, 2023, if any of the components contained in the vehicle's battery were manufactured or assembled by a foreign entity of concern.

Qualified manufacturer

Only manufacturers who enter into a written agreement with the Secretary of the Treasury to provide the information listed immediately above may qualify to sell vehicles eligible for the credit.

Modified AGI limit

Applicable to vehicles placed in service after December 31, 2022, taxpayers are eligible for the Clean Vehicle Credit if their modified AGI equals or is less than the following amounts in either the current or the prior tax year:

- $300,000 for MFJ;
- $225,000 for HOH; or
- $150,000 for all other taxpayers.
  (IRA '22 §13401(f); IRC §30D(f)(10))

Modified AGI is the taxpayer's AGI, increased for any foreign-income exclusion claimed under IRC §911, §931, or §933.

☑ Planning Pointer

The modified AGI thresholds are a cliff. A married couple filing jointly whose modified AGI in either the current or prior year is $300,000 will qualify for the full Clean Vehicle Credit. If the same couple's modified AGI is $300,001 in both years, they will receive zero credit.

Starting in 2024, taxpayers will be able to claim the Clean Vehicle Credit directly at the dealership (see "Credit transfer" discussion below). Taxpayers who claim the credit at the dealership but whose income is over the applicable threshold for their filing status will have a repayment requirement when they file their income tax return. We'll have to wait and see what IRS procedures and forms are required in 2024 to reconcile Clean Vehicle Credits claimed directly at the dealerships.

Vehicle price limitation

Also applicable to vehicles placed in service after December 31, 2022, the credit cannot be claimed for vehicles whose manufacturer's suggested retail price (MSRP) exceeds:

- $80,000 for vans, pick-up trucks, or SUVs; and
- $55,000 for all other vehicles.
  (IRC §30D(f)(11))

Comment

IRA '22 does not contain a provision for inflation adjustments to either the vehicle price limitations or the taxpayer's AGI limitation. Each of these dollar amounts are fixed and cannot be changed unless they are contained in another bill later.

Leased vehicles

Leased vehicles are eligible for the Clean Vehicle Credit.

Credit transfer

Beginning for vehicles placed in service after 2023, taxpayers will be able to transfer the credit to the licensed dealers that have registered with the Secretary of the Treasury and that disclose specified information to the taxpayer at the time of the purchase. The election to transfer the credit

must be made no later than the time of sale. The seller may not reduce the amount of any other offered incentive, rebate, or discount as a result of this credit transfer. (IRC §30D(g))

The transferred credit:

- Is not includable in the taxpayer's gross income; and
- Is not deductible by the dealer.

Comment

This will be a great benefit to the purchaser as they may apply the credit as part of the down payment and can lower the cost of the car immediately rather than have to wait to receive the benefit of the credit when they file their return.

However, taxpayers who exceed the modified AGI thresholds listed above may be in for a big surprise come tax filing time if they transferred the credit to the dealer believing they qualified for the credit and then determine that their modified AGI exceeded those thresholds.

We believe that under IRC §30(g)(10) the taxpayer will be on the hook for the credit transferred when they file their return, but we are awaiting further guidance from the IRS on this.

✐ **Practice Pointer**

It's important for tax professionals to review the car purchase contract prior to claiming any Clean Vehicle Credit on their client's return to make sure that the credit wasn't already transferred to the dealer.

Clean Vehicle Credit: Which Rules Apply When?	
Situation	**Applicable rules**
Purchased vehicle and took possession before August 16, 2022	Pre-IRA '22 rules, including the limitation of 200,000 per manufacturer
Entered into written purchase contract prior to August 16, 2022, and car placed in service any time after August 15, 2022 (even post-2022 years)	Pre-IRA '22 rules, including the limitation of 200,000 per manufacturer
Purchased vehicle after August 15, 2022, and car placed in service in 2022	Pre-IRA '22 rules, but only if vehicle assembled in North America (must run vehicle VIN number on IRS's website as noted on page 1-37). If vehicle not assembled in North America, taxpayer cannot claim the credit at all
Purchased vehicle after August 15, 2022, and car placed in service after 2022	IRA '22 rules apply

 ©2022

California nonconformity

California has no comparable credit but has a rebate for the purchase of "clean vehicles." The rebate amount ranges from $1,000 to $7,000 depending on the vehicle ($750 for eligible motorcycles). In addition, low-income families can get an additional rebate of up to $2,500. More information can be found at:

Website
https://cleanvehiclerebate.org/eng

Any California rebates received are federally taxable unless the rebates are applied directly to reduce the purchase price of the vehicle.

PREVIOUSLY OWNED CLEAN VEHICLE CREDIT

A new credit, the Previously Owned Clean Vehicle Credit under IRC §25E, is available for the purchase of used clean vehicles by qualified buyers with modified AGI below specified levels. The credit is available for qualified vehicles purchased after December 31, 2022, and before 2033. (IRA '22 §13402; IRC §25E)

Only sales by a licensed dealer of vehicles sold for $25,000 or less qualify for the credit. In addition, only the first resale of the vehicle qualifies.

Credit amount

The credit is equal to 30% of the vehicle's sales price, up to a $4,000 maximum credit. (IRC §25E(a))

Qualified vehicles

To qualify for this credit:

- The vehicle's model year must be at least two years earlier than the calendar year in which it was purchased;
- The original use of the vehicle must not have commenced with the taxpayer; and
- The vehicle must meet requirements similar to the:
  - "Qualified vehicle" requirements of the Clean Vehicle Credit (other than the requirement that the final assembly be in North America); or
  - "New qualified fuel cell motor vehicle" requirements under IRC §30B(b)(3) (other than being "new") and have a gross vehicle weight rating of less than 14,000 pounds.

Comment

Used car dealers will be able to identify to the buyer which vehicles qualify for the credit because they must provide credit information concerning the vehicle to the IRS.

Qualified buyers

The credit may only be claimed by individuals who purchase the vehicle for use and not for resale. Leases are not eligible for the credit, and the buyer cannot be claimed as a dependent by another taxpayer.

Buyers may only claim the credit for purchases once every three years.

> **✐ Practice Pointer**
>
> The one-purchase-every-three-years rule is tied to the date of the sale of the vehicle, not the taxable year. (IRC §25E(c)(3)(D))
>
> For example, a taxpayer who purchases a previously owned clean vehicle on January 27, 2023, and claims the credit under IRC §25E cannot claim the previously owned clean vehicle credit on another car purchase before January 28, 2026.
>
> Be sure to advise your clients that the precise date of purchase matters when claiming the Previously Owned Clean Vehicle Credit.
>
> The Inflation Reduction Act does not make clear whether each spouse in a married couple is eligible for the Previously Owned Clean Vehicle Credit. We will have to wait for further IRS guidance.

Modified AGI limit

Taxpayers are eligible for the credit if their modified AGI equals or is less than the following amounts in either the current or the prior tax year:

- $150,000 for MFJ;
- $112,500 for HOH; or
- $75,000 for all other taxpayers.
  (IRC §25E(b))

Modified AGI is the taxpayer's AGI, increased for any foreign-income exclusion claimed under IRC §911, §931, or §933. These AGI limits are not adjusted annually for inflation.

Credit transfer

Beginning with vehicles acquired after 2023, purchasers may transfer the credit to the dealer (similar to the Clean Vehicle Credit transfer, discussed on page 1-40).

> **☑ Planning Pointer**
>
> Like the Clean Vehicle Credit, the modified AGI thresholds are a cliff. A taxpayer whose modified AGI is even $1 over the amounts shown is ineligible for the Previously Owned Clean Vehicle Credit.

Other issues

Also like the Clean Vehicle Credit:

- Taxpayers must provide the vehicle's identification number (VIN) on the tax return for the year the credit is claimed;
- The vehicle's basis must be reduced by the amount of the credit claimed;
- Any other deduction or credit allowed for the vehicle must be reduced by the amount of the Credit for Previously Owned Clean Vehicles;
- The credit cannot be claimed for vehicles used predominantly outside the U.S.; and
- The vehicle must meet applicable air quality and motor vehicle safety standards.

ENERGY EFFICIENT HOME IMPROVEMENT CREDIT (AKA NONBUSINESS ENERGY CREDIT)

The nonrefundable Nonbusiness Energy Credit, available to individuals who make their homes more energy efficient by installing items such as insulation or energy efficient windows and doors, is:

- Reinstated retroactively to property placed in service after 2021 (the credit had previously only been available for property placed in service prior to 2022);
- Renamed the "Energy Efficient Home Improvement Credit"; and
- Extended an additional eleven years and is now available for purchases of qualified property placed in service after 2021 and prior to January 1, 2033.
  (IRA ′22 §13301; IRC §25C(g)(2))

> ✐ **Practice Pointer**
>
> For nonbusiness energy property placed in service in 2022, the pre-IRA ′22 rules apply. Under the pre-IRA ′22 rules:
>
> - The credit is 10% of the cost of eligible property placed in service in 2022;
> - The lifetime credit limit is $500 ($200 for windows); and
> - Qualifying property includes (among others):
>   - Energy-efficient exterior windows, doors and skylights;
>   - Roofs (metal and asphalt) and roof products; and
>   - Insulation.

Other changes to the Nonbusiness Energy Credit, applicable to property placed in service after December 31, 2022, except as noted, include:

- Increasing the percentage of the credit from 10% of the cost to 30% of cost of the:
  - Amount paid or incurred by the taxpayer for qualified energy efficient home improvements installed during such taxable year; and
  - The amount of the residential energy property expenditures paid or incurred by the taxpayer during such taxable year (prior to the IRA ′22 there was no percentage limit on these amounts).
    Note: See chart below for a listing of the differences between these two types of property;
- Allowing the credit to be claimed for home energy audits (up to $150 maximum credit; see the definition under the upcoming "Home energy audits" section);
- For purposes of the definition of residential energy property, removing the requirement that the residence be the taxpayer's principal residence (the home must be a personal-use property, thereby allowing the credit to be claimed for second homes and vacation homes);
- Replacing the $500 *lifetime* cap on the credit with a $1,200 *annual* credit limitation. The credit cap is further limited annually to:
  - $600 per any one item of qualified energy property;
  - $600 with respect to all exterior windows and skylights;
  - $250 with respect to any exterior door; and
  - $500 in the aggregate for all exterior doors;

- However, the annual cap is increased to $2,000 for the following purchases of specified residential energy property:
  - Electric or natural gas heat pump water heater;
  - Electric or natural gas heat pump; and
  - Qualified biomass stove or boiler as defined in IRC §25C(d)(2)(B);
- Updating the energy efficient standards that must be met for various items (see table below);
- Adding air sealing material or systems to the list of qualified residential energy property for which the credit may be claimed;
- Expanding the list of qualified energy property to include a natural gas heat pump and a natural gas, propane, or oil furnace or hot water boiler, a biomass stove or boiler, and improvements to or replacements of a qualified panelboard, sub-panelboard, branch circuit, or feeders;
- Removing asphalt and metal roofs from the list of building envelope components for which the credit may be claimed; and
- Requiring all items placed in service after 2024 for which the credit is claimed to be produced by a qualified manufacturer, and a qualified product identification number must be provided on the tax return filed by the taxpayer.

Identification numbers required

Applicable to property placed in service after December 31, 2024, the credit is only available for property produced by a qualified manufacturer for which the taxpayer includes the qualified product identification number of the item on the return for the taxable year. (IRA ’22 §13301(g); IRC §25C(h))

A qualified manufacturer is a manufacturer of property for which the credit can be claimed (other than insulation) that enters into an agreement with the Secretary of the Treasury to assign and label such property with a unique identifying number and provide written reports to the secretary listing such unique product identification numbers.

Mathematical error

Failure to provide a qualified product identification number on the return or other information or documentation required by the IRS will be treated as a mathematical error. (IRA ’22 §13301(g)(2); IRC §6213(g)(2)(R) and (S)) The mathematical error designation by IRA ’22 allows the IRS to disallow the credit quickly without the need to send multiple notices to a taxpayer notifying them of changes made to their return.

Home energy audits

A home energy audit is an inspection and written report with respect to a taxpayer’s U.S. principal residence that:

- Identifies the most significant and cost-effective energy efficiency improvements with respect to the residence, including an estimate of the improvements’ energy and cost savings; and
- Is conducted and prepared by a home energy auditor that meets the certification or other requirements outlined by the Secretary of the Treasury in regulations or guidance. (IRC §25C(e))

Qualifications for Energy Efficient Home Improvements and Residential Energy Property		
Qualifications	**Energy efficient home improvements**	**Residential energy property**
Baseline qualifications	Consists of: • Energy efficient building component; • Installed in a taxpayer's principal residence (within the meaning of IRC §121); • Original use commences with the taxpayer; and • Can reasonably expect to remain in use for at least five years	Must be: • Installed in a taxpayer's U.S. personal use property (for property placed in service prior to 2023, must be taxpayer's principal place of residence); • Originally placed in service by the taxpayer; and • Includes expenditures for labor costs for the onsite preparation, assembly, or original installation of the property
Types of property (after 2022)	Eligible property after 2022: • Any insulation material or system, including air sealing material or system; • Exterior windows, including skylights; and • Exterior doors	For property placed in service after 2022: • An electric or natural gas heat pump water heater; • An electric or natural gas heat pump; • A central air conditioner; • A natural gas, propane, or oil water heater; • A qualified biomass stove or boiler; and • Any improvement to, or replacement of, a panelboard, sub-panelboard, branch circuits, or feeders which: o Is installed in a manner consistent with the National Electric Code; o Has a load capacity of not less than 200 amps; and o Is installed in conjunction with and enables the installation and use of (1) any qualified energy efficiency improvements; or (2) any qualified energy property for which an IRC §25C credit is allowed

(continued)

Qualifications for Energy Efficient Home Improvements and Residential Energy Property (continued)		
Qualifications	**Energy efficient home improvements**	**Residential energy property**
Types of property (prior to 2023)	Eligible property prior to 2023: • Any insulation material or system • Exterior windows, including skylights; • Exterior doors; and • For property placed in service prior to 2022, qualifying metal roof and asphalt roof with cooling granules	For property installed prior to 2023: • Energy efficient property, which means: o An electric heat pump water heater; o An electric heat pump; o A central air conditioner; o A natural gas, propane, or oil water heater; o A qualified natural gas, propane, or oil furnace or hot water boiler; or o An advanced main air circulating fan
Energy standards	Must meet the following: • Exterior window or skylight: Energy Star most efficient certification requirements (Version 6.0 Energy Star program requirements for property placed in service prior to 2022); • Exterior door: applicable Energy Star requirements (Version 6.0 Energy Star program requirements for property placed in service prior to 2022); • Any other component: International Energy Conservation Code standards in effect for that component two years prior to the calendar year in which the component is placed in service (2019 code for property placed in service prior to 2022)	Note the following: • For all property listed above, other than a biomass stove or boiler, placed in service after 2022, the property must meet or exceed the highest efficiency tier (not including any advanced tier) established by the Consortium for Energy Efficiency that is in effect as of the beginning of the calendar year in with the property is placed in service • Energy efficiency standards for biomass stove or boilers are outlined in IRC §25C(d)(2)(C) and (D)) • For property placed in service prior to 2023, the property must meet the performance and quality standards, and certification requirements as outlined by the Secretary of Treasury and in effect for the year of the property's acquisition or construction

> ✐ **Practice Pointer**
>
> Many of our clients may purchase these items not realizing that they may now qualify for a tax credit. Consider adding a question to your client organizers asking them if they have purchased any of the items listed above to make sure you capture all available credits.

No carryover

As before there is no carryover of unused credits. Unused credits are simply lost, so this increased credit may provide minimal or no tax benefit for taxpayers with low or no income tax liability.

RESIDENTIAL CLEAN ENERGY CREDIT

The Residential Energy Efficient Property (REEP) Credit is renamed the "Residential Clean Energy Credit" and extended an additional 11 years. It is now available for property placed in service prior to January 1, 2035. (IRA '22 §13302; IRC §25D(g)(2))

We often refer to the Residential Clean Energy Credit (aka the Residential Energy Efficient Property (REEP) Credit) under IRC §25D as the solar credit because the vast majority of taxpayers who claim this credit do so because they have purchased solar energy property. However, the Residential Energy Efficient Property Credit is available for the installation of all of the following types of property:

- Solar electric;
- Solar water heating;
- Fuel cell;
- Small wind energy;
- Geothermal heat pumps;
- Biomass fuel property; and
- Qualified battery storage expenditures (added by the IRA '22)
  (IRC §25D(d))

> ***Comment***
>
> IRA '22 added qualified battery storage expenditures to the list of property qualifying for the Residential Clean Energy Credit. The IRS issued a private letter ruling in 2018 allowing home batteries to qualify for the credit if certain requirements were met. (PLR 201809003)
>
> IRA '22 essentially supersedes the PLR and imposes its own requirements to claim the Residential Clean Energy Credit for battery storage. The requirements to claim the credit for battery storage under IRA '22 are easier to meet than the IRS's 2018 PLR.

Full 30% credit retroactively reinstated

IRA '22 retroactively reinstates the full 30% credit for properties placed in service after 2021. (IRC §25D(g)) Under pre-IRA '22 law, the amount of the credit was phased down to 26% for solar energy property placed in service in 2021 and 2022 and was scheduled to be further reduced to 22% if the property was placed in service in 2023.

IRA '22 limits the application of the 26% rate to those properties that were placed in service in 2020 and 2021. This means taxpayers will be able to claim a 30% credit on their 2022 return if the property was placed in service in 2022.

The full 30% credit is now available for eligible expenditures through the end of 2032. The credit is phased down to 26% in 2033 and then to 22% in 2034.

Comment

There is no relief provided to those taxpayers who placed their solar property in service in 2020 or 2021. These taxpayers are still limited to claiming a 26% credit.

Battery storage technology defined

A qualified battery storage expenditure means costs incurred for battery storage technology that:

- Is installed in a U.S. dwelling unit used as a personal use property of the taxpayer (it does not have to be the taxpayer's principal residence); and
- Has a capacity of not less than three kilowatt hours.
(IRC §25D(d)(6))

Carryovers

As before, the credit under IRC §25D is nonrefundable, but unused credits can be carried over indefinitely.

California nonconformity

California has no comparable tax credit. Any state-provided benefits are provided through rebate programs that are detached from a property owner's income tax filings.

Credit limitations

The amount of the Residential Clean Energy Credit (aka the Residential Energy Efficient Property (REEP) Credit) available to taxpayers carries no real limitation. As such, it is a credit that high income taxpayers can take without fear of reduction. The credit's key features are:

- There is no maximum credit any taxpayer can take (annually or lifetime);
- The credit is not limited by the taxpayer's AGI;
- The credit can offset AMT;
- The credit is not subject to recapture if the home is sold immediately after installing solar; and
- The credit is nonrefundable, but any unused portion may be carried forward indefinitely, even into years where the credit is no longer available for new property.

Property must be personal use property

The credit is available for clean energy property installed on any personal use property, including a principal residence and vacation homes. There is no limit to the number of years or homes for which the taxpayer can claim the credit. The key is that the property must be personal use property.

Basis adjustments for Residential Clean Energy Credit

The home's basis must be reduced by the amount of any credit allowed. (IRC §25D(f))

Example of basis adjustment

Hana purchases and installs qualifying solar electric property (solar panels) on her principal residence at a cost of $45,000. At the time of the installation, Hana's basis in her home was $1.2 million. Hana's new basis is $1,233,300, calculated as follows:

Basis of home at time of solar installation	$1,200,000
Solar installation (capital improvement)	45,000
Less: solar credit	(13,500)
Adjusted basis	$1,231,500

AFFORDABLE CARE ACT (ACA)

ACA INDIVIDUAL MANDATE

Shared responsibility payment

The ACA's individual shared responsibility payment is zero. Taxpayers without health insurance are not penalized by the Internal Revenue Code.

California nonconformity

California has charged a tax penalty for failure to have health insurance since 2020. California's individual health care mandate is generally discussed on page 8-5.

PREMIUM TAX CREDIT

Taxpayers are allowed an advanceable and refundable Premium Tax Credit to help subsidize the purchase of health insurance through exchanges. (IRC §36B)

The credit is:

- Determined by reference to the premium amount for the second lowest cost silver plan offered by an exchange in the rating area where the taxpayer resides; and
- Based on the percentage of income the cost of premiums represents.

The credit is computed in four steps:

1. Determine the taxpayer's "household income" as a percentage of the poverty line for the taxpayer's family size;
2. Determine the "applicable percentage" relative to household income (expressed as a percentage of the poverty line determined in step 1);
3. Multiply the applicable percentage by household income. This determines the taxpayer's "expected contribution" (the amount the taxpayer is expected to pay for insurance for the taxpayer's household); and
4. Subtract the expected contribution from the "benchmark premium" (the cost of the second lowest cost silver plan).

The taxpayer's contribution amount (household income for the tax year times the applicable percentage) is determined using the taxpayer's household income and family size at the end of the current tax year.

Enhanced credit for 2021 through 2025

For 2021 through 2025, the American Rescue Plan Act of 2021, extended by the Inflation Reduction Act of 2022, expanded the Premium Tax Credit by:

- Increasing the amount of subsidies people can receive when purchasing the plans through the health care exchange by decreasing the taxpayer's maximum income contribution toward the premiums (ARPA §9661; IRC §36B(b)(3)(A)); and
- Repealing the 400% federal poverty level cap on receiving subsidies. Under pre-ARPA law there was a cliff, and taxpayers whose modified AGI exceeds 400% of the poverty level must pay 100% of their premiums for insurance coverage through the marketplace. By repealing the cap, all taxpayers with incomes above the 400% federal poverty level will not have to pay more than 8.5% of their income on health insurance premiums. (ARPA §9661; IRC §36B(b)(3)(A))

Under current law, the Premium Tax Credit is calculated as the difference between the benchmark premium (the premium for the second-lowest-cost silver plan available in the marketplace in the area of residence) and a specified percentage of income for a person with income at a given percentage of the federal poverty level. By lowering the specified percentage, the ARPA increases the amount of the subsidies/Premium Tax Credit available.

The following table shows the contribution rate for specified levels of the federal poverty level (FPL).

Maximum Income Contribution Percentage by Household Income for Premium Tax Credits for 2021–2025 (ARPA §9661; Rev. Proc. 2021-36)	
Income range (percentage of FPL)	**Range of maximum income contribution (percentage of income)**
100%–133%	0%
133%–150%	0%
150%–200%	0%–2%
200%–250%	2%–4%
250%–300%	4%–6%
300%–400%	6%–8.5%
400%+	8.5%

 ©2022

2022 Federal Applicable Percentage Per Income Range for ACA Subsidies						
ACA applicable percentage	**Income range (FPL percentage)**	**1 Person**	**2 People**	**3 People**	**4 People**	**5 People**
0%	100%–150%	$13,590–$20,385	$18,310–$27,465	$23,030–$34,545	$27,750–$41,625	$32,470–$48,705
0%–2%	150%–200%	$20,385–$27,180	$27,465–$36,620	$34,545–$46,060	$41,627–$55,500	$48,705–$64,940
2%–4%	200%–250%	$27,180–$33,975	$36,620–$45,775	$46,060–$57,575	$55,500–$69,375	$64,940–$81,175
4%–6%	250%–300%	$33,975–$40,770	$45,775–$54,930	$57,575–$69,090	$69,375–$83,250	$81,175–$97,410
6%–8.5%	300%–400%	$40,770–$54,360	$54,930–$73,240	$69,090–$92,120	$83,250–$111,000	$97,410–$129,880
8.5%	400%+	$54,360	$73,240	$92,120	$111,000	$129,880

Limitation of Payback of Excess Advance Credits for 2022 (Rev. Proc. 2021-45)		
Household income relative to poverty line	**All filing statuses except single**	**Single**
Less than 200%	$650	$325
At least 200% but less than 300%	$1,650	$825
At least 300% but less than 400%	$2,800	$1,400
400% or more	No limit	No limit

Limitation of Payback of Excess Advance Credits for 2023 (Rev. Proc. 2022-38)		
Household income relative to poverty line	**All filing statuses except single**	**Single**
Less than 200%	$700	$350
At least 200% but less than 300%	$1,800	$900
At least 300% but less than 400%	$3,000	$1,500
400% or more	No limit	No limit

California conformity

Beginning January 1, 2020, California began charging a penalty for failure to have health insurance.

EXPANDED AFFORDABILITY EXEMPTION

Beginning with the 2023 taxable year, spouses and dependents of employees who were previously ineligible for the Premium Tax Credit (PTC) because they were offered "affordable" employer health care coverage for the family may find that they qualify for the PTC if they purchase their health care coverage through a health care exchange. This is due to final regulations adopted by the IRS that revise whether an employer health care plan for related individuals (defined as spouses and dependents) is affordable or not. (TD 9968)

✐ **Practice Pointer**

It's important for your clients to review whether the employer-provided health care coverage is considered "affordable" (as discussed below). If the coverage is not affordable, they may find that they can qualify for substantial health care coverage savings by applying for health care through a health care exchange.

In this case, the family may choose to not re-enroll in the employers' family health insurance program. In recognition that some employers' IRC §125 cafeteria plans that offer family health care coverage do not operate on a calendar-year basis, the IRS is allowing employees to revoke their coverage under the cafeteria plan so that they may qualify for the PTC on the exchange. (IRS Notice 2022-14)

Eligibility for Premium Tax Credit

Individuals generally are not allowed a PTC if they are eligible for employer-sponsored health care coverage. However, under the Affordable Care Act (ACA), individuals are not considered "eligible" for employer coverage if the coverage is unaffordable or does not provide minimum value, unless they choose to voluntarily enroll in the coverage.

What's affordable for the family?

Coverage is not affordable for an employee if the portion of the premiums that must be paid by the employee for self-only coverage exceeds 9.5% (indexed for inflation; 9.61% for 2022 and 9.12% for 2023) of household income. (IRC §36B(c)(2)(C)(I)(II)) The question for policy makers has been, how do you measure "affordability" for an employee's family members?

The final regulations provide a separate affordability exemption test for an employee's spouse and dependents. Under this separate test, an eligible employer-sponsored plan is affordable for related individuals only if the portion of the annual premium the employee must pay for family coverage does not exceed 9.61% for 2022 (9.12% for 2023) of the household income. (Treas. Regs. §1.36B-2(c)(3)(v)(A)(2)) If the employee's required contribution rate for the family coverage exceeds 9.61% for 2022 (9.12% for 2023), then the related individuals would be eligible to claim the PTC and obtain their insurance on a health insurance exchange.

Previously, IRS regulations provided that if self-only employer coverage is affordable for an employee, then the coverage is automatically deemed affordable for a spouse with whom the employee is filing a joint return and all of the employee's dependents who may be eligible to enroll in the employer coverage.

Separate test for employee

The determination of whether the coverage for the employee is affordable is made separately from the family affordability determination. If the employee's contribution toward their premiums is 9.61% for 2022 (9.12% for 2023) or less of household income, then the employee is still ineligible for the PTC for their coverage because their employer-sponsored coverage is still considered affordable. This is true even if the family coverage is unaffordable.

 ©2022

Example of separate affordability tests

Jorge's employer offers health care insurance for Jorge and his family. The annual premium Jorge must pay for insurance for himself is $3,000. If he adds his wife and two children to the policy, his share of the premiums would be increased to $15,000. Jorge's household income is $100,000.

Jorge is ineligible for the PTC for himself because the cost of his insurance for himself is 3% of his household income, which is below the 9.61% affordability threshold. However, to add his family to the policy would require him to contribute 15% of his household income toward the family coverage premiums. Because this is over the 9.61% affordability threshold, the employer-provided family coverage health insurance is considered "unaffordable," and therefore Jorge's wife and children would be eligible for the PTC if they purchase their health insurance on an exchange.

Multiple offers of coverage

If a person has offers of coverage from both their employer and another family member's employer, the person is ineligible for the PTC if either of the health care coverage offered is considered affordable. (Treas. Regs. §1.36B-2(c)(3)(v)(A)(8))

Example of multiple offers of coverage

Harold and Maude are a married couple with no children. If Harold's contribution toward his employer's health insurance would require him to pay more than 10% of his household income toward his health insurance, but the cost of health insurance for Harold offered through his wife Maude's employer would only require him to pay 8% of their household income for Harold's health care coverage, Harold would not qualify for the Premium Tax Credit because he was offered "affordable" health care through his wife's employer.

Minimum value

Under the ACA, an employee is also not considered "eligible" for employer coverage when the employer-sponsored plan does not provide minimum value. A plan provides minimum value if the plan's share of the total allowed cost of benefits provided to an employee is at least 60%, and the plan benefit includes inpatient hospital services and physician services.

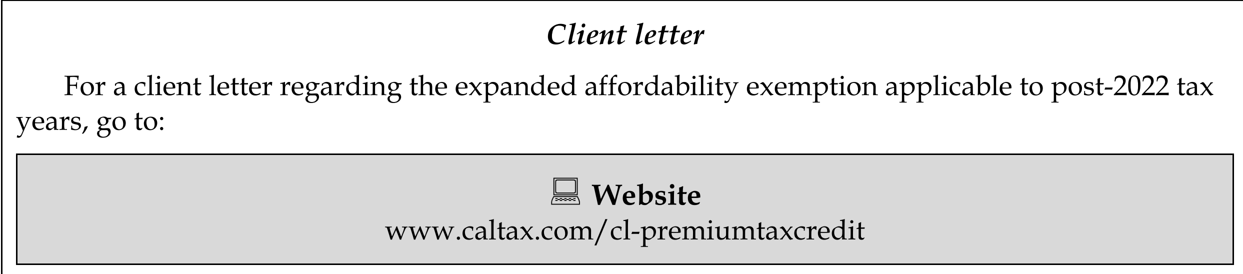
The final regulations clarify that the minimum value requirement relates both to the self-coverage provided to the employee and to the family coverage provided to the employee's family members. If the plan does not pay at least 60% of the benefits to the family members or does not provide for inpatient hospital services and physician services for the family members, then employer-provided coverage is not considered available to the family members, and they will qualify for the PTC. (Treas. Regs. §1.36B-6)

An employer plan that provides minimum value to an employee also provides minimum value to related individuals if the scope of benefits and cost sharing (including deductibles, copayments, coinsurance, and out-of-pocket maximums) under the plan is the same for employees and family members.

Impact on employers

The preamble to the final regulations states there will be no additional reporting requirements for employers under these final regulations. Under current law and regulations, employers must

report the cost of self-only coverage offered to an employee. The purposes of this reporting requirement is to determine whether the employer is subject to the employer shared responsibility penalty imposed on applicable large employers, not for purposes of determining whether coverage offered is affordable. According to the IRS, they do not intend to revise the employer's reporting responsibilities as a result of the adoption of these final regulations.



Client letter

For a client letter regarding the expanded affordability exemption applicable to post-2022 tax years, go to:

Website
www.caltax.com/cl-premiumtaxcredit

NANNY TAX THRESHOLD

For 2022, the nanny tax threshold is $2,400. For 2023, it is $2,600. (www.ssa.gov/oact/cola/CovThresh.html)

This is the applicable wage threshold for purposes of FICA withholding for wages paid to household employees (health care workers, butlers, maids, drivers, cleaning people, gardeners, babysitters, etc.).

Report and pay the federal nanny tax on Schedule H.

The filing due date for Forms W-2 and Forms W-3 with the Social Security Administration is January 31. (PATH Act of 2015)

Comment

Even though this provision is commonly referred to as the "nanny tax," it applies to any household employee.

California conformity

California does not allow household employers to pay household employment taxes on the California income tax return. Household employers must register with the EDD and report household employees by filing Form DE 1HW, Registration Form for Employers of Household Workers, when they employ one or more individuals and pay cash wages of $750 or more in a calendar quarter. (UIC §684) Household employers must also file Form DE 34, Report of New Employee(s), for each new employee within 20 days of hire.

Household employers who pay less than $20,000 in wages per year may elect to pay taxes annually by checking the "yes" box in Item D on Form DE 1HW or, if previously registered with the EDD, may complete Form DE 89, Employer of Household Worker Election.

 ©2022

COLLEGE SAVINGS

§529 Distributions			
	Postsecondary (college) and registered apprenticeships	**K–12**	**Student loan repayments**
Tuition	No limit	Limited to $10,000 annually	N/A
Fees, books, supplies, and equipment required for enrollment or attendance	Eligible expenses	Not eligible expenses (§529 distributions used for these purposes are taxable)	N/A
Expenses for special needs services of beneficiary in connection with enrollment or attendance	Eligible expenses	Not eligible expenses	N/A
Expenses for the purchase of computer or peripheral equipment, software, internet access and related services, if used during enrollment at education institution	Eligible expenses (but not for software designed for sports, games, or hobbies unless it is predominantly educational in nature; for example, if student is studying video game development)	Not eligible	N/A
Student loan repayments	N/A	N/A	$10,000 per lifetime, per student

California partial conformity

California does not allow §529 distributions to be used for K–12 education.

California residents who use distributions from §529 accounts for K–12 education will be subject to California's 2.5% early withdrawal penalty on the earnings withdrawn from the account. (R&TC §§17024.5, 17140, 17140.3)

EXPIRING TAX PROVISIONS

Many of the COVID-19–related tax provisions expired at the end of 2021 along with other provisions that either expired at the end of 2021 without extension or will expire at the end of 2022.

List of expiring tax provisions

Expired at the end of 2021

The following tax provisions expired at the end of 2021:

- Mortgage insurance premium deduction — expired 12/31/2021;
- COVID-19–related charitable contribution provisions, including those passed by the CARES Act and extended by the Taxpayer Certainty and Disaster Tax Relief Act (TCDTRA) expired at the end of 2021, including:
  - The 50% accuracy-related penalty imposed on any underpayment attributable to overstatements of the 2021 charitable contribution allowed on Form 1040, line 12b (TCDTRA §212; IRC §§6662(b)(9), 6751(b)(2)(A));
  - The increased charitable contribution limits for cash contributions applicable to individuals (100% of AGI) and corporations (25% of taxable income) and for donations of food inventory (25%) also apply for contributions made in 2021 (TCDTRA §213); and
  - The deduction for nonitemizers to claim a $300 deduction ($600 if married filing jointly) for cash contributions made to qualified organizations (excluding private foundations or donor advised funds) for 2021 (TCDTRA §212; IRC §§63(b), 170(p))
- The increased Child Tax Credit provisions from the American Rescue Plan Act, including the provision for advanced payments. See page 1-27 for a discussion of the Child Tax Credit provisions in effect for 2022;
- The enhanced Child and Dependent Care Credit provisions from the American Rescue Plan Act that were effective for the 2021 tax year only, including the increased eligible expenses and refundability provisions. See page 1-28 for a discussion of the Child and Dependent Care Credit provisions effective for 2022;
- The increased income exclusion for employer-provided dependent care assistance under the ARPA. See page 1-7 for a discussion of the dependent care assistance exclusion available for taxable years other than 2021;
- The enhanced Earned Income Credit provisions from the ARPA, including the easing of the age limitation and the increased credit limits, all of which were available for the 2021 tax year only. See page 1-31 for a discussion of the Earned Income Credit provisions for 2022.

Expiring at the end of 2022

The following tax provision will expire at the end of 2022:

- The flexible spending account carryover provisions in the ARPA expire at the end of 2022. See page 1-8 for a discussion of these rules.

 ©2022

OTHER INFLATION REDUCTION ACT PROVISIONS

HOMES RETROFIT REBATES

IRA ’22 provides $4.3 billion of funding to state governments to provide Home Owners Managing Energy Savings (HOMES) rebates to low- and moderate-income homeowners. The funds will be available for whole-house energy savings retrofit projects started after August 16, 2022 (the date of IRA ’22’s enactment) and completed by September 30, 2031. (IRA ’22 §50121(a) and (c)) The funds are also available to “aggregators,” but nowhere in the bill is that term specifically defined.

Comment

Although technically “available,” states will have to apply for these funds and set up systems to take applications and administer these funds, so it may be quite a while before these rebates are actually issued.

Tax issues

While this will undoubtedly provide welcome relief for most homeowners wanting to undertake these energy efficiency upgrades, it’s important to remember that these rebates are generally includable in gross income if paid directly to the homeowner/building owner. (IRC §61) However, they may not be includable in gross income if they are treated as a purchase price reduction. (See PLRs 9623035, 201027015, 199939021, 200142019, 200816027)

✎ **Practice Pointer**

At this stage, we will have to wait to see how these rebates will be paid and who they will be paid to before we can determine what the actual tax consequence may be. They will not be administered through an income tax filing as we saw for many of the COVID-19–related rebates.

Rebate amounts

For single family homes, the rebates cover 50% of the homeowner’s or aggregator’s retrofit costs if at least 35% of **“modeled energy”** system savings are achieved, up to a $4,000 maximum ($2,000 if the energy savings are more than 20% but less than 35%). (IRA ’22 §50121(c)(2)(A)(i))

Similar rebates are available for a home, or portfolio of homes, that achieves energy savings of not less than 15% of **“measured energy”** savings. In these cases, the rebate is equal to:

- $2,000 for a 20% reduction of energy use for the average home in the state; or
- 50% of the project cost.
  (IRA ’22 §50121(c)(2)(A)(iii))

Comment

The law does not address the difference between modeled energy and measured energy for the purposes of these rebates.

Also, unlike the rebate for modeled energy system savings, the rebate related to measured energy savings discussed immediately above does not limit the rebate to the lesser of $2,000 or 50% of the project cost.

Per-dwelling rebates are also available for efficiency upgrades of multifamily homes but are capped at $400,000 in aggregate ($200,000 if modeled energy savings are at least 20% and below 35%). (IRA ′22 §50121(c)(2)(B))

For measured energy savings that meet the 15% threshold, above, the same rebates discussed immediately above also apply on a per-dwelling unit basis.

These rebates are increased to up to 80% of project costs, with an $8,000 maximum, if at least 35% modeled energy system savings are achieved ($4,000 maximum if energy savings are more than 20% but less than 35%) for low- or moderate-income households, or for each unit in multifamily buildings with at least 50% of the units occupied by low- or moderate-income households. (IRA ′22 §50121(c)(2)(C)) Again, similar rebates are available for retrofits that attain measured energy savings of at least 15%.

A low- or moderate-income household is an individual or family whose total annual income is less than 80% of the median income of the area in which the individual or family resides. (IRA ′22 §50121(d)(3))

The following chart lists the 2021 80% of median income figures for an individual and a household of four in select cities.

80% of Median Income Figures		
City	**Individual**	**Family of four**
Chicago (2022)	$58,350	$83,500
Los Angeles (2021)	$66,250	$94,600
New York City (2022)	$74,720	$106,720
San Francisco (2021)	$74,600	$106,500

Comment

Geography-based tax and rebate provisions are often followed by online lookup tools created by the federal or state governments. Expect to see either the federal government or state agencies administering the HOMES rebates to create lookup tools to determine whether a taxpayer qualifies as a low- or moderate-income household based on where they live.

These low- and moderate-income household rebates may be increased by a state energy office if the office receives approval from the Secretary of Energy. (IRA ′22 §50121(c)(3))

Comment

These HOMES rebates cannot be combined with any other federal grant or rebate, including a rebate provided under a high-efficiency electric home rebate program for the same single upgrade. (IRA ′22 §50121(d)(7))

Contractor/aggregator rebates

Contractors performing a home energy efficiency retrofit, or an aggregator who has the right to claim a rebate, may also receive $200 for each home located in an underserved community that receives a rebate for the home energy efficiency rebate. (IRA ′22 §50121(b)(5))

HIGH-EFFICIENCY ELECTRIC HOME REBATES

States will also be awarded $4.275 billion in aggregate and Indian Tribes an additional $225 million in aggregate to provide high-efficiency electric home rebates to households equal to or below 150% of the area median income. The rebates will be available through September 30, 2031. (IRA ’22 §50122(a))

Eligible entities may receive rebates to purchase specified appliances under a qualified electrification project up to the following amounts:

- $1,750 for a heat pump water heater;
- $8,000 for a heat pump for space heating or cooling; and
- $840 for:
  - An electric stove, cooktop, range, or oven; or
  - An electric heat pump clothes dryer.

  (IRA ’22 §50122(c)(3)(A))

The following rebates may be used by eligible entities to purchase nonappliance upgrades under a qualified electrification project up to the following amounts:

- $4,000 for an electric load service center upgrade;
- $1,600 for insulation, air sealing, and ventilation; and
- $2,500 for electric wiring.
  (IRA ’22 §50122(c)(3)(B))

All the items above must be Energy Star certified and can be purchased:

- As part of new construction;
- To replace a nonelectric appliance; or
- As a first-time purchase with respect to that appliance.

Maximum rebate

The maximum total home-efficiency electric home rebates an eligible entity can receive is $14,000. (IRA ’22 §50122(c)(3)(C))

Limitations

The amount of rebate awarded for a qualified electrification project is limited to a specified percentage of costs depending upon who the "eligible entity" is, as follows:

- Low- and moderate-income households:
  - 100% of the cost for a household with annual income of less than 80% of the area median income; and
  - 50% of the cost for households with annual income of 80% to 150% of the area median income;
- Owners of multifamily buildings with at least 50% of residents who are low- or moderate-income households:
  - 100% of the cost if at least 50% of the resident households have annual incomes of less than 80% of the area median income; and
  - 50% of the cost if at least 50% of the resident households have annual incomes of less between 80% and 150%; and
- Governmental, commercial, or nonprofit entity carrying out a project on behalf of one of the entities above:
  - 100% or 50% depending upon the applicable household income levels as described above (reduced by any amount charged the individual household or building owners); plus
  - Up to $500 if the entity performs the installations.

Comment

These high-efficiency electric home rebates cannot be combined with any other federal grant or rebate, including a rebate provided under the HOMES rebate program for the same qualified electrification project.

2022–2023 PHASEOUT CHART

2022 AGI Phaseout (2023 in italics were changed from 2022)					
Provision	**IRC §**	**Joint return**	**Single**	**Head of household**	**Married filing separate**
Savings bond interest	135	$128,650–$158,650 *$137,800–$167,800*	$85,800–$100,800 *$91,850–$106,850*	$85,800–$100,800 *$91,850–$106,850*	None allowed
Social Security benefits	86(a)	(50%) $32,000 (85%) $44,000	(50%) $25,000 (85%) $32,000	(50%) $25,000 (85%) $32,000	$0 unless living apart
IRA deduction with pension	219(g)	$109,000–$129,000 *$116,000–$136,000*	$68,000–$78,000 *$73,000–$83,000*	$68,000–$78,000 *$73,000–$83,000*	$0–$10,000
IRA deduction with spouse covered	219(g)(7)	$204,000–$214,000 *$218,000–$228,000*	N/A	N/A	N/A
Roth IRA contribution	408A	$204,000–$214,000 *$218,000–$228,000*	$129,000–$144,000 *$138,000–$153,000*	$129,000–$144,000 *$138,000–$153,000*	$0–$10,000
Passive rental loss	469(i)	$100,000–$150,000	$100,000–$150,000	$100,000–$150,000	$50,000–$75,000
Student loan interest	221(b)(2)	$145,000–$175,000	$70,000–$85,000	$70,000–$85,000	None allowed
American Opportunity Tax Credit/Lifetime Learning Credit	25A	$160,000–$180,000	$80,000–$90,000	$80,000–$90,000	None allowed
AMT exemption phaseout	55(d)	$1,079,800 *$1,156,300*	$539,900 *$578,150*	$539,900 *$578,150*	$539,900 *$578,150*
Adoption Credit	23, 137	$223,410–$263,410 *$239,230–$279,230*	$223,410–263,410 *$239,230–$279,230*	$223,410–$263,410 *$239,230–$279,230*	None allowed
Retirement contribution 50% credit 20% credit 10% credit	25B	See page 1-34	See page 1-34	See page 1-34	See page 1-34

INVESTMENTS

SERIES I TREASURY BONDS

The interest rate on Series I U.S. savings bonds was set at 9.62% for the period May 1, 2022 through October 31, 2022 and is set at 6.89% for the period November 1, 2022, through April 30, 2023. When the rate hit 9.62%, Series I U.S. savings bonds started to generate a lot of buzz in the financial services world.

With the stock market still struggling throughout 2022 and interest rates rising, the prospect of receiving an inflation-protected guaranteed rate of return while inflation rates are so high is appealing to many. The interest rates paid on Series I bonds are adjusted every six months.

What is a Series I bond?

A Series I bond is a U.S. Treasury bond that earns interest based on both a fixed rate and a rate that is set twice a year based on inflation. The bond earns interest at an adjustable rate until it reaches 30 years or the holder cashes it in, whichever comes first.

The key benefits of Series I bonds include:

- Inflation protection because the rate is a combination of a fixed rate plus an inflation rate;
- Low risk because U.S. Treasury bonds are considered one of the safest investments possible;
- Interest income is exempt from state and local taxes;
- Interest income can be deferred up to 30 years;
- Interest is compounded semiannually; and
- If interest rates drop, taxpayers can redeem the bonds and invest their money into higher earning investments without penalties.

Series I bonds pay interest for up to 30 years and are generally not paid until the bond is redeemed.

Purchase limits

Investors can each buy up to $15,000 of I bonds annually ($10,000 electronic plus $5,000 paper if purchased with income tax refunds). (https://treasurydirect.gov/forms/savpdp0039.pdf) The limit is based on the purchaser's Social Security number. So, both spouses in a married couple can each purchase up to $15,000. Even children can purchase up to $15,000 (or the bonds can be purchased for them).

Series I bonds that are purchased electronically can come in any denomination, with a minimum $25 purchase. Paper bonds can only be purchased in one of five denominations: $50, $100, $200, $500, or $1,000.

Redemption

Series I bonds can be redeemed at most financial institutions. However, they are designed as long-term investments and generally cannot be redeemed during the first 12 months after purchase. There is an exception to the 12-month redemption rule where the taxpayer lives in an area affected by a disaster.

Using tax refunds

Taxpayers may use Form 8888, Allocation of Refund (Including Savings Bond Purchases), to purchase up to $5,000 in Series I bonds using their income tax refund. Series I bonds are the only type of U.S. Treasury bonds that can be purchased directly with an income tax refund.

Form 8888 can be used to direct refunds to purchase Series I bonds for the taxpayer or anyone else, such as children or grandchildren. Taxpayers who direct all or a portion of their refund to purchasing Series I bonds can expect to receive a paper bond in the mail within three weeks of the IRS processing their income tax return.

The IRS's webpage dedicated to using an income tax refund to buy Series I bonds contains helpful FAQs on the topic and can be found at:

Website
www.irs.gov/refunds/
now-you-can-buy-us-series-i-savings-bonds-for-anyone-with-your-tax-refund

Education planning with Treasury bonds

Series I savings bonds (as well as Series EE bonds) have an education exclusion that permits qualified taxpayers to exclude from their gross income all or a part of the interest paid on redemption of their bonds when the bond owner pays qualified higher education expenses at an eligible institution. (IRC §135) The exclusion is calculated on Form 8815, Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989, and reported on Schedule B (Form 1040), line 3.

"Qualified higher education expenses" include tuition and fees required for enrollment or attendance as well as contributions to a Coverdell education savings account (Coverdell ESA) or a qualified tuition program (QTP), such as a §529 college savings account.

The income exclusion is available if all of the following apply:

- The bonds were cashed in the same tax year for which the exclusion is claimed;
- The qualified higher education expenses were paid for by the taxpayer, spouse or dependents;
- The taxpayer's filing status can't be married filing separate;
- The taxpayer's modified AGI was less than:
  - $100,800 if filing single, head of household, or qualifying widow(er); or
  - $158,650 if married filing joint; and
- The taxpayer was at least 24 years old when their savings bonds were issued.

The age requirement for the interest income exclusion can be confusing. It's the taxpayer claiming the exclusion who must have been at least 24 years old when their savings bonds were issued.

Example of interest exclusion age requirement

Mel owns two Series I Treasury bonds with a face value of $10,000 each. The first bond was purchased by Mel's parents on his behalf before he was 24 years old, and he purchased the other one when he was 25 years old.

Mel is 35 years old now. He redeemed the bonds and contributed the proceeds into a §529 college savings account for his daughter.

Mel can exclude the interest income from the bond he purchased when he was age 25 from his gross income, but he cannot exclude the interest income from the bond that his parents purchased for him when he was under the age of 24. Mel will report the interest income exclusion on Form 8815.

TAXATION OF CRYPTOCURRENCY/NFTs/DeFi

Cryptocurrencies (aka virtual currencies) and the tax issues surrounding them are still a rapidly growing field. The issue burst onto the scene when Bitcoin was created in 2009. The IRS issued some guidance in 2014 but has issued minimal precedential guidance since that time.

Tax professionals can look at the limited guidance as a good thing because the entire body of IRS guidance is not burdensome to digest. However, it can also be a bad thing because tax professionals may be required to make judgment decisions where a guidance gap exists.

Key terms related to cryptocurrency

Airdrop: An airdrop for a cryptocurrency is a procedure of distributing tokens by awarding them to existing holders of a particular blockchain currency, such as Bitcoin or Ethereum. In the United States, the practice has raised questions about tax liabilities and whether they amount to income or capital gains.

Blockchain: A blockchain is a continuously growing list of records, called blocks, which are linked and secured using cryptography. Each block typically contains a cryptographic hash of the previous block, a timestamp, and transaction data. By design, a blockchain is inherently resistant to modifications of the data.

Cryptocurrency: A cryptocurrency is a digital asset designed to work as a medium of exchange that uses cryptography to secure its transactions, to control the creation of additional units, and to verify the transfer of assets. Cryptocurrencies are a form of digital currencies, alternative currencies, and virtual currencies. Cryptocurrencies use decentralized control as opposed to centralized electronic money and central banking systems.

Cryptocurrency address: A cryptocurrency address is an identifier of 26–35 alphanumeric characters, beginning with the number 1 or 3, that represents a possible destination for a bitcoin payment. Addresses can be generated at no cost by any cryptocurrency user.

DeFi: Decentralized finance (aka DeFi) uses emerging technology, similar to those used by cryptocurrencies, that is based on secure distributed ledgers. DeFi takes banks and other financial companies and their associated fees out of the transaction. Users keep their money in a digital wallet rather than a bank account. DeFi utilizes stablecoins rather than more volatile cryptocurrencies such as Bitcoin.

Digital currency exchanges: Cryptocurrency exchanges or digital currency exchanges (DCE) are businesses that allow customers to trade cryptocurrencies or digital currencies for other assets, such

as conventional fiat money or different digital currencies. They can be market makers that typically take the bid/ask spreads as transaction commissions for their services or simply charge fees as a matching platform.

Digital wallet: A digital wallet refers to an electronic device that allows an individual to make electronic transactions. This can include purchasing items online with a computer or using a smartphone to purchase something at a store. A cryptocurrency wallet is a digital wallet where private keys are stored for cryptocurrencies.

Hard fork: A hard fork occurs when a blockchain splits into two incompatible separate chains. This is a consequence of the use of two incompatible sets of rules trying to govern the system.

Initial coin offering: An initial coin offering (ICO) is a means of crowdfunding centered around cryptocurrency, which can be a source of capital for startup companies. In an ICO, a quantity of the crowdfunded cryptocurrency is preallocated to investors in the form of "tokens," in exchange for legal tender or other cryptocurrencies. These tokens supposedly become functional units of currency if or when the ICO's funding goal is met and the project launches.

Mining virtual currency: In cryptocurrency networks, mining is a validation of transactions. For this effort, successful miners obtain new cryptocurrency as a reward. The reward decreased transaction fees by creating a complementary incentive to contribute to the processing power of the network.

Nonfungible tokens (NFTs): NFTs are unique cryptographic tokens that exist on a blockchain and cannot be replicated. They typically represent items such as artwork, music, etc.

Stablecoins: Stablecoins are cryptocurrencies that attempt to peg their market value to some external reference such as the U.S. dollar or gold. They are designed to reduce volatility relative to unpegged cryptocurrencies such as Bitcoin.

Staking: Staking offers crypto holders a way of putting their digital assets to work and earning passive income without needing to sell them, similar to putting your money in a high-yield savings account. When an individual stakes their digital assets, they lock up the coins in order to participate in running the blockchain and maintaining its security. In exchange, the individual earns rewards calculated in percentage yields.

Cryptocurrency FAQs

The IRS has a webpage dedicated to cryptocurrency FAQs addressing various scenarios, many of which are discussed in these materials. The full FAQs are available at:

Website
www.irs.gov/individuals/international-taxpayers/
frequently-asked-questions-on-virtual-currency-transactions

Initial crypto reporting guidance

In 2014, the IRS issued its first guidance on cryptocurrencies and stated that they must be treated as property, not currency. (Notice 2014-21) This means most transactions involving cryptocurrencies must be evaluated to determine whether there is a gain or a loss, and more specifically, whether there is a capital gain or loss.

The IRS has also taken the following positions:

- Wages paid to employees using cryptocurrency are taxable to the employee, must be reported on a W-2, and are subject to federal income tax withholding and payroll taxes (see page 1-67 for a more complete discussion of paying employees with cryptocurrency);
- Payments made to independent contractors using cryptocurrency are taxable, and the self-employment tax rules apply. In addition, payers must issue a Form 1099-NEC, and the independent contractor's basis in the cryptocurrency is the FMV of the cryptocurrency on the date it is received;
- A taxpayer who mines cryptocurrency realizes taxable income, and if the taxpayer is involved in the trade or business of mining, then the income is subject to self-employment tax;
- Disposition of the cryptocurrency is reported on Schedule D and Form 8949, Sales and Other Dispositions of Capital Assets, or Form 4797, Sales of Business Property;
- The character of gain or loss from the sale or exchange of cryptocurrency depends on whether the cryptocurrency is a capital asset in the hands of the taxpayer; and
- A payment made using cryptocurrency is subject to information reporting and backup withholding in the same manner as any other payment made in property.
  (Notice 2014-21; IRS Frequently Asked Questions on Virtual Currency Transactions, available at: www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions)

Accepting crypto as payment

Taxpayers who accept cryptocurrencies as a form of payment in their business must recognize ordinary income equal to the fair market value of the cryptocurrency on the date it is received. (IRS FAQs #9, #12, and #13)

Getting a little more technical, IRC §83 governs the tax rules for property transferred in connection with the performance of services. In its simplest form, IRC §83(a) provides that if an employee receives something of value (other than cash or a cash equivalent) in exchange for their services (the work they perform as an employee or contractor), then they must recognize ordinary income equal to the fair market value of the property they received. We will illustrate this point in the next example discussing nonfungible tokens.

Nonfungible tokens (NFTs)

Nonfungible tokens (NFTs) in their most basic form are digital property: a work of art, video file, audio file, etc., and even virtual real estate. This is a simplified definition of NFTs because they can take many forms and have many variations, so much so that the IRS has yet to formally define an NFT. If you think that a digital picture can't have much value, then consider that the most expensive digital work ever sold was sold in March 2021 for $69.3 million. (www.npr.org/2021/03/11/976141522/beeple-jpg-file-sells-for-69-million-setting-crypto-art-record)

Taxing NFT transactions

Like cryptocurrencies such as Bitcoin and Ethereum (or Ether as the Ethereum tokens are called), NFTs are digital assets. NFTs likewise use blockchain technology to identify and store the digital asset and track its origin and history.

However, unlike cryptocurrencies, NFTs themselves are not mediums of exchange. In this respect, an NFT is less likely to be paid to an employee for compensation for services or used to purchase goods at a retailer.

 ©2022

To add another wrinkle, NFTs are almost exclusively sold in exchange for cryptocurrency, which inserts cryptocurrency complexities into the transaction.

Example of commingled NFT and cryptocurrency transactions

Franco has a sole proprietorship consulting business and accepts Bitcoin and Ether as forms of payment in exchange for his services. Franco received 10 Ether tokens in exchange for services on January 5, 2022. The tokens had a fair market value of $2,604 each on the date he received them, which becomes his basis per token. At the end of the year, the payor should issue Franco a 1099-NEC for $26,040 (10 Ether tokens × $2,604 each).

On February 28, 2022, Franco purchased a digital artwork NFT with five of the tokens at a time when they were valued at $2,621 per token. Franco has a taxable gain on the purchase of the NFT because he is deemed to have sold the Ether tokens. (IRS Notice 2014-21)

Franco's taxable gain on the purchase of his NFT is calculated as follows:

Sale price ($2,621 × 5 tokens)	$13,105
Less: basis in five Ether tokens ($2,604 × 5)	- 13,020
Short-term capital gain	$ 85

Franco's basis in his NFT is $13,105 ($2,621 Ether value on purchase × five tokens). On April 6, 2022, Franco sold the NFT for six Ether tokens at a time when the tokens were valued at $3,207 each.

Franco's gain on the sale of his NFT is calculated as follows:

Sale price ($3,207 × 6 tokens)	$19,242
Less: basis in the NFT	- 13,105
Short-term capital gain	$ 6,137

Franco now has two lots of Ether with different basis:

- **Lot 1:** Consists of the remaining five tokens he acquired through the performance of services with a basis of $13,020 ($2,604 value at the time he received them in exchange for services × five tokens);
- **Lot 2:** Consists of the six tokens received in exchange for the NFT. The basis of the second lot is $19,242 ($3,207 value on the sale of the NFT × six tokens).

In the example, Franco is not in the trade or business of buying and selling NFTs. If a taxpayer is in the trade or business of buying and selling NFTs, then the NFTs they purchase are classified as inventory, and the sales are classified as ordinary income reportable on Schedule C and subject to self-employment taxes.

Paying employees in cryptocurrency

Employers must consider the consequences of paying employees in cryptocurrency before doing so. Paying an employee directly in cryptocurrency is different than using a cryptocurrency exchange, where anyone paid in U.S. dollars can have the funds converted into cryptocurrency before the funds are deposited into their account, as NFL quarterback Aaron Rodgers and New York City Mayor Adams have done.

Wages must be paid in cash or its equivalent

Under the Fair Labor Standards Act (FLSA), payment of wages (including overtime compensation) must be made "in cash or negotiable instrument payable at par" ("payable at par" means payable at

face value). (29 USC §203(m)(1); 29 CFR §531.27) The Department of Labor (DOL) has not yet specifically opined on the concept of paying wages with cryptocurrency, but in a recent comment by the DOL Office of Public Affairs, the department emphasized that "whether in cash or facilities, wages must be paid finally or unconditionally, or free and clear." (29 CFR §531.35)

And in a 2006 opinion letter, the DOL addressed paying employees with foreign currency in combination with U.S dollars. The DOL accepted this arrangement where the foreign currency was exchanged into U.S. dollars using the exchange rate in the vicinity of where the employee was working at the time of the payment. Again, it's important for employers to understand that the DOL has not commented on whether cryptocurrency is considered "a negotiable instrument payable at par."

However, according to the IRS FAQs on cryptocurrency, remuneration paid in cryptocurrency to an employee in exchange for services constitutes wages for federal employment tax purposes. (www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions, FAQ #11)

State laws may prohibit

Notwithstanding the DOL's silence on this issue, states also have laws regarding how employees may be paid, and those laws may not be favorable to paying employees with cryptocurrency. For example, in Washington, wages must be provided at no cost to the employee; if there were a fee for converting cryptocurrency into dollars, the employer would have to bear that burden. Another example is Illinois, which requires that wages be paid in "lawful money of the United States."

Volatility could violate minimum wage laws

As we've seen since its inception, cryptocurrency has the potential to drastically fluctuate in value. With strict laws governing minimum wage and overtime compliance, these swings could cause employers to violate minimum wage laws, even if unintentionally.

Cryptocurrency wages — from the employee's standpoint

Employees who receive cryptocurrency in exchange for their services as an employee receive basis in the cryptocurrency equal to the taxable wages received. (IRC §83(a))

Example of cryptocurrency received as wages

Gwen is an employee working as an internet marketing consultant. Her employer pays its employees in Bitcoin. Gwen is paid the equivalent of 35 USD an hour for the work she does. She worked 80 hours in her last pay period. On her pay date, the value of one Bitcoin was $29,194. The amount of cryptocurrency received as gross wages is calculated as follows:

Gwen's hourly rate	$ 35.00
Hours worked	× 80
Gross pay in USD	2,800
Value of cryptocurrency to be paid in (Bitcoin)	÷ $29,194
Units of cryptocurrency received (Bitcoin, in this case)	0.09591012

If Gwen converts her Bitcoin received from her employer into U.S. dollars five days later when the value of a single Bitcoin has dropped to $28,500, then Gwen will recognize a short-term capital loss, calculated as follows:

Bitcoin units sold	0.09591012
Value of Bitcoin	× $28,500
Gross proceeds from sale of Bitcoin	2,733
Basis in Bitcoin units (Gross taxable wages received by Gwen)	- 2,800
Short-term capital loss	$ 67

Cryptocurrencies and wash sale rules

While your clients are understandably not happy to see the value of their cryptocurrency investments plunge, in some instances, this can provide an opportunity for them to harvest losses and offset some, if not all, of their taxable income.

And because the only real guidance we have from the IRS is that cryptocurrency is property and not a security, the wash sale rules do not apply (at least currently). (IRS Notice 2014-21) This means taxpayers wishing to harvest tax losses from the drops in the cryptocurrency market may be able to do so without having to comply with the 30-day wash sale period.

Under the wash sale rules, taxpayers who sell stocks and then purchase other substantially similar stocks within 30 days of the sale date may not claim a loss on their stock sale. (IRC §1091) Rather, the loss amount is added into the computation of the new stock's basis.

Example of wash sale rules

Mo purchases 50 shares in Lost Ark, Inc. on May 1, 2022, for $10,000. On May 15 he sold the shares for $8,000, realizing a loss of $2,000. Five days later he bought another 100 shares of Lost Ark for $7,500.

Because the new stocks were purchased prior to the end of the 30-day period, Mo may not deduct a $2,000 loss. Rather, the basis in the newly acquired stock is increased to $9,500 ($7,500 purchase price + $2,000 loss). This results in Mo not benefiting from the loss incurred in selling his initial shares until the newly purchased stock is sold.

☑ Planning Pointer

Taxpayers who recognized large capital gains in 2022 on the tail of the latest real estate boom can offset those gains against cryptocurrency losses.

Because the wash sale rules do not currently apply to cryptocurrency transactions, cryptocurrency owners can sell their cryptocurrency at a loss, lock in the loss amount to apply against the taxpayer's other capital gain, and then turn around and purchase the same cryptocurrency at the reduced rate, without having to wait 30 days to do so.

Wash sale rule proposals

President Biden and other legislators have proposed expanding the wash sale rules to apply to cryptocurrency transactions, but nothing has been codified or introduced into passable legislation yet.

Cryptocurrency accounting methods

If cryptocurrency is a capital asset in the taxpayer's hands (as it is for the vast majority of taxpayers), then gains and losses from cryptocurrency transactions are classified as capital gains and losses.

Key to determining whether a loss is a short-term or long-term capital loss is the cost-basis method chosen by the taxpayer. The IRS has stated through its cryptocurrency FAQs that taxpayers can use the specific identification method, but only if the taxpayer can specifically identify which crypto assets are being sold. (IRS Frequently Asked Questions on Virtual Currency Transactions, FAQ #39. Available at: www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions)

Taxpayers who can't specifically identify which crypto assets are being sold must use the default first-in, first-out (FIFO) accounting method. The FIFO method will produce a more unfavorable result than the specific identification method because the oldest assets are generally the ones with the lowest basis.

Specific identification requirements for cryptocurrency

The IRS FAQs state that a taxpayer may identify a specific unit of virtual currency either by documenting the specific unit's unique digital identifier, such as a private key, public key, and address, or by records showing the transaction information for all units of a specific virtual currency, such as Bitcoin, held in a single account, wallet, or address. (IRS Frequently Asked Questions on Virtual Currency Transactions, FAQ #40. Available at: www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions)

This information must show:

- The date and time each unit was acquired;
- The basis and the fair market value of each unit at the time it was acquired;
- The date and time each unit was sold, exchanged, or otherwise disposed of; and
- The fair market value of each unit when sold, exchanged, or disposed of, and the amount of money or the value of property received for each unit.

Answering the cryptocurrency question on the 1040

Starting with the 2019 tax year, taxpayers must affirm on their income tax return whether they had virtual currency transactions. The question first appeared on Schedule 1 but was subsequently

moved to the top of page 1 of the Form 1040. The wording has also changed slightly and currently states (on the draft 2022 return):

"At any time during 2022, did you: (a) receive (as a reward, award, or compensation); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)"

Through FAQs, the IRS has stated that if a taxpayer's only transaction involving cryptocurrency during were purchases of cryptocurrency with real currency, then the taxpayer does not have to answer "yes" to the question on the Form 1040. (FAQ #5, IRS Frequently Asked Questions on Virtual Currency Transactions, available at: www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions)

The IRS's FAQ makes sense because there is no potential taxable property-like transaction when the taxpayer only buys the cryptocurrency with real currency.

The IRS has also indicated that there is no income recognized when a taxpayer receives a gift of virtual currency or when a taxpayer simply exchanges virtual currency between digital wallets, accounts, or addresses all held by the taxpayer. However, the IRS did not specifically address whether the taxpayer would check the "yes" or "no" box in these situations. It might be safest to check the "yes" box with a statement attached in this situation.

Cryptocurrencies and 401(k)s

On March 10, 2022, the Department of Labor issued guidance to 401(k) plan administrators considering cryptocurrency options for plan participants. The DOL's guidance warned 401(k) plan administrators to exercise extreme care before adding cryptocurrency options to their plan's investment menu for plan participants, stating:

Under ERISA, fiduciaries must act solely in the financial interests of plan participants and adhere to an exacting standard of professional care. Courts have commonly referred to these prudence and loyalty obligations as the "highest known to the law." ***Fiduciaries who breach those duties are personally liable for any losses to the plan resulting from that breach [emphasis added].*** *A fiduciary's consideration of whether to include an option for participants to invest in cryptocurrencies is subject to these exacting responsibilities.*

At this early stage in the history of cryptocurrencies, the Department has serious concerns about the prudence of a fiduciary's decision to expose a 401(k) plan's participants to direct investments in cryptocurrencies, or other products whose value is tied to cryptocurrencies. These investments present significant risks and challenges to participants' retirement accounts, including significant risks of fraud, theft, and loss.

The DOL's strongly worded guidance appears to indicate that the department would support a plan administrator being held personally liable if a plan participant loses money invested either directly in virtual currencies or in funds whose value is tied to virtual currencies. The DOL release can be found at:

Website
www.dol.gov/agencies/ebsa/employers-and-advisers/
plan-administration-and-compliance/compliance-assistance-releases/2022-01

Crypto staking hitting the courts

Taxpayers who filed a complaint seeking a refund for overpaid tax stemming from cryptocurrency tokens that shouldn't have been reported as income have rejected the refund and are instead holding

out for an official ruling on the matter. (***Jarrett v. United States of America***, U.S. District Court, Middle District of Tennessee, Nashville Division, filed May 26, 2021)

The taxpayers paid $3,293 in tax on 8,876 Tezos tokens that they created through the staking process during 2019. Staking involves employing existing tokens and computer processing power to create new blocks on the blockchain in exchange for more tokens. The tokens are not the same as crypto coins. However, the taxpayers did not convert the tokens into cryptocurrency or other currency, and they did not sell any tokens. Because the tokens were not income in 2019, the taxpayers were entitled to a refund. (IRC §§6532, 7422)

The IRS agreed and sent the taxpayers a refund, which they rejected. They released a statement saying that "[U]ntil the case receives an official ruling from a court, there will be nothing to prevent the IRS from challenging again on this issue." (www.proofofstakealliance.org/wp-content/uploads/2022/02/Joshua-Jarrett-Statement-Feb-3-2022.pdf)

The Department of Justice Tax Division filed a motion to dismiss, stating that the taxpayers could not refuse the refund because it had already been delivered, and the issue is now moot.

The complaint and resulting refund, however, should not be interpreted as guidance from the IRS as to when the proceeds from the staking process are taxable. The IRS has not updated its existing guidance on cryptocurrency or the instructions for reporting virtual currency transactions.

Update on expanded reporting requirements

The Infrastructure Investment and Jobs Act (IIJA; P.L. 117-58) expanded information reporting requirements to apply to cryptocurrencies beginning January 1, 2023. The act expands the definition of brokers that must furnish Forms 1099-B to include businesses that are responsible for regularly providing any service accomplishing transfers of digital assets on behalf of another person, such as any platform on which cryptocurrency is bought or sold.

Comment

While the 1099-B reporting for virtual currency transactions does not officially go into effect until 2023 transactions, which are reported in early 2024, many virtual currency platforms such as Coinbase and Robinhood provided 2021 year-end reporting statements that bear a striking resemblance to the 1099-B forms issued by other brokerage companies.

Perhaps these year-end reporting statements were created in preparation for the forthcoming 1099-B reporting requirements.

The IIJA also expands the $10,000 cash transaction reporting requirement via Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business, to digital asset transactions, and defines a "digital asset" as any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology, which includes most cryptocurrencies and potentially some nonfungible tokens. (IRC §6050I)

The expansion of the Form 8300 filing requirements for cryptocurrencies is effective for returns required to be filed after December 31, 2023. (IRC §6050I(d)(3))

 ©2022

Practice Pointer

Note that the language from IRC §6050I(d)(3) states "returns required to be filed after December 31, 2023." Form 8300 must be filed by the 15th day after the date cash or cryptocurrencies are received exceeding $10,000. This means that the IIJA's expanded reporting requirements take effect for transactions on or after December 17, 2023 (15 days before January 1, 2024).

Even though the reporting requirements for cryptocurrency transactions don't go into effect until 2024, it's a good idea to start having early discussions with clients about these requirements if they are considering accepting cryptocurrency payments in their trade or business.

Form 8300 filing requirements

Form 8300 must be filed by any taxpayers engaged in a trade or business and who, in the course of the trade or business, receives more than $10,000 in cash or virtual currencies in one transaction (or two or more *related* transactions). (IRC §6050I(a)) Any transactions conducted between the same two parties in a 24-hour period are automatically deemed to be related transactions. However, transactions that occur more than 24 hours apart can also be considered related transactions depending on the facts and circumstances — for example, multiple payments made for the sale of a single item.

Form 8300 is not required if the cash or virtual currencies are received:

- By a financial institution required to file FinCEN Report 112, BSA Currency Transaction Report;
- By a casino required to file (or exempt from filing) FinCEN Report 112;
- By an agent who receives the cash from a principal, and the agent uses all of the cash or virtual currency within 15 days in a second transaction that is reportable on either Form 8300 or on FinCEN Report 112;
- In a transaction occurring entirely outside the United States; or
- In a transaction that is not in the course of the taxpayer's trade or business.
  (Form 8300 instructions)

Form 8300 must be filed by the 15th day after the date the cash or virtual currencies were received. If the 15th day falls on a weekend or legal holiday, then the form must be filed the next business day.

To access our cryptocurrency reporting client letter, go to:

Website
www.caltax.com/cl-vcreporting

Expanded crypto reporting likely won't affect miners

The crypto industry expressed concern over the expanded 1099 reporting changes made by the IIJA because of the tax reporting burdens placed on crypto miners and stakers, who typically don't deal with customers and therefore don't have access to the information they would be required to report. ("Staking" is a way of earning rewards for holding certain cryptocurrencies. Certain cryptocurrencies (like Tezos, Cosmos, and Ethereum) allow holders to "stake" some of their holdings and earn a percentage-rate reward over time).

The Treasury also plans to issue regulations to define "broker" and will analyze traditional securities versus digital assets.

IRS crackdown on cryptocurrency underreporting

Cryptocurrency reporting (or more appropriately, the lack thereof) has graced the IRS's Dirty Dozen list. The proliferation of digital assets across the world in the last decade or so has created tax administration challenges regarding digital assets, in part because there is an incorrect perception that digital asset accounts are undetectable by tax authorities. Taxpayers who fail to report transactions involving digital assets expose themselves to civil fraud penalties and criminal charges.

Compiled annually, the IRS's "Dirty Dozen" lists a variety of common scams that taxpayers may encounter anytime, but many of the schemes peak during filing season. The IRS's Dirty Dozen are often the subject of press releases warning taxpayers of these scams and are high audit targets for the IRS. Just because a transaction appears on the Dirty Dozen list doesn't make it *per se* fraudulent — rather it can simply mean that it's a topic where the fraud rate is very high.

ESTATE, TRUST, AND GIFT TAXES

UNIFIED EXCLUSION AMOUNT

The 2022 unified exclusion amount is $12.06 million. (Rev. Proc. 2021-45) The 2023 amount is $12.92 million. (Rev. Proc. 2022-38) For decedents dying and gifts made after 2025, the basic exclusion amount is scheduled to revert back to $5 million (adjusted for inflation after 2011).

Planning for a reduced exclusion

Due to the fact that the unified exclusion is scheduled to revert back to $5 million (plus inflation from 2011) after 2025, the IRS issued final regulations in 2019 to provide an anti-clawback rule so that individuals taking advantage of the increased gift and estate tax exclusion amounts currently in effect will not be adversely impacted when the exclusion amount is reduced. (IR-2019-189; Treas. Regs. §§20.2010-1, 20.2010-3; TD 9884)

The potential problem

The temporary increase in the unified estate exclusion amount contained in the TCJA generated questions about what will happen if individuals made gifts in excess of $5 million but die after 2025 when the exclusion amount is decreased.

For purposes of calculating estate tax at an individual's death, lifetime exclusion gifts are added back into the estate, and the estate tax is based on the total of the gifts plus any remaining assets.

 ©2022

Example of taxable estate

Anoush made lifetime gifts of $10 million to his children, filed gift tax returns when required, and applied $10 million of his exclusion amount to those gifts. As a result, no gift tax was paid on any of the transfers.

At Anoush's death in 2022, he had $4 million in assets remaining. His estate tax will be approximately $776,000.

Lifetime gifts	$10,000,000
Remaining assets at death	4,000,000
Taxable estate	14,000,000
Exclusion amount	(12,060,000)
Subject to estate tax	1,940,000
Estate tax (40%)	$ 776,000

If the individual dies after the exclusion is reduced, under this basic calculation, the decreased exclusion amount could greatly increase the estate tax liability.

Example of death after exclusion reduced

Assume the facts are the same as the previous example, except that at Anoush's death, the lifetime exclusion is $5.75 million ($5 million with an estimated adjustment for inflation). Without regard to the relief provided in the regulations, his estate tax would be approximately $3.3 million, assuming a 40% tax rate at the time of his death.

Lifetime gifts	$10,000,000
Remaining assets	4,000,000
Taxable estate	14,000,000
Exclusion amount	(5,750,000)
Subject to estate tax	8,250,000
Estate tax (40%)	$ 3,300,000

The fix provided in the regulations

The final regulations issued in 2019 provide a special rule that allows the estate to compute its estate tax credit using the higher of the exclusion applicable to gifts at the time the gifts are made or the exclusion applicable on the date of death. (Treas. Regs. §20.2010-1(c))

Example of death after exclusion reduced, with regulations fix

Once again, assume the facts are the same as the previous example, except that Anoush's estate applies the fix provided in the regulations. Remember, at Anoush's death, he has $4 million in assets remaining and the lifetime exclusion is $5.75 million. His estate tax will be approximately $1.6 million, assuming a 40% tax rate at the time of his death.

Lifetime gifts*	$10,000,000
Remaining assets	4,000,000
Taxable estate	14,000,000
Exclusion amount*	(10,000,000)
Subject to estate tax	4,000,000
Estate tax (40%)	$ 1,600,000

* Higher of the exclusion applicable to gifts at the time the gifts were made ($10 million) or the exclusion applicable at the time of death ($5.75 million)

Without the fix provided in the regulations, it's possible that taxpayers could end up with a tax liability greater than the assets remaining in their estate, as the following example illustrates.

Example of estate tax greater than assets

Jocelyn made a gift of $11 million to her daughter in 2018, when the exclusion amount was $11.18 million. She applied $11 million of her exclusion amount to the gift, and no gift tax was paid on the transfer.

Jocelyn dies in 2026, when the exclusion amount is reduced to $5.75 million, and she has $2 million of assets remaining in her estate. Without the fix provided in the regulations her estate tax would be approximately $3.3 million.

Lifetime gifts	$11,000,000
Remaining assets	2,000,000
Taxable estate	13,000,000
Exclusion amount	(5,750,000)
Subject to estate tax	7,250,000
Estate tax (40%)	$ 2,900,000

The result would be an estate tax liability that exceeds the assets remaining in the estate.

Applying the exclusion amount used during her lifetime reduces the estate tax lability to $800,000 (($13 million estate - $11 million exclusion) × 40%).

2022 proposed regulations limit 2019 relief

The IRS has issued a proposed regulation (REG-118913-21) that provides an exception to the gift and estate tax basic exclusion amount special anti-clawback rule. (TD 9884; Treas. Regs. §20.20101(c)) Unfortunately, the proposed regulations apply limitations that were not originally anticipated. This could create significant estate tax liabilities for some advanced gifting strategies.

Exceptions to the rule

It was clear the anti-clawback rule applies to completed gifts made during the donor's lifetime. However, the IRS stated at the time the 2019 final regulations were adopted that it would provide additional guidance that would provide exceptions to the anti-clawback rules where a donor makes a gift during his or her lifetime but still retains significant beneficial use, enjoyment, or control of the transferred property.

The 2022 proposed regulations officially create the IRS's exceptions to the anti-clawback rule. The proposed regulations provide that the anti-clawback rules do not apply to various transfers includable in the decedent's gross estate, including but not limited to:

- The following transfers includible in the decedent's gross estate, even if a charitable deduction or spousal deduction was claimed:
    - Near-death transfers (made within three years of the decedent's death) (IRC §2035);
    - Transfers with a retained life estate (IRC §2036);
    - Transfers taking effect at death or conditioned upon surviving the decedent (IRC §2037);
    - Revocable transfers (IRC §2038); and
    - Life insurance policies on the decedent's life over which the decedent retained certain incidents of ownership (IRC §2042);
- Transfers made by an enforceable promise (e.g., a promissory note) to the extent they remain unsatisfied at death; and
- Transfers of certain applicable retained interests in:
    - Corporations or partnerships (e.g., intrafamily equity interest transfers where the decedent still retains certain rights such as determining whether a distribution will be made); or
    - Certain trusts (e.g., grantor retained annuity trusts and qualified personal residence trusts).

The exceptions to the anti-clawback rule apply even if transfers described above are actually "completed" within 18 months of the donor's date of death, meaning that the decedent no longer had the use, enjoyment, or control of the property during the last 18 months of his or her life. In this case, the basic exclusion amount in effect on the decedent's date of death will apply.

Example of treatment of gift of promissory note

In 2022, Alberto made a completed gift of a promissory note of $9 million to his daughter Mikhaila, which was unpaid at the time of Alberto's death.

Alberto died after 2025. At the time of his death, the basic exclusion amount is $6.8 million. The exclusion applied on his estate tax return is limited to $6.8 million, even though at the time the promissory note was issued the exclusion amount was $12.06 million.

Exceptions to the exception

The anti-clawback rules will still apply, even to the type of transfers described above, to:

- Gifts that are not material, meaning that the taxable amount is 5% or less of the total amount of the transfer, valued as of the date of the transfer; and
- Transfers, relinquishments, or eliminations made within the last 18 months of the decedent's life if the transfer, relinquishment, or elimination occurred as a result of the termination of a durational period described in the original transfer by either the mere passage of time or the death of any person (e.g., the complete transfer will occur at the end of a five-year period or the death of the decedent's spouse).

Effective date

The proposed regulations, if adopted as final regulations, would be applicable to the estates of decedents dying on or after April 27, 2022. This means that if the basic exclusion amount is reduced prior to 2026 and these proposed regulations are adopted, then the reduced exclusion amount will apply to decedents who die after April 26, 2022.

DSUE PORTABILITY ELECTION

Estates that are filing an estate tax return only to make a portability election now have five years from the date of the decedent's death to make the election without having to pay any fee, effective July 8, 2022. (Rev. Proc. 2022-32) Previously, estates that had no filing requirement because of having gross income below the filing threshold could make an election within two years of the decedent's death.

Revenue Procedure 2022-32 supersedes Revenue Procedure 2017-34, which allowed the two-year filing period. The IRS determined that many otherwise eligible estates failed to make the election within the two-year period and therefore were filing private letter rulings to obtain an extension (at a cost of at least $10,000 just for the IRS user fee (aka filing fee)), placing a significant burden on overstretched IRS staff as well as the estate's bank account. By extending the period to five years, the IRS anticipates that it will dramatically reduce the number of private letter rulings being submitted.

Any private letter ruling requests currently pending will be closed, and the user fee will be refunded. Estates should then file their estate tax return (Form 706) within the five-year filing period prescribed under Revenue Procedure 2022-32.

Which estates qualify

To qualify for the simplified extension process, the following requirements must be met:

- The decedent must:
  - Be survived by a spouse;
  - Have died after December 31, 2010; and
  - Have been a citizen or resident of the United States on the date of death;
- No estate tax return is required under IRC §6018(a) based on the gross value of the estate and adjusted taxable gifts, without regard of the need to file for portability purposes;
- The executor did not file a timely estate tax return;
- The executor must file a properly prepared Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, on or before the fifth annual anniversary of the decedent's date of death; and
- State at the top of Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER IRC §2010(c)(5)(A)."

Practice Pointer

If a Form 706 is filed pursuant to Rev. Proc. 2022-32, then an extension request is not required. The estate is only required to file the Form 706 based on the requirements listed immediately above in order to receive the extension.

Practice Pointer

If a Form 706 is being filed only to elect portability, the IRS Form 706 instructions state that a complete Form 706 must be filed. However, estimated assets values are permitted. Under Treas. Regs. §20.2010-2(a)(7)(ii), if the total value of the gross estate and adjusted taxable gifts is less than the basic exclusion amount (see §6018(a)) and Form 706 is being filed only to elect portability of the DSUE amount, the estate is not required to report the value of certain property eligible for the marital or charitable deduction.

For the property being reported on Schedules A, B, C, D, E, F, G, H, and I, the executor must figure their best estimate of the value.

ANNUAL GIFT TAX EXCLUSION

For 2022, the annual gift tax exclusion is $16,000. (Rev. Proc. 2021-45) For 2023, the exclusion is $17,000. (Rev. Proc. 2022-38)

Superfunding IRC §529 accounts

Taxpayers can make yearly contributions up to the annual gift tax limit ($16,000 in 2022) without the need to file gift tax returns; however, there is an option to place up to five years' worth of the annual gift limit in a §529 account in one year and spread that contribution across five years. This amount is $80,000 using the 2022 gift limit ($16,000 × 5). Taxpayers can make this election for as many separate people for whom §529 plan contributions were made.

There is no immediate federal tax benefit for making contributions to a §529 plan, but certain states offer either a credit or a deduction from income. A chart of states that offer either a credit or a deduction can be found at:

Website
www.caltax.com/files/2022/529plans.pdf

Gift tax return requirement

If a taxpayer makes the election to treat up to $80,000 (for 2022) of a contribution to a §529 plan as being contributed ratably over a five-year period, then the taxpayer must file a gift tax return in the year of the gift. There is generally no gift tax return requirement in years two through five if the taxpayer otherwise did not make any reportable gifts. If the election applies to a portion of a larger contribution (for example, if the taxpayer contributed $120,000 to a §529 plan), a gift tax return is required in all years to report the excess of the five-year amount. (Instructions to Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return)

Example of filing gift tax returns

In 2022, Dominique contributed $100,000 to a §529 plan for the benefit of her son, and she elects to treat $80,000 of it as being contributed ratably over a five-year period ($16,000 2022 gift tax exclusion × five years = $80,000).

For 2022, she will file a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, to report the $20,000 gift to her son as well as the $80,000 excludable gift.

In 2023, Dominique gives a gift of $20,000 cash to her niece.

For 2023, Dominique will file a Form 709 to report the $20,000 gift to her niece ($16,000 of which is the annual gift tax exclusion), and so she will also report a $16,000 gift to her son (the one-fifth portion of the 2022 gift that is treated as made in 2023).

Dominique doesn't make any gifts in 2024, 2025, or 2026. She is not required to file Form 709 in those years to report the one-fifth portion of the §529 plan contribution because she is not otherwise required to file Form 709.

Alternative college expense planning: education gifting

Taxpayers who make tuition payments for another person directly to a qualified educational organization may exclude those payments from gift tax and reporting no matter their amount, and they do not count toward your client's annual exclusion or lifetime credit. (IRC §2503(e); Treas. Regs. §25.2503-6(b)(2)) The unlimited exclusion is not permitted for amounts paid for books, supplies, dormitory fees, or similar expenses that do not constitute direct tuition costs.

A qualified educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are carried on. (IRC §170(b)(1)(A)(ii))

☑ Planning Pointer

Making gifts by directly paying tuition may be a better alternative than gifting into a §529 college savings account. For example, grandparents, aunts, and uncles often want to give gifts that will be used for education. But what if the recipient will be drawing from their §529 account within a couple of short years? A gift made into a §529 account isn't likely to see much appreciation before it is spent.

In this scenario, it may be better to preserve the annual gift tax exclusion amount and simply wait to make a tuition payment directly to the educational institution.

 ©2022

☑ Planning Pointer

In addition to gifts of education tuition, direct payments of medical expenses to a medical care provider can be made gift-tax free. (IRC §2503(e); Treas. Regs. §25.2503-6(b)(3))

The medical gift does not count against the annual gift tax exclusion or the lifetime gifting credit, so the donors reduce their estate and retain the ability to make additional gifts.

This exclusion applies regardless of the relationship between the person making the payments and the individual on whose behalf the payments are made. This exclusion is available in addition to the annual gift tax exclusion. (Treas. Regs. §25.2503-6(a)) However, the payments must be made for medical care as it is defined under the IRC §213(d) medical expense deduction rules. This includes the costs of dental treatment, drugs and medicines, nursing, and certain transportation and travel.

Uncashed gifts at time of death

The Tax Court held that some checks a decedent had written before his death but that were paid after his death were includable in his estate, while others were not. (***Estate of DeMuth, Jr. v. Comm.***, TCM 2022-72) The decision hinged on whether the checks constituted completed gifts.

The decedent's son, under a power of attorney, wrote eleven checks to family members five days before the decedent's death totaling $464,000 from the decedent's investment account.

Only one of the checks was paid before the decedent died, and three other checks were deposited on the day of the decedent's death but not paid until three days after his death.

On its Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, Schedule B, the estate reported the investment account value, which did not include the value of any of the eleven checks.

Completed gifts

Under IRC §2033, "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." The regulations further explain that the "amount of cash belonging to the decedent at the date of his death, whether in his possession or in the possession of another, or deposited with a bank, is included in the decedent's gross estate." (Treas. Regs. §20.2031-5)

The regulations also state that a gift is not a gift until the donor has given up dominion and control and has no power to change the gift's disposition. (Treas. Regs. §25.2511-2(b)) However, this is determined under state law; federal law then determines the taxability (see ***Burnet v. Harmel*** (1932) 287 U.S. 103, 110).

The Tax Court examined Pennsylvania law (the state of the decedent's domicile at the time of his death), which states that to make a valid gift, there must be "a clear, satisfactory, and unmistakable intention of the giver to part with and surrender dominion over the subject of the gift, with an intention to invest the donee with the right of disposition beyond recall, **accompanied by an irrevocable delivery**, actual or constructive [emphasis added]." (***Packer v. Clemson*** (Pa. 1920) 112 A. 107, 107) If there is the potential for the donor to put a stop payment on the instrument, then its delivery is revocable. (13 Pa. Cons. Stat. §4403(a) (2015)) But once the instrument gets to a certain stage in the processing, a stop payment may be too late, and the check writer's funds can be drawn against.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. What is true about the kiddie tax?

   a) Parents may not report their child's income and pay the related tax on their own return
   b) A parent may elect to report a child's interest and dividends if the child's gross income was less than $12,000 for 2022
   c) The kiddie tax is determined using the tax rate of the custodial parent in cases where the parents aren't married
   d) All children with unearned income must attach Form 8615 to the parents' income tax return

2. What are among the details of the President's Student Loan Debt Relief Plan?

   a) The Department of Education will forgive up to $10,000 in student loan debt for all borrowers
   b) Debt relief is only for individuals with income under $100,000
   c) Forgiven loans will not be included in the taxpayer's gross income
   d) The debt relief plan covers all Department of Education loans and private student loan debt

3. For payments made by an employer on an employee's student loan, which of the following applies?

   a) Employer-paid student loans must be included in an employee's gross income
   b) Employer-paid student loan payments are subject to a maximum $5,250 per calendar year
   c) Taxpayers may claim a student loan interest deduction for any payment made with excluded employer benefits
   d) Employer-paid loans for the employee or a member of their family are excluded from gross income

4. A comparison of the American Opportunity Tax Credit and the Lifetime Learning Credit reveals which of the following to be true?

   a) Both are nonrefundable credits
   b) Both are available for an unlimited number of years
   c) The Lifetime Learning Credit covers tuition, fees, computers, and course materials
   d) The AOTC is available for the first four years of undergraduate education when enrolled on at least a half-time basis

5. There is a new credit for previously owned clean vehicles. What is true about this credit?

   a) Sales must be through a licensed dealer for vehicles sold for $28,000 or less
   b) The maximum credit is $3,750
   c) Buyers can only claim the credit once every three years
   d) The credit may be used by individuals who buy the care for resale

6. Which statement is correct regarding the Nonbusiness Energy Credit?

   a) The credit is available for purchases of qualified property prior to January 1, 2033
   b) It is renamed the Residential Energy Property Credit
   c) The percentage of the credit is increased from 10% to 25% of the cost paid or incurred by the taxpayer for qualified energy efficiency improvements
   d) Residential energy property must be the taxpayer's principal residence

7. Which choice best describes issues that are relevant to the ACA and the Premium Tax Credit under the IRS's final regulations for more affordability of health care coverage?

   a) Under the ACA, individuals are never allowed a PTC if they are eligible for employer-sponsored health care coverage
   b) Under the final regulations, if a plan doesn't pay at least 60% of the benefits to family members, then employer-provided coverage is considered not to be available to family members, and they will qualify for the PTC
   c) An individual is eligible for the PTC as long as their health care coverage is considered unaffordable, even if another family member's offered health care coverage is affordable
   d) Under the final regulations, if self-only employer coverage is affordable for the employee, it is automatically considered affordable for the spouse with whom the employee is filing a joint return

8. Which of these statements describing home energy efficiency rebates to homeowners is true?

   a) States will be awarded money to provide high-efficiency electric home rebates to households equal to or below 150% of the area median income
   b) Rebates provided to qualified homeowners and residential building owners for energy savings retrofits are not included in gross income
   c) States will be given money to provide Home Owner Managing Energy Savings (HOMES) rebates to low- and moderate-income homeowners for retrofit energy savings projects that achieve at least 15% in energy savings
   d) Rebates may be used by eligible entities to buy nonappliance upgrades under a qualified electrification project as long as the items are Energy Star-certified, and they must be part of new construction

 ©2022

SOLUTIONS TO REVIEW QUESTIONS

1. What is true about the kiddie tax? **(Page 1-6)**

    a) Incorrect. The may elect to do so on Form 8814, Parents' Election to Report Child's Interest and Dividends.
    b) Incorrect. There are eight conditions that must be met in order for parents to elect to report the child's interest and dividends on their own return, one of which is that the child's gross income for 2022 was less than $11,500.
    c) Correct. This is true under IRC §1(g)(5)(A).
    d) Incorrect. The Form 8615, Tax for Certain Children Who Have Unearned Income, is attached to the child's income tax return if certain conditions are met, including that the child's unearned income for 2022 was more than $2,300.

2. What are among the details of the President's Student Loan Debt Relief Plan? **(Page 1-13)**

    a) Incorrect. The amount is $20,000 for borrowers who received Pell Grants and $10,000 for all others.
    b) Incorrect. The thresholds are $125,000 annual income for individuals and $250,000 for married and head of household individuals.
    c) Correct. The exclusion applies to federal income tax and is a consequence of changes made under ARPA.
    d) Incorrect. The relief applies to Department of Education loans only.

3. For payments made by an employer on an employee's student loan, which of the following applies? **(Page 1-14)**

    a) Incorrect. The are excluded for loans made after March 27, 2020, and before January 1, 2026.
    b) Correct. The payments are treated as an employer educational assistance program payment under IRC §127, subject to the $5,250 maximum.
    c) Incorrect. There is no double benefit, so the taxpayer cannot claim a deduction for benefits that are excluded from income.
    d) Incorrect. The exclusion does not apply for family members and spouses.

4. A comparison of the American Opportunity Tax Credit and the Lifetime Learning Credit reveals which of the following to be true? **(Page 1-32)**

    a) Incorrect. The AOTC is up to 40% refundable.
    b) Incorrect. The AOTC is only available for four tax years per eligible student.
    c) Incorrect. This is true of the AOTC. The Lifetime Learning Credit covers only tuition and fees for enrollment.
    d) Correct. The Lifetime Learning Credit applies to any year of graduate or undergraduate enrollment.

 ©2022

5. There is a new credit for previously owned clean vehicles. What is true about this credit? **(Page 1-42)**

    a) Incorrect. The vehicles must be sold for $25,000 or less.
    b) Incorrect. The maximum credit is $4,000.
    c) Correct. This rule applies to the date of the sale of the vehicle, not the taxable year.
    d) Incorrect. The vehicle must be purchase for use.

6. Which statement is correct regarding the Nonbusiness Energy Credit? **(Page 1-43)**

    a) Correct. The credit has been extended for 11 years.
    b) Incorrect. It is renamed the Energy Efficient Home Improvement Credit.
    c) Incorrect. The percentage of the credit is increased to 30% of costs incurred or paid.
    d) Incorrect. The home must be a personal use property, including a second home, for property placed in service after December 31, 2022.

7. Which choice best describes issues that are relevant to the ACA and the Premium Tax Credit under the IRS's final regulations for more affordability of health care coverage? **(Page 1-53)**

    a) Incorrect. If the coverage is not affordable or doesn't provide at least minimum value, the employee is considered to not be eligible for employer coverage and is eligible for the PTC.
    b) Correct. The regulations provide that the minimum value requirement pertains to both the employee's self-coverage and coverage for their family members.
    c) Incorrect. With multiple offers of coverage, if another family member's coverage is considered affordable, the individual is not eligible for the PTC.
    d) Incorrect. This was previously true, but under the final regulations there is a separate affordability exemption test for an employee's spouse and their dependents.

8. Which of these statements describing home energy efficiency rebates to homeowners is true? **(Page 1-59)**

    a) Correct. This is also true for Indian Tribes up to $225 million in aggregate. The rebates will be available through September 30, 2031.
    b) Incorrect. They may be included in gross income if the rebate is paid directly to the homeowner/building owner, but if the rebate is a reduction in the purchase price, it would not be included in gross income.
    c) Incorrect. The threshold is to achieve a minimum of 20% in energy savings.
    d) Incorrect. They may also replace an existing nonelectric appliance or be a first-time purchase of that appliance.

 ©2022

This page intentionally left blank.

Chapter 2

Retirement

RETIREMENT

TRADITIONAL IRAs

IRA CONTRIBUTION AMOUNTS

Individual taxpayers may make contributions to an IRA up to the lesser of $6,000 for 2022 ($6,500 for 2023) or the individual's earned income if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. (IRC §219(b)) Married couples can make a deductible IRA contribution of up to $12,000 for 2022 ($13,000 for 2023) if the combined compensation of both spouses is at least equal to the contributed amount. (IRC §219(c))

There are no age limits for contributions to traditional retirement accounts after 2019.

Maximum IRA Contribution		
	Amount	**Catch-up (age 50 and over)**
2022 (Notice 2021-61)	$6,000	$1,000
2023 (Notice 2022-55)	$6,500	$1,000

TAXPAYER ACTIVE IN EMPLOYER-SPONSORED PLANS

Taxpayers who are active participants in an employer-sponsored retirement plan will have the deductible portion of their traditional IRA contributions reduced or completely eliminated if their AGI is over certain income limits, as follows:

AGI Phaseout Ranges for Taxpayers Active in Employer-Sponsored Plans			
Beginning taxable year	**Single, HOH, MFS (did not live with spouse)**	**MFJ**	**MFS (lived with spouse at any time during year)**
2022 (Notice 2021-61)	$68,000–$78,000	$109,000–$129,000	$0–$10,000
2023 (Notice 2022-55)	$73,000–$83,000	$116,000–$136,000	$0–$10,000

Caution

The AGI phaseout range for married taxpayers filing separate returns is $0–$10,000, unless the couple lived apart at all times during the tax year. In that event, the couple is treated as if they are not married for IRA contribution purposes. (IRC §219(g)(4)) Thus, only each individual's AGI and status as an active participant is taken into account, and the reduction begins at the AGI threshold applicable for unmarried taxpayers.

Planning Pointer

It is generally better to contribute to an employer-sponsored retirement plan before contributing to an IRA, at least up to the point of maximizing employer matching contributions.

TAXPAYER IS NOT AN ACTIVE PARTICIPANT, BUT SPOUSE IS

If the individual is not an active participant in an employer-sponsored retirement plan but the individual's spouse is, the IRA deduction limit is phased out for taxpayers with the AGIs listed here:

AGI Phaseout Ranges for Nonactive Participant Individual with Active Spouse		
Beginning taxable year	2022 (Notice 2021-61)	2023 (Notice 2022-55)
AGI phaseout range	$204,000–$214,000	$218,000–$228,000

FORM 5498

IRA trustees must file Form 5498, IRA Contribution Information, by May 31 each year for each IRA account they act as trustee. The Form 5498 reports deductible and nondeductible contributions, conversions, recharacterizations, and rollovers made by the IRA owner during the prior taxable year.

Form 5498 also reports the fair market value of the owner's IRA as of December 31 of the prior year as well as the taxpayer's RMD for the current year if one is required.

Form 5498 is not filed until May 31 each year because it must include all IRA contributions, even those made by the April 15 income tax filing deadline for the prior taxable year.

✎ Practice Pointer

Because the Form 5498 filing deadline is after the regular April 15 income tax filing deadline, tax professionals should request the form from their clients in June each year and should review it against their client's income tax returns.

Often, clients will forget about IRA contributions they made, particularly if they make nondeductible contributions. If the tax professional is able to catch the nondeductible IRA contribution on their client's Form 5498, they can file an amended income tax return and attach Form 8606, Nondeductible IRAs. Doing so will allow the client to accurately track basis in their IRA.

Catching contributions that your client didn't tell you about is only one benefit of reviewing Form 5498. Tax professionals can also harvest RMD information from the form and use it to start mid-year planning conversations with your clients.

California conformity

California conforms to all the IRA contribution limits except for the provision permitting a deduction for traditional IRA contributions after age 70½.

EXCESS IRA CONTRIBUTIONS

Excise tax on excess contributions

Excess contributions from one year may be treated as IRA contributions in a later taxable year, but the 6% excise tax applies to each year the excess contribution remains in the IRA. (IRC §§219(f)(6), 4973(a)) This correction occurs automatically for any year for which a taxpayer fails to contribute the maximum allowable amount to the taxpayer's IRA. Note, however, that if the statute of limitations has expired in the year of the excess contribution and a deduction was taken for the contribution in that year, the excess contribution is instead remedied by reducing the allowable deduction for the later year. (IRC §219(f)(6)(C))

 ©2022

Example of carryover of excess contribution

Kay earned $3,000 in salary in 2022 and contributed $5,000 to an IRA. Assume that Kay does not withdraw any amount after the contribution. She has an excess contribution for 2022 of $2,000 and must pay a penalty of $120 (6% × $2,000) for 2022. In 2023, she earns $15,000 in compensation and makes a $1,000 contribution to her IRA. Kay will be treated as having made an additional contribution of $2,000 for 2023 and will be allowed to deduct $3,000 as her 2023 IRA contribution.

Withdrawing excess contributions by due date of return

Taxpayers can avoid the 6% excise tax on excess IRA contributions if the excess amount is withdrawn, plus earnings on the excess contribution, by the due date of the taxpayer's return, including extensions. (IRC §408(d)(4))

The calculation of net earnings on excess contributions is computed using Worksheet 1-3 from IRS Publication 590-A. The following example is illustrative.

Example #1 of withdrawing excess contributions

Amara made a contribution to her traditional IRA account of $7,000 on June 30, 2022, at a time when her IRA account was valued at $281,000. However, Amara is under the age of 50 and was only eligible to contribute $6,000, thus leaving her with an excess IRA contribution of $1,000.

In order to avoid paying the 6% excise tax, Amara must withdraw the $1,000 from her traditional IRA, plus earnings, by the due date of her 2022 income tax return, including extensions. Amara ended up distributing the excess contribution on April 2, 2023, when her traditional IRA had a FMV of $290,000.

The calculation here is from IRS Publication 590-A, Worksheet 1-3:

1	Excess contribution amount to be withdrawn	$1,000
2	FMV of IRA immediately prior to withdrawal	$290,000
3	FMV of IRA immediately prior to excess contribution	$281,000
4	Line 2 – Line 3	$9,000
5	Line 4 ÷ Line 3	0.031
6	Line 1 × Line 5[A]	$31
7	Line 1 + Line 6[B]	$1,031

[A] This product is the net income (loss) attributable to the excess contribution
[B] This sum is the amount of the excess IRA contribution plus net earnings (or minus net loss) that must be withdrawn by the due date of Amara's 2022 income tax return, including extensions

Accounting for losses in IRA account

When performing the calculation of earnings that must be withdrawn from excess IRA contributions, taxpayers can take into account any loss on the excess contribution while it was in the IRA. If there is a loss, then the net income that must be withdrawn can be a negative amount.

Example #2 of withdrawing excess contributions

Assume the facts are the same as the previous example, except that Amara's IRA lost value in 2022, and the FMV of her account on April 2, 2023, was $269,000.

The calculation here is from IRS Publication 590-A, Worksheet 1-3:

1	Excess contribution amount to be withdrawn	$1,000
2	FMV of IRA immediately prior to withdrawal	$290,000
3	FMV of IRA immediately prior to excess contribution	$269,000
4	Line 2 – Line 3	($21,000)
5	Line 4 ÷ Line 3	(0.0781)
6	Line 1 × Line 5[A]	($78.10)
7	Line 1 + Line 6[B]	$921.90

[A] This product is the net income (loss) attributable to the excess contribution
[B] This sum is the amount of the excess IRA contribution plus net earnings (or minus net loss) that must be withdrawn by the due date of Amara's 2022 income tax return, including extensions

The calculation to determine net income or loss on excess IRA contributions is the same for excess Roth IRA, SEP IRA, or SIMPLE IRA contributions as well.

✐ **Practice Pointer**

Calculating the net income or loss on excess IRA contributions is typically performed by IRA custodians, but they have been known to punt to the tax professional to perform the calculation of earnings on excess contributions.

IRA DISTRIBUTIONS

Taxpayers must begin taking required minimum distributions (RMDs) in the year they turn age 72. (IRC §401(a)(9))

California conformity

California automatically conforms to the age at which RMDs must begin. (R&TC §17501)

RMDs when multiple accounts are owned

IRA owners must calculate their RMDs separately for each IRA they own, but they can withdraw the total RMD amount from one or any combination of their IRA accounts. Similarly, taxpayers who own more than one IRC §403(b) account must calculate their RMD separately for each 403(b) account but can withdraw the total from one or more of the accounts.

However, RMDs required from other types of retirement plans, such as 401(k)s and 457(b)s must be taken separately from each of those plan accounts.

Spouses are treated as separate owners of retirement accounts, so if each spouse owns an IRA, for example, then each spouse must take their RMDs from their own accounts.

Example of combining retirement accounts

Noah and Mila are married and file jointly. Noah turned age 74 in 2022, and Mila turned age 76. They own the following retirement accounts:

Retirement Accounts			
	FMV on 12/31/21 (A)	**Life expectancy factor (B)**	**2022 RMD (A ÷ B)**
Noah			
Traditional IRA #1	150,000	25.5	$5,882
Traditional IRA #2	60,000	25.5	$2,353
403(b) #1	400,000	25.5	$15,686
403(b) #2	200,000	25.5	$7,843
Mila			
Traditional IRA	$260,000	23.7	$10,970
401(k) #1	$370,000	23.7	$15,612
401(k) #2	$50,000	23.7	$2,110

Noah's total traditional IRA RMD is $8,235 ($5,882 + $2,353). He can take his traditional IRA RMD all from one account or any combination of his two traditional IRAs, but his traditional IRA RMD must come from these two accounts only.

Similarly, Noah's 403(b) RMD of $23,529 ($15,686 + $7,843) can be taken from any combination of distributions from these two 403(b) accounts.

Mila must take her traditional IRA RMD of $10,970 from her traditional IRA account. She has only one traditional IRA account, so she cannot combine distributions from any other account. Mila and Noah cannot combine distributions from each other's traditional IRA accounts.

RMDs from Mila's 401(k) accounts must be taken separately from each other. As such, the $15,612 RMD from her 401(k) #1 must come from that account and her $2,110 RMD from her 401(k) #2 account must come from the 401(k) #2 account.

✐ **Practice Pointer**

Taxpayers must typically inform their retirement account custodian/trustee regarding distributions amounts and timing. It is the taxpayer's responsibility to ensure they take the proper RMD each year.

However, many financial planners and account custodians/trustees do the legwork of calculating the annual RMD and can often set up a regular distribution schedule based on the taxpayer's RMD. This allows many retirees to "set it and forget it" when it comes to their annual RMDs.

Tax professionals should work to understand what type of advice and counsel their client is receiving to help ensure they aren't missing any RMDs.

Missed RMDs

Comment

There have been many questions about inherited IRAs and potential missed RMDs because of new regulations. That issue is discussed in detail on page 2-17.

A penalty tax is imposed for failure to take an RMD. The penalty is 50% of the amount by which the amount of the RMD exceeds the actual distributions taken for the year. (IRC §4974(a)) The IRS may waive the penalty if the taxpayer shows that the failure is due to reasonable cause and that reasonable steps are being taken to remedy the shortfall. (IRC §4974(d)) Reasonable cause can include mistakes (such as forgetting) brought about by the infirmity of age.

Taxpayers who feel they meet the reasonable cause criteria of IRC §4974(d) may exclude the 50% excise tax when they file their returns. The instructions to Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, indicate to put "RC" on line 54, with the amount you want waived in parentheses, and attach a statement to the return explaining the reasons why you believe a reasonable cause waiver is warranted and what steps you are taking to remedy the shortfall. The penalty is due only if relief is denied. There is no provision to exclude any of the other penalties, including the 10% penalty for failing to meet the 60-day rollover requirement.

Sample waiver explanation (attachment to return: explanation on Form 5329, line 52)

Taxpayer is elderly and made a mistake by not taking the full amount of the 2022 required minimum distribution caused by the infirmities of age. Upon discovery of the shortfall, taxpayer took a distribution on February 5, 2023, of $10,000, the full amount of the required minimum distribution.

Taxpayer has already taken the full required minimum distribution amount for 2023 and has taken steps to ensure that the failure does not occur in the future.

Taxpayer will not report the missed $10,000 as a taxable distribution in 2022. Instead, the taxpayer will report both the $10,000 and the 2023 RMD as income in 2023.

California conformity

California does not impose a penalty against taxpayers who fail to take a required minimum distribution.

Delaying first RMD

Taxpayers who turn age 72 during the year can put off their first RMD until April 1 of the year after they turn age 72. Taxpayers who put off their first RMD must take two RMDs in the second year (one for the year they turned age 72 and one for the following year).

A taxpayer's RMD is calculated by dividing a life expectancy factor published by the IRS by the fair market value of all their traditional IRAs as of December 31 of the previous year.

On November 12, 2020, the IRS published updated life expectancy tables in the Federal Register. The new life expectancy tables took effect as of January 1, 2022, and are used to calculate required minimum distributions. The tables are published in IRS Publication 590-B, Distributions from Individual Retirement Arrangements (IRAs).

 ©2022

The 2021 publication can be found at the following website and contains the new 2022 RMD tables. The 2022 version of the publication will be updated sometime in the spring of 2023.

Website
www.irs.gov/pub/irs-pdf/p590b.pdf

Comment

If the taxpayer delays taking their first RMD until after the year they turn age 72, the calculation of the taxpayer's first RMD is based on the FMV of assets in the taxpayer's IRA as of December 31 of the year before the taxpayer turns age 72. It does not include any increase in value of the assets during the year the taxpayer turns age 72 nor does it take into account any additional contributions or rollovers into the IRA during the year the taxpayer turned age 72.

The taxpayer's RMD for the year after they turn age 72 may be inflated because that year's RMD is based on the fair market value of their IRA as of December 31 of the year they turn age 72. So, if the taxpayer didn't take their RMD in the year they turned age 72, the additional funds in their account on December 31 will be factored into the following year's RMD.

Of course, stock market conditions will affect each year's RMD. For example, 2022 was a terrible year for the stock market.

Example of delaying RMD at age 72

Dawn is single and turned age 72 in 2022. The fair market value of her traditional IRA was $2.25 million on December 31, 2021. Dawn's 2022 RMD is calculated as follows:

FMV of traditional IRA on December 31, 2021	$2,250,000
Distribution period from Uniform Lifetime Table	÷ 25.6
Dawn's 2022 RMD	$ 87,891

If Dawn delays the 2022 RMD until 2023, then she must take her 2022 RMD, as calculated above, by April 1, 2023, and she must also take her 2023 RMD by December 31, 2023.

If she postpones the distribution, assume that the fair market value of her traditional IRA on December 31, 2022, is $1.8 million (we had a massive market decline in 2022).

Dawn's total RMDs in Year 2 are calculated as follows:

FMV of traditional IRA on December 31, 2022	$1,800,000
Distribution period from Uniform Lifetime Table	÷ 24.7
Dawn's 2023 RMD (by December 31, 2023)	72,875
Dawn's 2022 RMD (by April 1, 2023)	+ 87,891
Total RMDs Dawn must take in 2023	$ 160,766

If Dawn took her 2022 RMD of $87,891 in 2022 instead of delaying it, and assuming that the FMV of her account on December 31, 2022, is reduced by the distribution amount of $87,891 ($1,800,000 - $87,891 = $1,712,109), then her 2023 RMD would be $69,316 ($1,712,109 ÷ 24.7).

Thus, her total IRA distribution will be $157,207 ($87,891 + $69,316) or $3,559 less than taking all the distribution in 2023.

Comparing the new and old lifetime tables

The new lifetime tables reflect the fact that people are living longer. Hence, the tables provide for a smaller distribution at any given age.

To download the RMD tables, go to:

Website
www.caltax.com/files/2022/rmdtables.pdf

Example of required minimum distribution

The following chart shows the required minimum distribution for a person who turned age 72 in 2022 with an IRA valued at $1 million on December 31, 2021:

Age in 2022	A IRA value on 12/31/2021	B Life expectancy per tables	A ÷ B RMD for 2022
72	$1,000,000	25.6 (before 2022)	$39,063
72	$1,000,000	27.4 (after 2021)	- 36,496
			$ 2,567

For most taxpayers, such a small reduction in a single year's RMD won't mean much. But what do these new RMD tables mean over time? Assume the same taxpayer in the example above who turns age 72 in 2022 earns a consistent 8% return on his investment account year over year and only distributes his RMD each year.

A comparison of the old and new tables shows the compounding difference through age 90. To download the life expectancy tables, go to:

Website
www.caltax.com/files/2022/lifetables.pdf

Note the following observations:

- At age 90, under the new lifetime expectancy tables, the taxpayer's account is $365,058 higher than under the old rules; and
- Under the new lifetime expectancy tables, the taxpayer's RMD outpaces earnings at age 90, but under the old rules, the RMDs outpace earnings four years earlier at age 86.

Qualified longevity annuity contracts (QLACs)

Qualified longevity annuity contracts (QLACs) are investment vehicles that allow taxpayers to remove assets from their IRAs and hold them until later retirement years. (Treas. Regs. §1.401(a)(9)-6, Q&A 17)

The cornerstone of the QLAC is the removal of RMD requirements for assets placed in a QLAC. They make it easier for retirees to address the risk of outliving their assets by using a limited portion of their retirement savings to purchase a policy in a retirement plan that will provide guaranteed income for life starting at an advanced age. The regulations modify the RMD rules by excluding the value of the QLAC from the total figure used to determine RMD. The regulations require that distributions commence not later than age 85 (although the contract may specify an earlier age).

Maximum QLAC investment

The premiums paid for all QLAC contracts for the benefit of any individual cannot exceed the lesser of:

- $145,000 (increased to $155,000 in 2023); or
- 25% of the balance of all eligible accounts held by the individual. Roth and inherited IRAs can't be included in calculating the maximum premium the individual can put into a QLAC.

Eligible accounts

QLACs may be purchased under:

- Defined contribution plans;
- Traditional IRAs;
- IRC §403(b) plans; and
- Governmental IRC §457(b) plans.

QLACs cannot be purchased with funds from an inherited IRA.

QLAC requirements

Under a QLAC, a plan may provide that if the purchasing retiree dies before (or after) the age when the annuity begins, the premiums they paid but have not yet received as annuity payments may be returned to their accounts.

Example of stretching IRA

Bruce is 72 years old and his IRA contains $1.5 million. Bruce's RMD is $54,745 ($1,500,000 ÷ 27.4 life expectancy factor). Bruce receives Social Security benefits and other sources of passive income, so he does not need to use the money from his IRA to live on. So he put $145,000 in a QLAC, which reduced his current-year RMD by $5,292 ($145,000 ÷ 27.4 life expectancy factor).

In addition to reducing his RMDs, if the annuity pays 3.5% over the next 13 years, Bruce's $145,000 will be worth $228,540 when he is 85 years old when he must begin drawing on the annuity.

Alternatives to QLACs

Qualified longevity annuity contracts may be a good way to help IRA funds last deeper into retirement, but with a low guaranteed rate of return, currently about 3.5%, taxpayers may prefer to take a taxable distribution from their IRA and invest the funds in the general stock market.

Example of alternative to QLAC investment

Assume Bruce from the previous example were to distribute $145,000 from his IRA instead of moving it into a QLAC. Assume Bruce is in the 24% marginal federal tax bracket and the 9.3% marginal California tax bracket (for a combined rate of 33.3%).

When Bruce distributes the $145,000 from his IRA, his tax burden will be $48,285, leaving him with $96,715 left to invest ($145,000 distribution minus $48,285 tax burden).

If Bruce earns an 8% rate of return year over year in a taxable investment account, then his $96,715 investment will grow to $207,707 by the time he reaches age 85. For this calculation, we factored in his annual tax burden on the earnings assuming his earnings are taxed at 15% federal capital gain rates and 9.3% California tax rate.

Even though the balance of his account is only $207,707 at age 85 versus $228,540 at age 85 under the QLAC, Bruce has already paid tax on the initial $145,000 distribution. His annual tax burden going forward on his taxable account is only on his annual earnings.

With the QLAC, he will be taxed at ordinary income rates on the annuity distributions.

If an 8% interest rate seems aggressive for planning purposes, remember that the S&P 500 index, which is a key stock market indicator, has produced an average annual return of 11.88% from its inception in 1957 through the end of 2021.

IRA to charity (qualified charitable distributions)

Taxpayers may exclude up to $100,000 annually in "qualified charitable distributions" (QCDs) from their AGI. (IRC §408(d)(8))

QCDs are:

- Made directly by the IRA trustee to a charitable organization; and
- Made on or after the date the taxpayer reaches age 70½.

Comment

Some IRA trustees provide their clients with checkbooks attached to their IRA accounts. Charitable contributions made using checks attached to an IRA account count as distributions made directly by the IRA trustee.

Comment

Even though the SECURE Act increased the age at which RMDs must begin from age 70½ to age 72, taxpayers can still make qualified charitable distributions starting at age 70½.

 ©2022

✐ **Practice Pointer**

When making qualified charitable distributions, be sure to include the initials "QCD" on the dotted line next to taxable IRA distributions on page one of the Form 1040. Most tax software products should insert these initials if you have done your data input correctly.

The initials "QCD" tell the IRS that the taxable IRA distributions won't match what's reported on Form 1099-R. Remember, Form 1099-R does not contain any codes or other indications that a taxpayer sent a portion of their distribution directly to a charitable organization.

Distributions may not be made to a:

- Private foundation;
- Donor-advised fund;
- Charitable remainder trust; or
- Charitable annuity.

These QCDs are ignored for tax purposes; that is, they are not included in gross income, and they are not deductible as charitable contributions on Form 1040, Schedule A. Accordingly, QCDs are not subject to the AGI limitation on charitable contributions.

Because an IRA distribution made to a charity is not included in taxable income, the many AGI-related phaseouts are minimized, and Social Security taxation may be decreased. Also, because the contribution is excluded from income rather than deducted as a charitable contribution, taxpayers who don't itemize get the full benefit of the contribution.

These charitable distributions are treated as distributions for RMD purposes up to the $100,000 maximum.

Example of charitable distributions

Kelly is 75 years old and has an IRA consisting solely of deductible contributions and earnings. Her RMD from her IRA is $45,000. She wants to contribute $5,000 to Meals on Wheels. She directs the IRA trustee to send $5,000 directly to Meals on Wheels and $40,000 to her. She will include $40,000 in her AGI, and she has met her RMD for the year.

Warren is 71 years old and has an IRA consisting solely of deductible contributions and earnings. He writes a check for $15,000 each year to his church. Assuming he and his wife take the standard deduction, he gets no tax benefit. For the current year, Warren's RMD is $15,000. Assuming he is in the 24% tax bracket, if he has the IRA trustee send the funds directly from his IRA to his church, he saves $3,600 in tax (24% × $15,000).

Basis goes last

The normal distribution ordering rules are ignored when a taxpayer makes a qualified charitable distribution, and basis is not distributed on a *pro rata* basis. Instead, basis is distributed last. As such, a taxpayer who has basis in his IRA and makes charitable distributions in the current year will have a higher percentage of basis and a lower taxable amount in future distributions including RMDs.

> ***Example of charitable distribution from account with nondeductible contributions***
>
> Nathaniel, age 81, has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Nathaniel has no other IRAs and made no contributions after age 70½. Nathaniel directs his IRA trustee to contribute $80,000 to his favorite charity.
>
> If, instead of using the QCD, Nathaniel took a distribution of $80,000 from his IRA and then made a contribution, a portion of the distribution would be treated as a nontaxable return of nondeductible contributions (basis) under the ordering rules. The nontaxable portion of the distribution would be $16,000. The amount of the distribution is multiplied by the ratio of the nondeductible contributions to the account balance ($80,000 × ($20,000 ÷ $100,000)). Thus, $64,000 of the distribution ($80,000 - $16,000) would be includable in Nathaniel's income.
>
> When the IRA trustee makes the contribution through the QCD, the entire $80,000 distributed to the charitable organization is treated as coming from the taxable portion of the distribution.
>
> No amount is included in Nathaniel's income, and the distribution is not taken into account in determining the amount of his charitable deduction for the year.
>
> Nathaniel's remaining $20,000 is treated as nondeductible contributions with basis.

This rule is effective even if the amounts are in separate accounts.

> ***Example of multiple accounts***
>
> Edna has two IRA accounts. One has a balance of $100,000 with a $20,000 basis in nondeductible contributions. The other has a balance of $30,000, consisting of $10,000 of nondeductible contributions and $20,000 of deductible contributions and earnings.
>
> Edna directs the IRA trustee to contribute the full amount of the $100,000 IRA to the Girl Scouts of America. The IRA accounts are aggregated, and the distribution is deemed to have come from the $100,000 taxable amount, and the $30,000 in the remaining IRA is her basis.

Qualifying distributions

The distributions may be made from a traditional IRA or from a Roth IRA, including an inherited account. (IRC §408(d)(8)) QCDs may also be made from SEP and SIMPLE IRAs, but only if the participant is no longer working and receiving contributions into the plan. (IRS Notice 2007-07, Q&A #36)

> **Planning Pointer**
>
> Even though QCDs can be made from a Roth IRA, doing so makes little sense. Roth IRA distributions are not taxable, and the taxpayer loses the opportunity to take a distribution and then make a deductible contribution.

Client letter for QCDs

To download a copy of Spidell's client letter for QCDs, go to:

> **Website**
> www.caltax.com/cl-qcd

 ©2022

EARLY WITHDRAWAL PENALTY/ADDITIONAL TAX

CORONAVIRUS-RELATED DISTRIBUTIONS

Under the CARES Act, qualified individuals who were affected by the coronavirus in specified ways were allowed penalty-free withdrawals of up to $100,000 from certain retirement plans and IRAs for distributions made from January 1, 2020, to December 30, 2020. (CARES Act §2202; IRC §72(t); IRS Notice 2020-50) The distributions were generally included in income ratably over a three-year period beginning with the year the taxpayer received the distribution. Alternatively, the taxpayer could have elected to include the entire distribution in income in 2020.

Three-year repayment window

For distributions from an eligible retirement plan or an IRA, the taxpayer may repay amounts to their retirement account at any time during the three-year period beginning on the day after the date on which the coronavirus-related distribution was received. (CARES Act §2202(a)(3)(A); IRS Notice 2020-50) The repayments do not have to be made to the same retirement account from which the distributions were made.

Repayments of coronavirus-related withdrawals will be treated as a nontaxable direct trustee-to-trustee transfer as if they were made within 60 days of the distribution (even if they aren't made until the third year following the distribution).

If a coronavirus-related withdrawal is repaid into a different retirement account, then the account to which the repayment is made must be an account type that is eligible to receive a rollover contribution from the account from which the coronavirus withdrawal was made (see our list of eligible rollover accounts on page 2-31).

Reporting repayments made in 2021, 2022, and 2023

A repayment is first applied against the amount of income recognition in the year of the repayment. Any excess repayment can be carried forward or back at the taxpayer's choosing.

Applying this rule, the instructions to Form 8915-F, Qualified Disaster Retirement Plan Distributions and Repayments, state that a taxpayer should include repayments of their 2020 coronavirus-related distributions (or any other qualified 2020 disaster distribution) on their 2022 return if:

- A taxpayer makes a repayment of a qualified distribution after the due date of the taxpayer's 2021 return (including extensions) but before the due date of the taxpayer's 2022 return (including extensions); and
- The taxpayer spread the income over three years.

However, the taxpayer may file an amended Form 8915-F for 2021 if either of the following applies:

- The taxpayer elected on their 2020 Form 8915-E, lines 9 and 17, as applicable, to include all of their distributions in income in 2020 (instead of over three years); or
- The taxpayer spread the income over three years, the amount of the repayment exceeds the amount of the qualified 2020 distributions that are included in income on the taxpayer's 2021 Form 8915-F, and the taxpayer chose to carry the excess back to 2020.

Comment

The repayment instructions described here are from the 2021 Form 8915-F instructions. The 2022 instructions have not been released as of the publication of these materials, but we expect they will contain identical wording.

Example of reporting repayments made after 2020

Grace received a coronavirus-related distribution on May 19, 2020, of $75,000. She chose to spread the $75,000 over three years ($25,000 in income in 2020, 2021, and 2022).

On October 31, 2022, Grace made a repayment of $35,000. She has not made any other repayments into her retirement account.

For 2022, none of the qualified 2020 distribution is included in income because her $35,000 repayment is greater than the $25,000 she is required to include in her 2022 income.

The excess repayment of $10,000 ($35,000 repayment in 2022 minus the $25,000 that would have been included in 2022 income had Grace not made the repayment) can be carried back to either 2020 or 2021 at Grace's choosing.

Grace must file an amended 2020 or 2021 return and claim a refund if she chooses to carry the excess payment back to either 2020 or 2021.

Comment

IRS Form 8915-F replaces Form 8915-E for tax years beginning after 2020. This means that taxpayers who report repayments of coronavirus-related distributions made in 2020 will report the repayments on Form 8915-F.

Form 8915 was first created in 2005 to report qualified hurricane retirement plan distributions and repayments. Subsequent revisions to the form saw numeric designations, such as Form 8915-A, B, C, D, E, and now F for the 2021 tax year.

The instructions for the 2021 Form 8915-F state that the form is a "forever form," meaning that beginning in 2021, additional alphabetical forms will not be issued. The same Form 8915-F will be used for distributions for 2020 and later disasters and for each year of reporting of income and repayments of those distributions.

California conformity

California conforms to the waiver of the early withdrawal penalties (R&TC §17085(c)), and the inclusion of the income from the IRA distribution over a three-year period (unless the taxpayer elects to include all the income in the year of the distribution). (R&TC §17057)

Taxpayers could have made a different election for California purposes and, for example, reported all the income in 2020 for California purposes but spread the income over three years for federal purposes or vice versa. (R&TC §17024.5) Taxpayers who elected to spread the income over three years and then moved out of California in 2022 are not required to pay the California tax for the year they became a nonresident.

 ©2022

Similar provisions for disaster distributions

In 2020 and 2021, individuals could have taken penalty-free withdrawals from their qualified retirement accounts up to $100,000, less all other amounts treated as qualified disaster distributions to the individual for all prior taxable years. (TCDTRA §302(a))

The amount withdrawn is recognized in gross income ratably over a three-year period beginning with the year of withdrawal, unless the taxpayer elected to have it recognized in the year of the withdrawal. (TCDTRA §302(a)(5))

IRA DISTRIBUTIONS SUBJECT TO 10% TAX

The following website provides a helpful IRS chart of exceptions to the early withdrawal penalty:

Website
www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions

INHERITED IRAs

PROPOSED RMD REGULATIONS

The IRS issued proposed regulations on February 24, 2022, that focus mainly on the new required minimum distribution (RMD) rule changes and inherited account provisions made by the SECURE Act.

Comment

The proposed RMD regulations have raised concerns in the tax community, particularly with regard to the provisions that require annual distributions from some inherited accounts. The proposed regulations contradict the plain language of the SECURE Act, which gives most beneficiaries 10 years to distribute the funds from these inherited accounts. We will explore this contradiction on the next page.

Additionally, the proposed regulations apply to accounts inherited after December 31, 2019. This means that some beneficiaries who inherited IRAs in 2020 could have been required to take distributions for 2021, but failed to do so.

Fortunately, in November 2022, the IRS announced that the proposed regulations requiring annual RMDs to designated beneficiaries of an inherited IRA over a 10-year period, which appear likely to be adopted, will not apply until the 2023 distribution year at the earliest. (Notice 2022-53) The notice does not officially adopt the proposed regulations, but was issued to assuage concerns regarding potentially missed RMDs that were voiced in comments to the proposed regulations.

To view the full text of the proposed regulations and to find information to submit comments, go to:

Website
www.regulations.gov/document/IRS-2022-0003-0001

The SECURE Act changes

The SECURE Act was passed into law on December 20, 2019, and contained numerous retirement account changes, the most prominent of which:

- Removed the age limitation for deductible contributions to IRAs (SECURE Act §107; repealing IRC §219(d)(1));
- Increased the RMD age from 70½ to 72 years old for taxpayers born on or after July 1, 1949 (SECURE Act §114; IRC §401(a)(9)); and
- Fundamentally altered the rules for inherited retirement accounts by eliminating the stretch IRA provisions for most nonspousal beneficiaries. (SECURE Act §401; IRC §401(a)(9)(H))

Three beneficiary classifications

Under the SECURE Act and the proposed regulations issued in 2022, there are three types of beneficiaries:

- Nondesignated beneficiaries;
- Designated beneficiaries; and
- Eligible designated beneficiaries.

The distributions rules for retirement account owners who die after December 31, 2019, depend on which type of beneficiary inherits the account.

"Designated beneficiaries" and "eligible designated beneficiaries" are defined by the Code and regulations. Any beneficiary who doesn't fall under one of those two definitions is a nondesignated beneficiary.

Designated beneficiaries

Designated beneficiaries are generally individuals and "see-through" trusts (discussed below).

Eligible designated beneficiaries

There are five types of eligible designated beneficiaries:

- Surviving spouse;
- Minor child of the decedent (under age 21);
- A person who is not more than 10 years younger than the decedent;
- A person who is disabled; or
- A person who is chronically ill.

The proposed regulations provide a hard definition of "minor child" to mean anyone under the age of 21 at the time of the account owner's date of death and also provide definitions and documentation requirements for disabled and chronically ill beneficiaries.

RMD distribution rules

Under the SECURE Act, there are potentially three different periods in which the inherited IRA must be distributed:

RMD Distribution Timetable (Prop. Treas. Regs. §1.401(a)(9)-3(b))	
Distribution period	**When it applies**
Five years (nondesignated beneficiaries)	• If account holder did not have a designated beneficiary; • If retirement account is a defined benefit plan
10 years (designated beneficiaries)	• If account holder died after December 31, 2019, and there is no "eligible designated beneficiary "*
Life expectancy of beneficiary (eligible designated beneficiaries	• If account holder died prior to January 1, 2020, and had a designated beneficiary under pre-SECURE Act rules; • If account holder died after December 31, 2019, and had an "eligible designated beneficiary "*
* An eligible designated beneficiary is defined as the surviving spouse, a minor child of the decedent, a person not more than 10 years younger than the decedent, or a person who is disabled or chronically ill If there are multiple designated beneficiaries and any one of them is not an "eligible designated beneficiary," then none of them is treated as an eligible designated beneficiary unless a specific exception applies (e.g., one of the eligible designated beneficiaries is disabled or chronically ill, or the individual is "disregarded" due to their death or a qualified disclaimer) (Prop. Treas. Regs. §1.401(a)(9)-4(e) and (g))	

Under the proposed regulations, if the deceased grantor had already started taking RMDs, the beneficiaries must take at least an RMD each year based on the life expectancy of the decedent, with the balance of the account fully distributed by year 10. If the decedent had not already started taking RMDs, the beneficiary can wait until the tenth year to distribute the funds from the account.

Required minimum distributions

The SECURE Act replaced existing rules for inherited retirement accounts. The pre-SECURE Act rules applied to accounts owned by taxpayers who died before January 1, 2020. Under the pre-SECURE Act rules, certain designated beneficiaries were allowed to take distributions using their own life expectancy, and the rules provided for a five-year distribution rule for other beneficiaries.

Under the five-year rule, the entire amount in the IRA was required to be distributed no later than December 31 of the taxable year containing the fifth anniversary of the account owner's date of death. No amount was required to be distributed until the fifth calendar year, but all had to be distributed by the end of the fifth year. (IRC §401(a)(9))

Under the SECURE Act, for accounts inherited from individuals who die after December 31, 2019, fewer beneficiaries are permitted to use the life expectancy rules, and the five-year rule was

modified by "substituting '10 years' for '5 years'" for designated beneficiaries. (SECURE Act §401; IRC §401(a)(9))

This was interpreted by most to mean that beneficiaries of defined contribution plans, including IRAs and some government plans, must distribute the entirety of their inherited account by December 31 of the taxable year containing the tenth anniversary of the account owner's date of death unless the beneficiary is an "eligible designated beneficiary." Eligible designated beneficiaries are permitted to distribute the inherited account over their own life expectancy.

The 10-year RMD controversy

To drive the point home, the controversy created by the proposed RMD regulations lies in the fact that the SECURE Act merely substituted a 10-year distribution rule for a five-year distribution rule. Under the old five-year distribution rule, beneficiaries could take distributions at any time during the five years.

The proposed regulations, on the other hand, require RMDs throughout the 10-year period, even though this was not the general understanding of the vast majority of the tax community at the time the SECURE Act was enacted.

IRS provides relief from proposed RMD distribution rules

The IRS has announced that the proposed regulations requiring annual RMDs to designated beneficiaries of an inherited IRA over a 10-year period, which appears likely to be adopted, will not apply until the 2023 distribution year at the earliest. (IRS Notice 2022-53) This notice does not officially adopt the proposed regulations but was issued to assuage concerns regarding potentially missed RMDs that were voiced in comments to the proposed regulations.

The IRS's proposed regulations took many taxpayers and tax professionals by surprise because they assumed that the pre-SECURE Act rules that governed the five-year distribution period, extended to 10 years by the SECURE Act, would apply. This would have allowed taxpayers with inherited IRAs to wait until year 10 to take any distributions from those accounts.

The proposed regulations, as originally released, applied to accounts inherited after December 31, 2019, which meant that many beneficiaries who inherited IRAs in 2020 were required to take distributions for 2021, but failed to do so. This would have resulted in many taxpayers being subject to the IRC §4974 50% excise tax for failing to take a required distribution. As a result of the delayed effective date, taxpayers are not subject to this excise tax for failing to take the annual RMDs in 2021 or 2022 and may apply for a refund if the excise tax was already paid.

RMD requirement during 10-year distribution period

Under the proposed regulations, the beneficiaries must continue taking RMDs each year during the 10-year distribution period, ensuring that the entire account balance is distributed by the end of the 10-year period if:

- The deceased account owner had reached their required beginning date for taking RMDs at the time of their death; and
- The account beneficiaries are not one of the five types of eligible designated beneficiaries. (Prop. Treas. Regs. §1.401(a)(9)-2)

The IRS's new rule that eligible designated beneficiaries must take RMDs during the 10-year period contradicts the previous five-year rule.

Caution

If the regulations are finalized in their current form, clients who expected to wait until the end of the 10-year period to take any distributions will find themselves with missed RMDs. These clients will be forced to take the missed RMDs and file Form 5329, Additional Taxes on Qualified Retirement Plans (including IRAs) and Other Tax-Favored Accounts, to request penalty abatement for the "missed" distributions.

Application of SECURE Act when beneficiary dies

Retirement accounts that are inherited from a person who dies after December 31, 2019, are generally subject to the SECURE Act's new inherited retirement account rules. However, certain governmental plans and plans negotiated in collective bargaining agreements are subject to these new rules for account owners who die after December 31, 2021.

But what if the original account owner dies before January 1, 2020? Does the SECURE Act apply when the beneficiary ultimately dies? The answer is yes. If a beneficiary inherits an account prior to 2020, the pre-SECURE Act rules don't apply. However, when that beneficiary then dies after 2019, the subsequent beneficiaries must comply with the new SECURE Act provisions.

Scenario 1

Retirement account owner dies before January 1, 2020 (pre-SECURE Act), and only names one beneficiary. That beneficiary dies after December 31, 2019. Do the SECURE Act inherited account rules apply to the beneficiary's beneficiaries? The answer is yes. Upon the death of the original beneficiary, subsequent beneficiaries must distribute the remaining retirement account using the SECURE Act rules. (Prop. Treas. Regs. §1.401(a)(9)-1)

Scenario 2

The facts are the same as Scenario 1, except the retirement account owner names a trust as the beneficiary of his retirement account, and the trust has two or more beneficiaries. In this scenario, if the oldest trust beneficiary dies after December 31, 2019, then the SECURE Act applies for distributions after that beneficiary's death. (IRC §401(a)(9)(E)(iii))

Example of multiple beneficiaries

Joe had a defined contribution retirement account with his employer when he died prior to January 1, 2020. He named a trust with his two minor children, Jan and Marcia, as the beneficiaries of his account. The pre-SECURE Act rules apply to the distributions to the trust upon Joe's death. Marcia is the older of the two children, so they began taking distributions from the account using her life expectancy under the pre-SECURE Act rules.

Marcia died in 2022, so now the SECURE Act will apply to future distributions from the account. Jan must now take annual distributions using Marcia's life expectancy but must have the full balance of the account distributed by 2032 (the year that contains the tenth anniversary of Marcia's death).

> ***Comment***
>
> While these are the rules proposed in the regulations, it is unclear how this would actually be administered by the surviving beneficiaries and their financial institutions, especially in situations involving unrelated beneficiaries. After all, one beneficiary might not know when a fellow beneficiary dies.

Scenario 3

Surviving spouses can either roll their deceased spouse's retirement accounts into their own retirement account and begin taking distributions in the year they turn age 72, or they can keep their deceased spouse's retirement account as an inherited retirement account and begin taking distributions in the year their deceased spouse would have turned age 72.

Even if the surviving spouse (e.g., wife) chooses the latter option, then the wife steps into her deceased husband's shoes. This means that if the wife died before January 1, 2020, but her beneficiary (e.g., her son) dies after December 31, 2019, then the SECURE Act applies to any distributions to the son's beneficiaries.

Plan terms can define payout

The proposed regulations also contain a provision that effectively allows an employer's defined contribution plan to require the use of the 10-year rule, even if the beneficiary is an eligible designated beneficiary. (Prop. Treas. Regs. §1.401(a)(9)-3(c)(5)(iii)) This optional provision is available only where an employee dies before their required beginning date for taking distributions. The IRS's explanation of this provision (in its official synopsis of the proposed regulations) states:

"These proposed regulations also provide that in the case of a defined contribution plan, if an employee has a designated beneficiary who is an eligible designated beneficiary, the plan may provide either that the 10-year rule applies or that the life expectancy payments rule applies. Alternatively, the plan may provide the employee or the eligible designated beneficiary an election between the 10-year rule or the life expectancy payments rule."

If a plan provides for this type of election, then the plan must specify the method of distribution that applies if neither the employee nor the eligible designated beneficiary makes the election. If the plan does not include the optional provision and the employee has an eligible designated beneficiary, then the plan must provide for the life expectancy payments rule.

> ***Example of optional defined contribution plan provision***
>
> Anya was 58 years old and a participant in her employer's 401(k) plan when she died in 2022. Anya's sister Vera, who is five years younger, is the sole beneficiary of the 401(k).
>
> Anya's employer's 401(k) plan provides that if an employee dies before their required beginning date for taking distributions, then all beneficiaries must distribute the entire account by the end of the year containing the 10th anniversary of the employee's date of death.
>
> Vera is an eligible designated beneficiary because she is not more than 10 years younger than Anya. Under the SECURE Act, as written, it appeared that Vera could distribute Anya's 401(k) based on her own life expectancy. However, the proposed regulations allow Anya's employer to force the 10-year distribution rule upon Vera if it is written in the plan's terms, which they have done in this example.

Age of majority

Under the SECURE Act, minor children of the deceased retirement account owner are classified as eligible designated beneficiaries and can take RMDs based on their own life expectancy, but only until they reach the age of majority. (IRC §401(a)(9)(E)(iii)) Once the child reaches the age of majority, they must distribute the remainder of the retirement account within 10 years.

The proposed regulations create a hard definition of the term "age of majority" to mean a person's 21st birthday. (Prop. Treas. Regs. §1.401(a)(9)-4) However, defined benefit plans that have used a prior permitted definition can continue to use the prior definition.

Defining disability

The proposed regulations also seek to provide a uniform definition to determine whether a person is disabled. A person who is disabled as of the date of the employee's death is classified as an eligible designated beneficiary under the SECURE Act and can distribute an inherited retirement account over their own life expectancy. A disability that develops after the deceased account owner's date of death is disregarded.

Under the proposed regulations, if, as of the date of the retirement plan owner's death, a beneficiary is younger than the age of 18, then the beneficiary must have a medically determinable physical or mental impairment that results in marked and severe functional limitation, and that can be expected to result in death or to be of long-continued and indefinite duration.

Whether a person who is age 18 or older is disabled continues to be determined under IRC §72(m)(7), based on whether they are able to engage in substantial gainful activity. A person will be automatically treated as disabled for these RMD rules if they are considered disabled for Social Security benefit purposes.

Example of disability

Jane is a participant in her employer's retirement plan. The beneficiary of her plan is her 10-year-old daughter Eve, who is not disabled. If Jane dies, Eve is an eligible designated beneficiary until her 21st birthday because she is a minor child of the decedent.

If Eve later becomes disabled before her 21st birthday, she will not be treated as a disabled person under the SECURE Act because she was not disabled as of Jane's date of death. As such, Eve must distribute the remainder of her mom's retirement account within 10 years of her 21st birthday.

Documenting disability or chronic illness

Documentation of the beneficiary's disability or chronic illness must be provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the retirement plan owner's death. If the designated beneficiary is chronically ill, as defined, the documentation must include a certification by a licensed health care practitioner.

Can a trust be a designated beneficiary?

As discussed in the "RMD distribution rules" box on page 2-17, if the deceased account holder does not have a "designated beneficiary" under the plan, then the account must be fully distributed within five years.

As under the pre-SECURE Act rules, if one of the beneficiaries is not an individual (e.g., a charity), then the general rule is that none of the beneficiaries are considered a "designated beneficiary," and the account must be distributed within five years to all of the beneficiaries. (Prop. Treas. Regs. §1.401(a)(9)-4(b)) However, there are exceptions to this general rule if by September 30 of the calendar year following the account owner's date of death, the nonindividual beneficiary receives the entire benefit they are due. (Prop. Treas. Regs. §1.401(a)(9)-4(c))

The rule prohibiting nonindividuals from being a designated beneficiary applies to trusts as well, unless:

- The trust is a "see-through trust" that meets specified requirements; or
- Separate account rules pursuant to Prop. Treas. Regs. §1.409-8(1)(iii) apply (related to multiple beneficiary trusts involving disabled or chronically ill eligible designated beneficiaries).

What is a see-through trust?

Similar to the pre-SECURE Act rules, if a trust is a see-through trust, then the beneficiaries of the trust are considered designated beneficiaries of the grantor's retirement plan rather than the trust being considered the beneficiary of the plan. This allows the payments to be paid out over a 10-year period or over the life expectancy of certain eligible designated beneficiaries rather than being distributed over a five-year period.

A trust is treated as a see-through trust if it is:

- A valid trust under state law (or would be but for the fact that there's no corpus);
- The trust is irrevocable (or will be upon the grantor's death);
- The beneficiaries of the trust are identifiable; and
- Specified documentation requirements are met.
  (Prop. Treas. Regs. §1.401(a)(9)-4(f)(2))

However, the proposed regulations provide many more examples and detailed explanations to clarify how these rules are applied in light of the SECURE Act.

Beneficiaries of the plan

An individual trust beneficiary is considered a designated beneficiary of the grantor's retirement plan (and eligible for 10-year and/or life expectancy rules) if the beneficiary has a right to receive the amounts distributed to the trust that are not contingent upon or delayed until the death of another beneficiary. This is true whether the trust is either:

- A conduit trust (in which the plan distributions are automatically paid out by the trust to the beneficiary); or
- An accumulation trust (which holds the distributions for later disbursement to the beneficiary).
  (Prop. Treas. Regs. §1.401(a)(9)-4(f)(3))

A beneficiary of an accumulation trust is also considered a beneficiary of the grantor's retirement plan if they can receive distributions from the trust after a noncontingent beneficiary receives their distributions. This rule applies even if the residual interest in the trust can only be paid after the death of the noncontingent beneficiary. However, there are exceptions if the noncontingent beneficiary is a minor child.

Example of residual interest

Barb names an accumulation trust to be the beneficiary of her 401(k) plan. Barb dies at age 65. Under the terms of the trust, the trust pays her spouse, Chris, the income from the account annually, which is less than the RMD paid to the trust for the year. The trust terms also provide that upon Chris' death, the remainder is to be paid to Barb's sister Lori, who is less than 10 years younger than Barb.

Both Chris and Lori are considered designated beneficiaries of Barb's 401(k) plan: Chris because he has a noncontingent right to the plan payments made to the trust, and Lori because she has a residual right to the remaining benefits left in the trust after Chris dies.

Both Chris and Lori are also eligible designated beneficiaries (see definition in "RMD distribution rules" box on page 2-17). The trust may distribute the plan benefits using Chris's life expectancy (presuming Chris is older than Lori).

Disregarding some trust beneficiaries

Some trust beneficiaries are disregarded for purposes of determining whether they may be considered a beneficiary of the grantor's retirement plan. This applies in situations where they have only minimal or remote interests.

This is important in those instances where a charity or other entity is named as a beneficiary only if other specified individual beneficiaries die prior to the plan's benefits being fully distributed. If the charity is not disregarded, then all of the benefits would be required to be paid out within five years.

Example of remote interest

Continuing the example of Barb's trust, above, if the trust terms provide that Charity A will receive the remaining interest in the plan distributions after Chris dies but only if Lori dies before Chris, Charity A will be disregarded, which means the life-expectancy distribution period will still apply.

Are the beneficiaries identifiable?

Generally, trust beneficiaries are identifiable if it is possible to identify each person designated by the grantor as eligible to receive a portion of the grantor's interest in the plan through the trust. The proposed regulations make it clear that if a grantor names a class of individuals as the beneficiary (such as the grantor's grandchildren), the addition of another member of the class (e.g., the birth of another grandchild) will not cause the trust to fail to meet the identifiability requirements. (Prop. Treas. Regs. §1.401(a)(9)-4(f)(5))

In addition, beneficiaries are also "identifiable" if per the terms of the trust an individual is given the power to appoint a portion of the deceased grantor's interest in the plan to one or more beneficiaries and does so by September 30 of the calendar year following the calendar year of the account owner's death.

If an additional beneficiary is added after September 30 of the following calendar year, the determination of whether all beneficiaries are designated beneficiaries will be applied, but if a full distribution will be required (because a nonindividual beneficiary was added) or should have been required because there are no "designated beneficiaries" applying the rules above, then distributions may be delayed until the end of the following calendar year.

California conformity

California automatically conforms to the inherited IRA provisions. (R&TC §17501)

ROTH IRAs

ROTH IRA CONTRIBUTION AMOUNTS

For taxpayers with AGI not exceeding certain amounts, nondeductible contributions to a Roth IRA are allowable up to the lesser of $6,000 for 2022 ($6,500 for 2023) or the taxpayer's annual compensation. This amount is reduced by the amount the taxpayer contributes to another IRA for the same taxable year.

Consistent with general IRA rules, joint-filing couples may contribute up to $6,000 each ($7,000 each if both spouses are age 50 or older) to a Roth IRA, provided the couple's combined compensation is at least equal to the amount contributed.

Annual contribution limitations due to income

The maximum contribution that can be made to a Roth IRA is phased out based on the taxpayer's AGI, adjusted annually for inflation.

Roth IRA AGI Limits

Filing status	2022 (Notice 2021-61)	2023 (Notice 2022-55)
Single, HOH, or MFS and did not live with spouse at any time during the year	$129,000–$144,000	$138,000–$153,000
MFJ	$204,000–$214,000	$218,000–$228,000
MFS and lived with spouse at any time during the year	$0–$10,000	$0–$10,000

✐ **Practice Pointer**

Unlike a traditional IRA that has a limitation on the ability to make deductible contributions based on whether the individual or spouse is a participant in a retirement plan, a Roth IRA has a limitation based only on the amount of earned income and the taxpayer's AGI.

Roth IRA does not have an age limit

Roth IRAs, like traditional IRAs, have no age limit for contributions. Any individual with earned income can contribute to a Roth IRA. (IRC §§219(d)(1), 408A(c)(4))

California conformity

California conforms to IRC §408A and automatically conforms to any federal Roth IRA rules. (R&TC §§17501–17509, 23701)

ROTH CONVERSIONS

A conversion of assets from a traditional IRA, SEP IRA, SIMPLE IRA, or an employer plan to a Roth IRA results in taxation of any untaxed amounts in the traditional IRA. See page 2-31 for a reference guide to which types of accounts can be converted to a Roth IRA. A taxpayer may also recharacterize a contribution from one type of IRA to another type of IRA on or before the original due date for the return for the contribution year.

Example of permissible recharacterization

Izzy contributed $5,000 to her traditional IRA in 2022. She may recharacterize the traditional IRA to a Roth IRA on or before April 15, 2023, but not after.

Why do it?

You may want to convert a traditional IRA to a Roth because, in so doing, all future earnings will be tax-free. But there is a cost: The amount of the conversion, less any basis, is taxable income in the year of conversion. Additionally, a partial contribution from the traditional IRA to a Roth IRA requires an allocation of the basis.

Partial conversions

You may choose to convert only part of a traditional IRA to a Roth. In that case, the distribution ordering rules come into play, and all of your traditional IRAs and the total basis in all the IRAs are combined. (IRC §408(d)(2)) The amount of basis considered converted is the percentage of the total basis that bears the same ratio as the amount converted bears to the total value of all of your traditional IRAs.

Example #1 of partial conversion

Sun has a traditional IRA with a balance of $100,000 and a basis of $10,000. He wants to convert $20,000 into a Roth IRA. He must report $18,000 as taxable income ($20,000 – (($20,000 × $10,000) ÷ $100,000)). He must file form 8606, Nondeductible IRAs.

Example #2 of partial conversion

Laura owns two traditional IRAs with the following attributes:

	IRA 1	**IRA 2**	**Total**
Nondeductible contributions (basis)	$20,000	$ 0	$ 20,000
Deductible contributions	0	50,000	50,000
Earnings	10,000	20,000	30,000
Current FMV	$30,000	$70,000	$100,000

Laura converts IRA 1 to a Roth IRA. She believes she will only have $10,000 of taxable income because she has basis in IRA 1 of $20,000 (the amount of nondeductible contributions). However, the distribution ordering rules require her to allocate basis ($30,000 total amount of traditional IRA funds to be converted to Roth IRA ÷ $100,000 current FMV of all traditional IRAs × $20,000 basis in all traditional IRAs). As such, she can only use $6,000 of her basis. She is taxed on $24,000 ($30,000 converted amount less basis of $6,000).

Roth IRA planning

Contributing to a Roth IRA can be a no-brainer for an individual nearing retirement age with a few extra dollars to save. But does that same taxpayer benefit from a Roth IRA conversion?

Sometimes yes, and sometimes no. Consider such issues as tax bracket, income fluctuation, and estate tax considerations when making the decision to convert a traditional IRA (or other qualified employer plan such as a 401(k) or 403(b) plan, to name a couple) to a Roth IRA.

Individuals nearing retirement are often in the top tax bracket. If an individual will drop to a lower bracket in the next few years, paying the tax on the Roth IRA conversion now may not compensate for tax-free income later.

But, if a taxpayer currently has a low-income year, consider converting the traditional IRA to a Roth IRA. Taxpayers with large business losses, NOLs, or large itemized deductions combined with low income are good candidates.

Example of low-income year

Horace and Ida file a joint return and usually have income in the $200,000 range. They have itemized deductions of about $75,000, including their home mortgage interest of almost $50,000, their tithes to their church, property taxes, and other things.

In Year 1, however, Horace loses his job and their income drops to $50,000. They keep up their mortgage payments, but they must reduce their tithes to their church. Nonetheless, their itemized deductions remain at about $60,000. As such, their deductions exceed their income by about $10,000.

They can do a tax-free conversion of up to $10,000.

In spite of Horace's job loss, they had substantial savings, and their financial situation remained sound throughout Year 1. Late in Year 1, Horace found a new job that paid even better than his old one. Horace and Ida decide to convert more than the $20,000 tax-free amount and take advantage of low tax brackets while they can. They can convert approximately an additional $15,000 in the 10% tax bracket and approximately $50,000 more than that in the 12% tax bracket.

Overall, they could convert about $70,000 at a total tax cost of $7,500 ((10% × $15,000) + (12% × $50,000)). That's a tax rate of less than 11%, which will likely be a much lower rate than they'll be paying in retirement.

Using charitable contributions

The charitable contribution deduction is based on federal AGI. For most contributions, the law limits your deduction for charitable contributions to no more than 60% of AGI. Unused contributions may be carried over for five years before they expire. If a taxpayer is in danger of losing charitable contribution carryovers, doing a Roth IRA conversion will:

- Increase AGI;
- Increase charitable contributions by 60% of the AGI increase; and
- Increase taxable income by only 40% of the amount of the conversion.

The net effect of this plan is to cut the tax on the Roth conversion in half. This is a particularly good strategy if the charitable deduction carryover is going to expire at the end of the current year.

 ©2022

Example of charitable contributions

Olga made a large charitable contribution in 2017. In 2022, she has $40,000 of the contribution carryover that she has not used and which expires after 2022. Her AGI in 2022 is expected to be $50,000, which will limit her charitable contribution deduction to $30,000. If she converts $20,000 of her traditional IRA to a Roth IRA, she may deduct the entire $40,000 of her charitable contribution, and she will effectively pay tax on only $8,000 of the conversion.

Effect on AGI

As AGI affects a myriad of other taxes and deductions, consider the effect on AGI when determining the conversion amount.

Estate planning issues

Although the value of Roth IRAs is includable in a taxpayer's gross estate and is subject to estate tax in the same manner as a traditional IRA, beneficiaries receive tax-free distributions. Also, there is no income in respect of a decedent (IRD), which means:

- High-income beneficiaries get the maximum inheritance; and
- Beneficiaries do not need to calculate IRD each time they take a distribution from the plan.

Middle-income parents with high-income children may maximize the value of the estate to the children by doing a Roth conversion. This works best for parents who are not yet drawing Social Security because the Roth conversion income may increase taxable Social Security.

Example of inheritance issues

Ronaldinho retired in Year 1 at age 60. In Year 2, he will receive a pension of $50,000, and his tax rate for the year will be 15%. His traditional IRA is valued at $10,000. If he converts the IRA to a Roth IRA in Year 2, he may have these benefits:

- His son, who is in the 24% tax bracket, will not pay tax on the Roth IRA if he inherits it;
- Ronaldinho will be able to draw the $10,000 plus any accrued interest after he reaches age 65 (five years after the conversion) tax-free; and
- Drawing from the Roth IRA will not cause him to increase the taxability of his Social Security.

Comment

Look at a Roth IRA conversion for a taxpayer who is having a low-income year:

- Consider a Roth IRA conversion to increase AGI and allowable charitable contributions;
- Do Roth IRA conversions when there is an NOL — sometimes it's tax-free;
- Do Roth IRA conversions before drawing Social Security;
- Use a Roth IRA when the parent's tax rate is lower than the child's will be if they inherit it;
- Use a Roth IRA to avoid IRD upon death of the owner; and
- Consider doing a large Roth IRA conversion, which raises income in one year but will keep AGI down in subsequent years.

Credit carryovers

The taxpayer may have some tax credit carryovers that can be unlocked with a Roth IRA conversion. These are generally the nonrefundable tax credits. Examples include:

- Clean Vehicle Credit;
- Child and Dependent Care Expenses Credit;
- American Opportunity Tax Credit; and
- Residential Clean Energy Credit.

Each of these credits is discussed in more detail in Chapter 1.

AMT planning

Roth IRA conversions can come into play when doing AMT break-even planning. Under the TCJA, the AMT exemptions have been increased, and the SALT deduction is now limited to $10,000, which means AMT planning with Roth IRA conversions may not be as sensitive as in the past. However, this may come into play if there are AMT credits that may be utilized. A Roth IRA conversion may limit or reduce the amount of AMT credit utilization. Accordingly AMT planning should still be considered in Roth IRA conversions.

Stock market declines

A stock market decline may provide an opportunity for a Roth IRA conversion. For example, let's say a taxpayer's traditional IRA was worth $100,000, but due to a market decline, it is now worth $80,000. The taxpayer can convert the traditional IRA to a Roth IRA and pay tax on $80,000. When the market recovers, the Roth IRA's value returns to $100,000 — the taxpayer just made $20,000 tax free.

However, the taxpayer must roll the investments as is to the Roth. If the investments are sold and cash recontributed, they will lose the potential to recoup the losses.

Comment

Stock markets have had a rough year throughout 2022 and may not have yet seen their bottom. As such, now is a good time to visit this strategy with your clients.

A recent example of the Roth IRA conversion strategy during a stock market decline took place during the early days of the COVID-19 pandemic in the spring of 2020. Using the S&P 500 as an example, the S&P 500 was at a high of 3,380.16 points on February 14, 2020, but dropped down to 2,304.92 points on March 20, 2020 (a decrease of 31.81%). The drop in the S&P 500 was fully recovered by mid-August 2020 and has continued to increase since.

So, a taxpayer with a traditional IRA valued of $100,000 invested solely in the S&P 500 index on February 14, 2020, had a value of $68,190 ($100,000 × (1 - .3181)) on March 20, 2020. If the taxpayer engaged in a Roth IRA conversion on March 20, 2020, they would recognize $68,190 of taxable income on that date, and once the S&P 500 recovered by mid-August 2020, they would have realized $31,810 ($100,000 - $68,190) of tax-free growth in only five short months.

Of course, the taxpayer would either have to come up with other funds out of pocket to pay the tax liability or use some of the rollover funds to pay the tax liability. But the longer the taxpayer can allow the Roth IRA to grow before withdrawing the funds in retirement, the more benefit will be realized.

This is a good lesson for owners of traditional IRA accounts to monitor stock market declines with an eye toward Roth IRA conversions during the next down market.

Setting up Roth IRA for young workers

Consider funding a Roth IRA for children with earned income. Roth IRAs have the best financial benefit when contributions are made in low tax bracket years and distributions are taken in high tax bracket years. Many young adults who are dependents have earned income that does not exceed their standard deduction and therefore pay no federal income tax. Roth IRA distributions later in the child's life will likely occur when they are in a federal tax bracket above 0%.

> ***Example of child's Roth IRA***
>
> Nick is 13 years old and started his first job working as a youth soccer referee. Nick earned $4,000 in 2022 and expects to earn about that same amount until he is 18.
>
> Each year his parents fund a Roth IRA with $4,000 (equal to his earned income). Assuming a growth rate of 5%, Nick will have over $27,000 in his Roth IRA at age 18. With no additional contributions the account will top $220,000 when he turns age 59½, assuming a 5% annual rate of return.

Backdoor Roth conversions

The "backdoor" Roth conversion strategy allows high-income individuals to make a nondeductible contribution to a traditional IRA and then convert the traditional IRA to a Roth IRA. However, be aware of the IRA aggregation rules under IRC §408(d)(2) when considering a backdoor Roth IRA whereby the total value of all of the traditional IRA accounts becomes a component when computing taxability of the Roth conversion.

> ***Example of simple backdoor conversion***
>
> Jameson made a $6,000 nondeductible contribution to a traditional IRA. His income was $310,000, so he was unable to make a Roth contribution. Immediately after contributing the $6,000 to the IRA, he converted the $6,000 IRA to a Roth IRA in a nontaxable event. He had no other IRA accounts.

> ***Example of aggregation rules***
>
> Nya made a nondeductible $6,000 contribution to her IRA. Nya also has a rollover IRA with a balance of $220,000. When she converts the $6,000 to the Roth, her basis in her IRA accounts is $6,000. She must include all $226,000 in her taxable income computation. Nya's taxable amount is $5,820:
>
> $220,000 ÷ $226,000 = 97%
> $6,000 × 97% = $5,820

California conformity

California conforms to IRC §408A and automatically conforms to any federal changes including the Roth recharacterization repeal. (R&TC §§17501–17509, 23701)

Maximum Deductible Contributions to IRAs, Keogh Plans, and SEPs						
Tax Year	Maximum deductible amount of Keogh contribution		Maximum deductible amount of IRA contribution		Maximum deductible amount of SEP contribution	
	Federal	California	Federal	California	Federal	California
1963–67	$ 1,250[1]	$ – 0 –				
1968–70	2,500	– 0 –				
1971–73	2,500	2,500				
1974	7,500	2,500				
1975	7,500	2,500	$1,500	$ – 0 –		
1976–78	7,500	2,500	1,500	1,500		
1979–81	7,500	2,500	1,500	1,500	$ 7,500	$ 2,500
1982–83	15,000	2,500	2,000	1,500[2]	15,000	2,500
1984–86	30,000	2,500	2,000	1,500[2]	30,000	2,500
1987–93	30,000	30,000[3]	2,000	2,000[2]	30,000	30,000[3]
1994–96	30,000	30,000	2,000	2,000	22,500	22,500[3]
1997–99	30,000	30,000	2,000	2,000	24,000	24,000
2000	30,000	30,000	2,000	2,000	25,500	25,500
2001	35,000	35,000	2,000	2,000	25,500	25,500
2002–03	40,000	40,000	3,000[4]	3,000[4]	40,000	40,000
2004	41,000	41,000	3,000[4]	3,000[4]	41,000	41,000
2005	42,000	42,000	4,000[4]	4,000[4]	42,000	42,000
2006	44,000	44,000	4,000[5]	4,000[5]	44,000	44,000
2007	45,000	45,000	4,000[5]	4,000[5]	45,000	45,000
2008	46,000	46,000	5,000[5]	5,000[5]	46,000	46,000
2009–11	49,000	49,000	5,000[5]	5,000[5]	49,000	49,000
2012	50,000	50,000	5,000[5]	5,000[5]	50,000	50,000
2013	51,000	51,000	5,500[5]	5,500[5]	51,000	51,000
2014	52,000	52,000	5,500[5]	5,500[5]	52,000	52,000
2015–16	53,000	53,000	5,500[5]	5,500[5]	53,000	53,000
2017	54,000	54,000	5,500[5]	5,500[5]	54,000	54,000
2018	55,000	55,000	5,500[5]	5,500[5]	55,000	55,000
2019	56,000	56,000	6,000[5]	6,000[5]	56,000	56,000
2020	57,000	57,000	6,000[5]	6,000[5]	57,000	57,000
2021	58,000	58,000	6,000[5]	6,000[5]	58,000	58,000
2022	61,000	61,000	6,000[5]	6,000[5]	61,000	61,000
2023	66,000	66,000	6,500[5]	6,500[5]	66,000	66,000

[1] For tax years 1963–67, the maximum allowable Keogh contribution was $2,500, but only 50% of it was deductible

[2] For these years, California did not allow a taxpayer who was covered by an employer's plan at any time during the year to deduct an IRA

[3] Although the maximums were the same for federal and California, the deductible amount may have been different. The federal maximum was based on federal net income and the California maximum on California net income

[4] Plus $500 if at least age 50 as of the end of the year

[5] Plus $1,000 if at least age 50 as of the end of the year

ALLOWABLE ROLLOVERS

Comparison Chart of Allowable Rollovers									
		Rollover To							
		IRA	SEP-IRA	SIMPLE IRA	Roth IRA	457(b)	403(b)	Qualified Plan	Designated Roth Account
Rollover From	IRA	Yes	Yes	Yes, after two years	Yes, must include in income	Yes, must have separate accounts	Yes	Yes	No
	SEP-IRA	Yes	Yes	Yes, after two years	Yes, must include in income	Yes, must have separate accounts	Yes	Yes	No
	SIMPLE IRA	Yes, after two years	Yes, after two years	Yes	Yes, after two years. Must include in income	Yes, after two years. Must have separate accounts	Yes, after two years	Yes, after two years	No
	Roth IRA	No	No	No	Yes	No	No	No	No
	457(b)	Yes	Yes	Yes, after two years	Yes, after December 31, 1997. Must include in income	Yes	Yes	Yes	Yes, must include in income, must be an in-plan rollover
	403(b)	Yes	Yes	Yes, after two years	Yes, after December 31, 1997. Must include in income	Yes, must have separate accounts	Yes	Yes	Yes, must include in income, must be an in-plan rollover
	Qualified Plan	Yes	Yes	Yes, after two years	Yes, after December 31, 1997. Must include in income	Yes, must have separate accounts	Yes	Yes	Yes, must include in income, must be an in-plan rollover
	Designated Roth Account	No	No	No	Yes	No	No	No	Yes, if a direct trustee-to-trustee transfer

Warning: The comparison chart shows general information that may not be applicable to all plans. Not all accounts allow rollover contributions. (Treas. Regs. §1.402(a)(31)-1, Q&A 13) Check with your pension administrator for additional requirements. A trustee-to-trustee transfer is required in some instances. A 60-day rollover rule may apply. (www.irs.gov/retirement-plans)

PLAN LIMITATION AMOUNTS

Maximum Contributions to Retirement Plans					
	2019	**2020**	**2021**	**2022**	**2023**
IRAs (regular and Roth)					
Up to age 50	$6,000	$6,000	$6,000	$6,000	$6,500
Age 50+	$7,000	$7,000	$7,000	$7,000	$7,500
401(k); 403(b); 457 plans					
Up to age 50	$19,000	$19,500	$19,500	$20,500	$22,500
Age 50+	$25,000	$26,000	$26,000	$27,000	$30,000
SIMPLE IRAs					
Up to age 50	$13,000	$13,500	$13,500	$14,000	$15,500
Age 50+	$16,000	$16,500	$16,500	$17,000	$19,000
Defined contribution plans					
Profit sharing/ money purchase	$56,000	$57,000	$58,000	$61,000	$66,000
SEP IRA	$56,000	$57,000	$58,000	$61,000	$66,000
Solo 401(k)					
Up to age 50	$56,000	$57,000	$58,000	$61,000	$66,000
Age 50+	$62,000	$63,500	$64,500	$67,500	$73,500

Annual Compensation Limits of Defined Benefit Plans (IRC §§401(a)(17), 404(j), 408(k)(3)(C)(7))	
2021	$290,000
2022	$305,000
2023	$330,000

California conformity

California conforms to these amounts. (R&TC §17501)

 ©2022

SOCIAL SECURITY

SOCIAL SECURITY (FICA)

FICA wage base

FICA is made up of two components:

- Old Age, Survivor, and Disability Insurance (OASDI); and
- Medicare.

Both the employer and employee are subject to a 6.2% rate for OASDI and 1.45% for Medicare. In addition, an employer is required to collect from each of its employees the 0.9% additional Medicare tax only to the extent the employer pays wages to the employee in excess of $200,000 in a calendar year. This rule applies regardless of the employee's filing status or other income. (Prop. Treas. Regs. §31.3102-4) There is no requirement that the employer match the 0.9% tax or notify its employees if it withholds additional Medicare tax.

FICA and Self-Employment Tax Update					
	2019	**2020**	**2021**	**2022**	**2023**
Maximum FICA (OASDI) wage base	$132,900	$137,700	$142,800	$147,000	$160,200
FICA tax rate (employer/employee)	7.65% (employer) + 7.65% (employee)				
Self-employment tax rate	15.3%				
Max FICA tax (employer)	$10,167	$10,534	$10,924	$11,246	$12,255
Max FICA tax (employee)	$10,167	$10,534	$10,924	$11,246	$12,255
Max self-employment tax (to OASDI limit)	$20,334	$21,068	$21,848	$22,491	$24,511
Max Medicare health insurance wage base	Unlimited				
Medicare health insurance rate	$1.45% + 0.9% above $200,000				
Earned income ceilings for SS benefits: early retirement age	$17,640 ($1,470/mo.)	$18,240 ($1,520/mo.)	$18,960 ($1,580/mo.)	$19,560 ($1,630/mo.)	$21,240 ($1,770/mo.)
Earned income ceilings for SS benefits: full retirement age and over	Unlimited				

COLA for 2023

Social Security and Supplemental Security Income (SSI) beneficiaries will receive an 8.7% cost of living adjustment in 2023. For 2022, it was 5.9%.

Practice Pointer

Occasionally, a client is unable to locate their SSA-1099. Taxpayers who have created an online account with the Social Security Administration can instantly download a printable copy of their SSA-1099 online at the following Social Security website:

Website
www.ssa.gov/myaccount/replacement-SSA-1099.html

All taxpayers, not just those currently receiving benefits, who have not created an online account with the Social Security Administration should create one. Taxpayers can review their earnings history online, print annual statements, and order replacement Social Security cards.

MEDICARE

For 2022, the basic Medicare premiums are $170.10, plus the cost of a prescription drug plan. For 2023, basic Medicare premiums drop to $164.90 plus the cost of a prescription drug plan.

HIGH-INCOME INDIVIDUALS

Individuals with incomes above certain thresholds pay a higher Medicare premium surcharge and do not receive the benefit of the hold-harmless rule. The surcharge is based on "modified AGI" using a two-year look-back. A two-year look-back means, for example, that the 2023 surcharge is based on 2021 modified AGI.

Taxpayers may be able to get the surcharge reduced if their income has dropped because of certain life-changing events, such as marriage, divorce, or the death of a spouse, or if the taxpayer or spouse stopped working or reduced their work hours. In that case, the taxpayer must contact the Social Security Administration. Taxpayers cannot contest the surcharge just because their income was unusually high in the look-back year for other reasons.

Modified AGI is the taxpayer's adjusted gross income plus:

- Tax-exempt interest;
- Excluded savings bond interest used to pay for educational expenses;
- Excluded foreign-earned income;
- Income derived from sources within Guam, American Samoa, and the Northern Mariana Islands; and
- Income from sources in Puerto Rico.

Comment

Noticeably absent from the MAGI calculation for Medicare are distributions from Roth accounts (IRAs or 401(k)s). The fact that Roth distributions won't create additional income for purposes of calculating the Medicare surcharge is yet another benefit of Roth retirement accounts.

Taxpayers who file as head of household, or qualifying widow or widower, are treated as single for purposes of the Medicare premium surcharge.

Part D subject to surcharge

High-income beneficiaries who pay the Part B premium surcharge also pay a graduated surcharge on Part D premiums if they are enrolled in Part D. The income levels are the same for Part D surcharges as Part B.

2023 Medicare Parts B and D Premium Surcharge			
If 2021 Modified AGI is …		**2023 Part B monthly premium**	**2023 Part D monthly premium**
Single	**Married**		
$97,000 or less	$194,000 or less	$0	Plan premium
$97,000–$123,000	$194,000–$246,000	$65.90	Plan premium + $12.20
$123,000–$153,000	$246,000–$306,000	$164.80	Plan premium + $31.50
$153,000–$183,000	$306,000–$366,000	$263.70	Plan premium + $50.70
$183,000–$500,000	$366,000–$750,000	$362.60	Plan premium + $70.00
$500,000 and above	$750,000 and above	$395.60	Plan premium + $76.40

2022 Medicare Parts B and D Premium Surcharge			
If 2020 Modified AGI is …		**2022 Part B monthly premium**	**2022 Part D monthly premium**
Single	**Married**		
$91,000 or less	$182,000 or less	$170.10	Plan premium
$91,001–$114,000	$182,001–$228,000	$238.10	Plan premium + $12.40
$114,001–$142,000	$228,001–$284,000	$340.20	Plan premium + $32.10
$142,001–$170,000	$284,001–$340,000	$442.30	Plan premium + $51.70
$170,001–$500,000	$340,001–$750,000	$544.30	Plan premium + $71.30
$500,001 and above	$750,001 and above	$578.30	Plan premium + $77.90

Practice Pointer

If the Social Security Administration determines that a Medicare participant should pay the Medicare premium surcharge, then it will mail the participant an initial determination notice. Taxpayers can appeal the surcharge by filing Form SSA-44, Medicare Income-Related Monthly Adjustment Amount — Life-Changing Event.

Form SSA-44 should be used where a Medicare participant experiences a life-changing event.

Life changing events are:

- Change in marital status (marriage, divorce/annulment, or death of a spouse);
- Work stoppage or work reduction (retirement, reduced work hours, etc.);
- Loss of income-producing property;
- Loss of pension income; or
- Employer settlement payment.

Taxpayers can attempt to get ahead of a Medicare premium surcharge by either filing Form SSA-44 or by calling the Social Security Administration at (800) 772-1213 ahead of time. A copy of Form SSA-44 can be found at:

Website
www.ssa.gov/forms/ssa-44-ext.pdf

MEDICARE-RELATED PROVISIONS OF THE INFLATION REDUCTION ACT

In addition to the ACA changes made by the IRA ′22 discussed on page 1-50, the IRA ′22 also:

- Caps out-of-pocket costs for prescription drugs at $2,000 (adjusted for inflation) for Medicare recipients, beginning in 2025 (IRA ′22 §11201);
- Limits the annual Medicare Part D premium increases to 6% per year for the 2024 through 2029 calendar years (IRA ′22 §11201(d));
- Provides free vaccines for seniors covered by Medicare for 2023 through 2025 (IRA ′22 §11401); and
- Expands premium and co-pay assistance on prescription drugs for low-income individuals by providing full, rather than partial subsidies to seniors earning 135% to 150% of the federal poverty level, for post-2023 plan years. (IRA ′22 §11404)

 ©2022

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

9. An excess contribution to an IRA:

   a) Is subject to a 6% penalty only in the year in which the contribution is made
   b) May be treated as an IRA contribution in a later tax year without penalty
   c) May be treated as an IRA contribution in a later tax year, but the 6% excise tax applies each year the excess contribution stays in the IRA
   d) Is always corrected by reducing the allowable deduction for the later year

10. For IRA distributions, which of these statements is correct?

    a) IRA owners must calculate their required minimum distributions separately for each IRA account they own, but they can withdraw the total RMD from one account only
    b) Spouses are considered co-owners of their respective retirement accounts
    c) The penalty for failing to take an RMD is 25% of the amount by which the amount of the RMD is more than the actual distributions taken for the year
    d) Taxpayers must begin taking their RMDs in the year they turn age 72 without exception

11. What are among the details of making repayments of coronavirus-related retirement account distributions?

    a) Any repayment is applied first against the amount of income recognized in the year of repayment
    b) Repayments must be made to the same account from which the distribution was made
    c) Repayments of coronavirus-related distributions made in 2021 must be reported on IRS Form 8915-E
    d) Any excess repayments may be carried forward but not back

 ©2022

12. Under the proposed regulations to the SECURE Act, which of these statements is true regarding an employer's defined contribution plan?

    a) The proposed regulations provide that with a defined contribution plan, if an employee has a designated beneficiary who is considered an eligible designated beneficiary, the life expectancy payments rule applies
    b) The employer's defined contribution plan can require the use of the 10-year rule even if the beneficiary is a designated beneficiary
    c) The proposed regulations state that the plan may provide the option of how distributions may be taken by the employee, but not by the designated beneficiary
    d) If the plan does not include an optional provision of how distributions may be taken and the employee has an eligible designated beneficiary, the plan must provide for the 10-year rule

13. The IRS has issued proposed regulations on required minimum distribution rules for inherited retirement accounts. Which of these statements is accurate regarding these proposed regulations?

    a) If a trust is a see-through trust, the beneficiaries of the trust are treated as designated beneficiaries of the grantor's retirement plan, and payments must be paid out over a five-year period
    b) For purposes of RMD rules, if a trust is a see-through trust, it is revocable
    c) Trust beneficiaries with only minimal interests are disregarded when determining whether they may be considered a beneficiary of the grantor's retirement plan
    d) For an individual trust beneficiary to be considered a designated beneficiary of the grantor's retirement plan, the trust must be a conduit trust

14. What is true about FICA?

    a) OASDI stands for Old Age and Supplemental Disability Insurance
    b) FICA is made up of OASDI plus Medicare
    c) An employer must collect from each of their employees 0.9% additional Medicare tax if the employee's wages are more than $150,000
    d) The employer must match the 0.9% additional Medicare tax paid by qualified employees

 ©2022

SOLUTIONS TO REVIEW QUESTIONS

9. An excess contribution to an IRA: **(Page 2-2)**

   a) Incorrect. It occurs each year the excess contribution stays in the IRA.
   b) Incorrect. The 6% penalty applies each year the excess remains.
   c) Correct. This occurs automatically for any year the taxpayer does not contribution the maximum allowable amount to their IRA.
   d) Incorrect. This is how an excess contribution is remedied when the statute of limitations has expired on the year of the excess contribution and a deduction was taken for the contribution in that year.

10. For IRA distributions, which of these statements is correct? **(Page 2-4)**

    a) Correct. The RMD may be taken from one or any combination of their IRA accounts.
    b) Incorrect. Spouses are separate owners of their respective accounts.
    c) Incorrect. The penalty percentage is 50%.
    d) Incorrect. The first RMD can be delayed until April 1 of the year after the taxpayer turns age 72.

11. What are among the details of making repayments of coronavirus-related retirement account distributions? **(Page 2-13)**

    a) Correct. Any excess repayment can be carried forward or back.
    b) Incorrect. Repayments may be made to a different retirement account as long as the account is eligible to receive a rollover from another account.
    c) Incorrect. Any repayments are reported on IRS Form 8915-F, which replaced 8915-E for tax years beginning after 2020. Form 8915-F is considered a "forever form."
    d) Incorrect. Excess repayments may be carried back.

12. Under the proposed regulations to the SECURE Act, which of these statements is true regarding an employer's defined contribution plan? **(Page 2-20)**

    a) Incorrect. Either the life expectancy payments rule or the 10-year rule can apply.
    b) Correct. This is considered an optional provision that would apply only when an employee dies before their required beginning date for taking distributions.
    c) Incorrect. The plan may provide for an election between the two rules for the eligible designated beneficiary.
    d) Incorrect. In this case, the plan must provide for the life expectancy payments rule.

 ©2022

13. The IRS has issued proposed regulations on required minimum distribution rules for inherited retirement accounts. Which of these statements is accurate regarding these proposed regulations? **(Page 2-23)**

    a) Incorrect. Payments may be paid out over a 10-year period.
    b) Incorrect. Among other conditions, a trust is a see-through trust if it is irrevocable.
    c) Correct. This is important when a charity, for example, is named as a beneficiary only if other specified individual beneficiaries die before the plan's benefits are fully distributed. If the charity isn't disregarded, then all of the benefits would have to be paid out within five years.
    d) Incorrect. It may be either a conduit trust or an accumulation trust.

14. What is true about FICA? **(Page 2-33)**

    a) Incorrect. OASDI is Old Age, Survivor, and Disability Insurance.
    b) Correct. These are the two components of FICA.
    c) Incorrect. The increased tax is for employee's wages in excess of $200,000.
    d) Incorrect. The employer is not required to match the additional tax.

 ©2022

Chapter 3

Business

BUSINESS

PPP AND ERC LINGERING ISSUES

EMPLOYEE RETENTION CREDIT PENALTY RELIEF

The IRS has confirmed that taxpayers may claim reasonable cause penalty relief if they owe additional tax because their deduction for qualified wages is reduced by the amount of a retroactively claimed Employee Retention Credit (ERC). (IRS Notice 2021-49; IR-2022-89) The IRS has acknowledged that due to their delays in processing the backlog of Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund, for ERC refunds, many taxpayers are unable to pay the additional income tax because the ERC refund payment has not yet been received.

✐ **Practice Pointer**

Taxpayers that file an amended Form 941-X to claim an ERC refund must also file an amended income tax return for the tax year the ERC-eligible wages *were paid* to reduce their wage expense for the amount of the credit claimed. For taxpayers with large ERC refunds, this can result in a significant tax liability due to the decreased wage expense.

Example of reduced wages for ERC

In 2022, Geary, Inc. filed Forms 941-X, Adjusted Employers QUARTERLY Federal Tax Return or Claim for Refund, so that it could claim an ERC of $320,000 for wages paid in 2020 and $375,000 for wages paid in 2021.

In addition to claiming the ERC in 2022, Geary must amend its 2020 and 2021 income tax returns and reduce its deductible wages by the $320,000 and $375,000, respectively (the amount of the ERC claimed for each of those years).

Taxpayers in Geary's position often do not have the cashflow available to pay the additional tax liability generated in 2020 and 2021 caused by reducing their deductible wages. This is where IRS Notice 2021-49 and IR-2022-89 come into play.

The IRS has also stated that taxpayers may also utilize the first-time penalty abatement program. However, keep in mind that this relief may only be claimed once every four years. For this reason we recommend utilizing reasonable cause penalty abatement in this situation rather than first-time penalty abatement so the taxpayer has the option of utilizing first-time penalty abatement in the future.

California conformity

For California purposes, the ERC is treated like any other federal credit:

- The refund is not included in taxable income for California tax purposes; and
- There is no adjustment to taxable income nor is there a payroll tax reduction.

According to FTB Publication 1001, Supplemental Guidelines to California Adjustments, the only adjustment on the California return is that unlike federal law, the wage expense deduction is allowed in full. There is no adjustment to the California payroll tax deduction, nor is there any basis adjustment for the amount of the federal refund.

Why all the amended returns?

Many businesses never realized that they were eligible to claim the Employee Retention Credit until:

- Their payroll company informed them they may be eligible for the credit;
- Firms specializing in ERC refund claims contacted them; or
- You realized when reviewing their returns that they may be eligible.

If a client filed their Form 941, Employer's Quarterly Federal Tax Return, and was eligible to take the Employee Retention Credit but did not do so, they may amend the Form 941 to take the credit. Keep in mind that the ERC can only be claimed for wages paid from March 12, 2020, through December 31, 2021.

Generally, taxpayers may correct overreported taxes by filing Form 941-X within the later of:

- Three years from the date the original Form 941 was filed; or
- Two years from the date the tax reported on Form 941 was paid.

IMPROPERLY FORGIVEN PPP LOANS ARE TAXABLE INCOME

The IRS issued a Chief Counsel Advice Memorandum stating that Paycheck Protection Program (PPP) loans that were improperly forgiven are taxable income. (CCA 202237010) The CCA addresses the situation where a taxpayer received a PPP loan. The taxpayer didn't spend their PPP loan on eligible expenses but requested forgiveness of their loan, attesting that they did spend their loan on eligible expenses. In this scenario, the loan forgiveness is taxable income.

According to the CCA, because the taxpayer received forgiveness based on omissions and misrepresentations, the taxpayer therefore had "an accession to wealth, clearly realized, over which they had complete dominion" — the very definition of taxable gross income. (IRC §61(a); see ***Tufts v. Comm.*** (1983) 461 U.S. 300)

Caution

The CCA is a good reminder to tax professionals and their clients that just because they received PPP loan forgiveness, a business is still subject to audit by both the IRS and the SBA.

ERC FRAUD

According to an August 31, 2022, report from the Treasury Inspector General for Tax Administration (TIGTA), the IRS has identified 11,096 suspicious payroll tax returns (Forms 941)

claiming COVID-19-related payroll tax credits. (www.treasury.gov/tigta/auditreports/2022reports/202246059fr.pdf) The report also concluded that the IRS does not have processes in place to verify whether a business claiming the ERC is a recovery start-up business. Only recovery start-up businesses are eligible to claim the ERC for wages paid in the fourth quarter of 2021.

Caution

Tax professionals should be on the lookout for clients who have fraudulently claimed the ERC. When clients hire outside companies to determine whether they are eligible to claim the ERC and file amended payroll tax returns, the client will typically look to their tax professional to file amended income tax returns for them.

Even though an amended income tax return would be filed to reduce deductible wages, tax professionals should not sign a return they know contains fraudulent information.

Consider also the fact that the statute of limitations for imposing an assessment attributable to the ERC is five years from the later of:

- The date on which the original return, which includes the calendar quarter with respect to which the credit is determined, is filed; or
- April 15, 2022 (pursuant to IRC §6501(b)(2)).
  (IRC §3134(l))

However, the statute of limitations to file a refund claim on a federal income tax return is three years from the due date of the return.

It's entirely possible that a client that fraudulently claims an ERC can be audited and assessed additional payroll taxes and penalties after the statute of limitations has expired to file a refund claim on their income tax return. Remember, a taxpayer who claimed an ERC must reduce the wage deduction claimed on their income tax return for the year the wages were paid. If their ERC is denied on a later payroll tax audit, they will not be able to amend their income tax return to claim a deduction for the wages paid if the statute of limitations has expired.

INFLATION REDUCTION ACT PROVISIONS FOR BUSINESSES

"BASE" AND "BONUS" CREDITS

Some of the clean energy business provisions of the Inflation Reduction Act (IRA '22) contain a "base" benefit (either a credit or deduction) and a "bonus," where the maximum bonus benefit is five times the base benefit. For example, the Energy Investment Tax Credit contains a 6% base credit, but the credit can be as high as 30% (6% base credit × 5).

In order to claim the maximum benefit, the taxpayer must meet certain wage and apprenticeship requirements. The incentives that will impact most of our clients that are affected by the wage and apprenticeship requirements are the:

- Energy Efficient Commercial Building (EECB) deduction (discussed on page 3-8);
- Alternative Fuel Refueling Property Credit (discussed on page 3-10);
- New Energy Efficient Homes Credit (discussed on page 3-11); and
- Energy Investment Tax Credit (discussed on page 3-12).

Wage and apprenticeship requirements

The IRS officially published its wage and apprenticeship guidance on November 30, 2022. (IRS Notice 2022-61) The notice starts an important 60-day clock. Under the Inflation Reduction Act, the wage and apprenticeship requirements apply to projects that begin construction 60 days after the IRS publishes wage and apprenticeship requirements.

Projects that begin construction on or after January 30, 2023, are not eligible for the Inflation Reduction Act's enhanced (aka "bonus") credits or deduction unless prevailing wage and apprenticeship requirements are satisfied.

Prevailing wages

Taxpayers satisfy the prevailing wage requirements of the Inflation Reduction Act by paying at least the prevailing wages for the geographic area and type(s) of construction applicable to the facility on which work is being performed, including all labor classifications for the construction, alteration, or repair work that will be done on the facility by laborers or mechanics.

The prevailing wage rates are published by the Secretary of Labor at:

If the Secretary of Labor has not published a prevailing wage determination for the geographic area and type of construction for the facility on www.sam.gov (or if one or more labor classifications for the project are not listed), then the taxpayer must contact the Department of Labor Wage and Hour Division via e-mail and request the correct prevailing wage rate for the worker(s) at issue.

When e-mailing the Depart of Labor Wage and Hour Division, the taxpayer must provide the following information to the Department of Labor for each classification that is not listed:

- Type of facility;
- Facility location; and
- Proposed labor classifications;
- Proposed prevailing wage rates;
- Job description and duties; and
- Any rationale for the proposed classifications.

The e-mail address is:

E-mail
iraprevailingwage@dol.gov

Even though the Inflation Reduction Act requires the payment of prevailing wages, the term "wages" includes amounts paid to all individuals performing services for the taxpayer, contractor, or subcontractor in exchange for remuneration, regardless of whether the individual would be characterized as an employee or independent contractor for other federal tax purposes.

When calculating whether prevailing wages are paid, taxpayers include any *bona fide* fringe benefits defined under 29 CFR §5.2(p).

Apprenticeship requirement

In order to satisfy the apprenticeship requirements, taxpayers must:

- Satisfy the apprenticeship labor hour requirements;
- Satisfy the apprenticeship participation requirements; and
- Comply with the same general bookkeeping requirements that apply to the prevailing wage requirement under IRC §6001 and Treas. Regs. §1.6001-1 et seq.

If a taxpayer is not able to satisfy either the apprenticeship labor hour requirements or the participation requirements, then the taxpayer is deemed to have met the requirements if they meet the good faith effort exception. (IRC §45(b)(8)(D)(ii)) Under the good faith exception, the taxpayer must:

- Request qualified apprentices from a registered apprenticeship program, as defined in IRC §3131(e)(3)(B); and
- Either:
  - The request must have been denied (for purposes other than the taxpayer's failure to meet the requirements of the apprenticeship program's established standards); or
  - The registered apprenticeship program fails to respond to the taxpayer's request within five business days from the date the registered apprenticeship program received the taxpayer's request.

Under the apprenticeship labor hour requirement, the taxpayer must ensure that at least the applicable percentage of the total labor hours for the project is performed by qualified apprentices. The applicable percentages are:

- 10% for projects which begin before January 1, 2023;
- 12.5% for projects which begin after December 31, 2022, and before January 1, 2024; and
- 15% for projects that begin after December 31, 2023.

Comment

As noted above, the wage and apprenticeship requirements do not apply until 60 days after the IRS issues guidance on these requirements. The guidance was not issued until November 30, 2022, which is only 31 days before January 1, 2023.

So, any project which begins before January 30, 2023, is not subject to apprenticeship labor hour requirements outlined above. Due to the IRS's delay in issuing its guidance, the first bullet listed here requiring that at least 10% of the total labor hours be performed by registered apprentices for projects which begin before January 1, 2023, is irrelevant.

Comment

Certain provisions of the Inflation Reduction Act, such as IRC §§45, 45Y, and 48 require prevailing wages to be maintained for any alterations or repairs on a facility for which enhanced credits were claimed for up to 10 years.

Beginning of construction

The IRS provides two methods to determine when construction begins:

- Starting physical work of a significant nature (the Physical Work Test); and
- By paying or incurring 5% or more of the total cost of the project (Five Percent Safe Harbor Test).

These tests were first established in IRS Notice 2013-29 (and subsequently clarified and modified by IRS Notices 2018-59 and 2021-41) and have been around for other purposes for nearly a decade.

QUALIFIED COMMERCIAL CLEAN VEHICLE CREDIT

A new Qualified Commercial Clean Vehicle Credit is available for qualified vehicles purchased after December 31, 2022, and before 2033 and that are used in a trade or business. (IRA '22 §13403; IRC §45W) The credit is part of the IRC §38 General Business Credit.

Credit amount

The credit is equal to the lesser of:

- 15% of the vehicle's basis (30% if the vehicle is not powered by a gasoline or diesel internal combustion engine); or
- The excess of the vehicle's purchase price over the cost of a comparable vehicle in terms of size and use, which is powered solely by a gasoline or diesel internal combustion engine. (IRC §45W(b))

Comment

The IRA '22 directs the IRS to issue further guidance regarding the calculation of the Qualified Commercial Clean Vehicle Credit. As of the publication date of these materials, no additional guidance has been issued.

The credit is capped at $40,000 per vehicle ($7,500 for vehicles with a gross vehicle weight rating of less than 14,000 pounds). (IRC §45W(b)(4))

Comment

Unlike the Clean Vehicle Credit, the Qualified Commercial Clean Vehicle Credit cannot be transferred to the dealer at the time of purchase. However, purchasers that are tax-exempt entities can treat the seller as the purchaser. (IRC §45W(d)(2))

©2022

Qualified commercial clean vehicle

A qualified commercial clean vehicle is a vehicle that:

- The original use of which commences with the taxpayer;
- Is made by a qualified manufacturer (one that registers with the Secretary of the Treasury and discloses specified information to the IRS, including the vehicle's identification number (VIN));
- Is acquired for use or lease by the taxpayer and not for resale;
- Either is:
  - A motor vehicle under Title II of the Clean Air Act; or
  - A mobile machinery under IRC §4053(8);
- Either is:
  - Propelled to a significant extent by an electric motor that draws electricity from a battery with a minimum capacity of 15 kilowatt hours (seven kilowatt hours for vehicles that weigh less than 14,000 pounds) and is capable of being recharged from an external source of electricity; or
  - A fuel cell vehicle as defined under IRC §30B; and
- Is subject to depreciation.

Comment

The credit is subject to recapture if the vehicle is no longer qualified (e.g., does not continue to be used in a trade or business). (IRC §45W(d)(1))

The IRA '22 directs the IRS to issue regulations setting forth the recapture rules, which have not been issued as of the publication date of these materials. (IRC §30D(f)(5))

Other issues

Also, like the Clean Vehicle Credit:

- Taxpayers must provide the VIN on the tax return for the year the credit is claimed;
- The vehicle's basis must be reduced by the amount of the credit claimed;
- Tax-exempt entities that purchase a qualified vehicle may elect to have the seller treated as the taxpayer for purposes of the credit;
- The credit cannot be claimed for vehicles used predominantly outside the U.S.;
- Only one credit may be claimed per vehicle; and
- The vehicle must meet applicable air quality and motor vehicle safety standards.

No double benefit

The Qualified Commercial Clean Vehicle Credit cannot be claimed for a vehicle for which the taxpayer claimed the Clean Vehicle Credit under IRC §30D.

Any other deduction or credit allowed for the vehicle must be reduced by the amount of the Qualified Commercial Clean Vehicle Credit.

ENERGY EFFICIENT COMMERCIAL BUILDING DEDUCTION

IRC §179D allows a taxpayer who owns or leases a commercial building to deduct the cost or a portion of the cost to install energy efficient commercial building property.

Beginning with the 2023 taxable year, the IRC §179D energy efficient commercial buildings deduction is modified by:

- Increasing the maximum amount of the deduction (see below);
- Repealing the provision allowing taxpayers to claim a partial allowance if they do not fully comply with the required efficiency standards;
- Replacing the lifetime deduction cap with a three-year cap;
- Allowing taxpayers to claim an alternative deduction for energy efficient lighting, HVAC, and building envelope costs incurred in connection with a qualified retrofit plan (IRC §179D(f));
- Revising the efficiency "reference standard" the taxpayer must meet in order to qualify for the deduction; and
- Allowing tax-exempt entities, including governmental agencies and Indian tribes, to allocate the deduction to the designer of the building or qualified retrofit plan. (IRC §179D(d)(3)) (IRA '22 §13303; IRC §179D)

Comment

Tax-exempt and governmental/Indian tribal agencies may allocate the deduction to the designer of the building. Doing so may lower the costs of the project for these entities, making it much more economically feasible for them to make their buildings more energy efficient. (IRC §179D(d)(3)(A))

Energy efficient commercial building property

The term "energy efficient commercial building property" means property:

- That is depreciable or amortizable for the taxpayer;
- That is located in the United States and within the scope of Reference Standard 90.1 (defined below); and
- That is part of one of the following three buildings systems:
  - Interior lighting system;
  - HVAC system; or
  - The building's envelope.

  (IRC §179D(c)(1))

Reference Standard 90.1

The term "Reference Standard 90.1" means, with respect to any property, the most recent Standard 90.1 published by the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America, which has been affirmed by the Secretary, after consultation with the Secretary of Energy, for purposes of this section not later than the date that is two years before the date that construction of such property begins. (IRC §179D(c)(2))

Maximum deduction

The prior maximum lifetime deduction is increased depending on:

- The overall efficiencies achieved; and
- Whether the taxpayer qualifies for the bonus deduction rate by meeting certain wage requirement and apprenticeship standards.

Base amount

Beginning with the 2022 tax year, the maximum value of the base deduction is $0.50 per square foot of the building, increased by $0.02 per square foot for every percentage point by which the designed energy cost savings exceed 25% (50% for pre-2023 taxable years) of the reference standard (to be posted by the Secretary of the Treasury), up to a $1.00 per square foot maximum. All figures are subject to inflation adjustments. (IRC §179D(b))

Note: The deduction calculation must still be computed using qualified computer software; however, the IRA '22 clarifies that the software must be certified by the Secretary of the Treasury.

This amount is then reduced by the amount of the §179D deductions taken for the previous three taxable years (or for any taxable year ending during the four taxable year period ending with such taxable year if the deduction is claimed by a person other than the taxpayer).

Previously the maximum credit was $1.80 (adjusted for inflation) multiplied by the building's square footage and reduced by all prior §179D deductions claimed for the building in all prior tax years.

Bonus deduction amount

If the taxpayer meets wage and apprenticeship requirements, the maximum deduction is increased to $2.50 per square foot, with an additional $0.10 for each percentage point the designed energy cost savings exceed 25% of the reference standard, up to a $5.00 maximum per square foot.

However, the wage and apprenticeship requirements do not have to be met to qualify for the increased bonus deduction amount if the installation of the energy efficient commercial building property, energy efficient building retrofit property, or property installed pursuant to a qualified retrofit plan begins prior to the date that is 60 days after the Secretary publishes guidance with respect to the wage and apprenticeship requirements.

Comment

With a jump in the maximum deduction from $1.80 per square foot to $5.00 per square foot, many energy efficiency experts are anticipating a dramatic increase in the number of property owners and lessees willing to make the investment in energy efficiency retrofits.

Basis adjustment

The basis of the commercial building must be reduced by the amount of any Energy Efficient Commercial Building Deduction. (IRC §179D(e))

Alternative deduction for energy efficient building retrofit property

Beginning with the 2023 taxable year, taxpayers may elect to take an alternative, parallel deduction for energy efficient lighting, HVAC, and building envelope costs placed into service in connection with a qualified retrofit plan. A qualified retrofit plan must reduce a building's energy usage by at least 25%. The building must be in the U.S. and must have been originally placed in service for at least five years prior to the establishment of the qualified retrofit plan.

The value of the base deduction is determined by the reduction in a building's energy usage intensity (EUI) upon completion of the retrofit. The same computation is used as the standard deduction (e.g., the same base amount and bonus amount), but the reference is to the amount of reduction in EUI rather than the reference standard.

So the base amount is $0.50 per square foot, increased by $0.02 per square foot for every percentage point by which the reduction in EUI exceeds 25%.

Comment

Rather than look at the projected energy savings, the alternative deduction looks at the actual reduction in energy usage.

California nonconformity

California does not conform to the IRC §179D energy efficient commercial building deduction. (R&TC §17257.2) This will create a difference in basis as well as any allowable depreciation deductions.

ALTERNATIVE FUEL VEHICLE REFUELING PROPERTY CREDIT

IRC §30C provides a credit of 30% of the cost of qualified alternative fuel vehicle refueling property. Alternative fuel includes electricity and fuel that contains specified percentages of ethanol, natural gas, biodiesel, kerosene, etc. The credit had expired at the end of 2021 and is only available for alternative fuel vehicle refueling property installed by a business or at a taxpayer's principal residence.

Comment

Taxpayers that install electric charging stations in their business or homes can claim this credit. However, for property placed in service after 2022, only property placed in service in low-income or rural census tracts qualifies for the credit. (IRC §30C(c)(3))

The IRA '22 reinstated the credit "as is" for property purchased in 2022 and made the following additional changes:

- Extending the credit for an additional eleven years through 2032;
- Applicable to property placed in service after December 31, 2022, revising the credit amount to:
  - Reduce the 30% credit amount for depreciable property to 6% unless the taxpayer meets specified wage and apprenticeship hour requirements (discussed on page 3-4); and
  - Change the $30,000 per-location limit for depreciable property to a $100,000 per-item limit. The $1,000 limit for nondepreciable property remains the same;
- Expanding the definition of eligible property to include bidirectional charging equipment and charging stations for qualified two- and three-wheeled vehicles intended for use on public roads; and
- Limiting the availability of the credit beginning in 2023 to charging or refueling property placed in service in low-income or rural census tracts.
  (IRA '22 §13404; IRC §30C)

 ©2022

NEW ENERGY EFFICIENT HOME CREDIT

The New Energy Efficient Home Credit available to eligible contractors or manufacturers that construct or substantially reconstruct or rehabilitate new energy efficient homes is retroactively reinstated and extended an additional 11 years and applies to qualified new energy efficient homes acquired prior to January 1, 2033. (IRA '22 §13304; IRC §45L) The credit had expired at the end of 2021.

The current credit amounts of $1,000 and $2,000 are also increased for dwelling units acquired after 2022 to:

- $2,500 for single-family homes that:
    - Are eligible to participate in the Energy Star Residential New Construction Program or the Energy Star Manufactured New Homes Program;
    - Meet the Energy Star Single-Family New Homes National Program Requirements 3.1 (3.2 version for homes acquired after 2024); and
    - Meet the most recent Energy Star Single-Family New Homes program Requirements applicable to the location of the home (as in effect on the latter of January 1, 2023, or January 1, of two calendar years prior to the home's acquisition date); or
- $5,000 for eligible single-family and manufactured new homes that are certified as a Zero Energy Ready Home under the Department of Energy's Zero Energy Ready Home Program as in effect on January 1, 2023 (or any successor program).

Comment

Although the IRA '22 allows taxpayers to claim the credit for homes acquired in 2022, taxpayers claiming the credit for a home acquired in 2022 are limited to the $1,000 and $2,000 credit maximums. Only those homes acquired after 2022 are eligible for the increased credit amounts.

Multifamily homes

A contractor/manufacturer may claim a base credit of $500 for each dwelling unit eligible to participate in the Energy Star Multifamily New Construction Requirement that meets the specified national and local requirements. The credit is increased to $1,000 if the unit is certified as zero energy ready under the Department of Energy's Zero Energy Ready Home Program. (IRC §45L(a)(2)(B) and (c)(3))

The base credit rates are increased to bonus credit rates of $2,500 and $5,000 if the contractor/manufacturer ensures that any laborers and mechanics employed by the contractor/manufacturer or any other contractor or subcontractor is paid prevailing rates for construction, alteration, or repair of a similar character in the locality where the residence is located. (IRC §45L(g))

Contractors/manufacturers may "cure" any failure to satisfy the prevailing wage rate requirement in a manner similar to that described under the Renewable Electricity Production Credit described on page 3-14.

Basis adjustments

Taxpayers claiming the credit do not have to reduce the property's basis for purposes of calculating the IRC §42 Low-Income Housing Credit. (IRC §45L(e))

ENERGY INVESTMENT TAX CREDIT

The IRC §48 Energy Credit, which allows businesses to claim a tax credit for the cost of specified energy property (including solar property), is generally extended an additional year to apply to property for which construction begins before January 1, 2025 (January 1, 2035, for geothermal heat pump property). (IRA ′22 §13102; IRC §48) Previously the credit was scheduled to sunset for most energy property whose construction began after January 1, 2024.

In addition, applicable to property placed in service after 2022, the definition of energy property for which the credit can be claimed is expanded to include:

- Energy storage technology as defined in IRC §48(c)(6);
- Qualified biogas property as defined in IRC §48(c)(7);
- Microgrid controllers as defined in IRC §48(c)(8); and
- Interconnection property as defined in IRC §48(a)(8).

Comment

Solar credits for businesses, including rental properties, are claimed under the IRC §48 Energy Credit. The solar credits for personal use properties (principal residences, vacation homes, etc.) are claimed under the Residential Clean Energy Credit (formerly known as the Residential Energy Efficient Property Credit) under IRC §25D. The Residential Clean Energy Credit is discussed on page 1-47.

Amount of credit

For energy property placed in service after December 31, 2021, a two-tiered credit system is applied with a “base” amount and a “bonus” credit amount.

Base amount

The amount of the base credit is:

- 6% for solar energy property, hybrid solar lighting systems (now expanded to include dynamic glass), geothermal property, qualified fuel cell property, qualified small wind energy property, waste energy property, energy storage technology, qualified biogas property, microgrid controllers, combined heat and power system property, and waste energy recovery property. Energy storage technology, qualified biogas property, and microgrid controllers would also qualify for the 6% base credit;
- 6% for geothermal heat pump systems if construction begins before January 1, 2033 (reduced to 5.2% if construction begins in 2033 and to 4.4% if construction begins in 2034); and
- 2% for stationary microturbine property, and other energy property not specifically listed above.

Bonus amount

Taxpayers may be eligible for a “bonus credit rate” equal to five times the base credit amount if they meet the wage and apprenticeship requirements discussed above for the “energy project,” which may consist of one or more energy properties that are part of a single project. Five times the base credit amount for most qualifying property is 30% (10% for microturbine property and other energy property not specifically listed in IRC §48(a)(2)(A)(i)).

 ©2022

The maximum 30%/10% credit can still be claimed even if the wage/apprenticeship requirements are not met if:

- The facility has a maximum net output of less than 1 megawatt; or
- The construction of the facility began prior to the date that is 60 days after the Secretary of the Treasury publishes guidance related to the wage and apprenticeship requirements discussed immediately below.
  (IRA ′22 §13101; IRC §45(b)(6))

However:

- The prevailing wages must only be maintained for a five-year period after the project is placed in service;
- There is no opportunity to "cure" the failure to comply with the prevailing wage requirements by paying penalties; and
- The Treasury Secretary is charged with developing regulations or other guidance to provide for the recapture of the credit if the prevailing wages are not maintained for the full five-year period.

Who's responsible for wage and apprenticeship requirements?

One of the most common types of property eligible for the Energy Investment Tax Credit is solar energy property. This includes solar panels installed on a business or rental property. The owner of the property is the one claiming the tax credit for qualifying property purchased and installed on their property, but they aren't the one hiring workers for the project.

This leads to the natural question: Who's responsible for satisfying the wage and apprenticeships requirements?

With regard to the wage requirement, IRC §48(a)(10) provides:

"The requirements described in this subparagraph with respect to any energy project are that ***the taxpayer shall ensure that any laborers and mechanics employed by the taxpayer or any contractor or subcontractor*** *in:*

(i) the construction of such energy project, and
(ii) for the 5-year period beginning in the date such project is originally placed in service, the alteration or repair of such project, shall be paid wages at rates not less than the prevailing rates for construction, alteration, or repair of a similar character in the locality where such project is located as most recently determined by the Secretary of Labor…."

IRC §§45(b)(8) and 48(a)(11) contain similar language regarding the apprenticeship requirement.

Because the taxpayer claiming the credit is ultimately responsible for the wage and apprenticeship requirements, even of contractors and subcontractors, the taxpayer should make sure that any contracts with contractors and subcontractors require them to meet the wage and apprenticeship requirements set forth in the Internal Revenue Code.

Phaseouts retroactively repealed

Taxpayers that purchase property that meets the wage and apprenticeship requirements will be able to claim a full 30% credit if the property is placed in service in 2022.

Under pre-IRA ′22 law, the amount of the Energy Credit was phased down to 26% for solar energy property, qualified fuel cell property, and qualified small wind property if the construction

began after 2019, and the property was placed in service prior to 2026. The credit was scheduled to be further reduced to 22% if the construction began after 2022. The IRA '22 limits the application of the 26% rate to those properties that were placed in service prior to 2022. Properties whose construction began after 2019 and that were placed in service in 2022 may claim the full 30% credit.

This means taxpayers will be able to claim a 30% Energy Credit on their 2022 return if the property was placed in service in 2022.

Additional credit amount enhancements

The Energy Credit is increased by 2% (10% if the wage and apprenticeship requirements are met) if the taxpayer meets the domestic content requirements or is located in an energy community as discussed on page 3-17, applicable to property placed in service after 2022.

Projects receiving an allocation of the environmental justice solar and wind capacity limitation from the Secretary of the Treasury that are located in a low-income community (as defined under the IRC §45 New Markets Credit) or on Indian land are eligible for an additional 10% credit. (IRA '22 §13103; IRC §48(e)) The additional credit is increased to 20% if the project is a qualifying low-income residential building project or a low-income economic benefit project as defined in IRC §48(e)(2)(C). The Secretary must establish a program to start issuing such allocations in late February 2023.

Depreciable life of solar property

Solar property falls under the five-year property classification under IRC §168 (MACRS) and is bonus depreciation eligible. (CCA 201032038; IRC §168(e)(3)(B)(vi)(I)) Solar property is not eligible property for purposes of IRC §179.

California conformity

California conforms to IRC §179 but limits the deduction to $25,000. As such, solar property is also not eligible for IRC §179 expensing for California purposes.

Basis adjustments for business solar credit

If a business receives an investment credit for qualifying solar energy property, the basis of the property must be reduced by 50% of the credit. (IRC §50(c))

Example of basis adjustment

Pembroke, Inc., a C corporation, is a manufacturer and owns its factory. Pembroke purchased and installed solar panels on its factory on September 3, 2022, at a cost of $130,000 and received an Energy Investment Tax Credit of $39,000 ($130,000 × 30%).

The basis of Pembroke's five-year MACRS solar property is $110,500, calculated as follows:

Solar panel installation (capital improvement)	$130,000
Less 50% of credit	(19,500)
New basis	$110,500

RENEWABLE ELECTRICITY PRODUCTION TAX CREDIT

The IRC §45 Renewable Electricity Production Tax Credit is generally extended for three years for facilities that begin construction before January 1, 2025. (IRA '22 §13101; IRC §45) Facilities that

begin construction after 2024, will likely qualify for the new IRC §45Y Clean Energy Production Tax Credit discussed on page 3-17.

Comment

While many of the energy-related business credits will only benefit large energy-related companies, this credit and the Energy Investment Tax Credit previously discussed, may provide the impetus for smaller start-up companies (e.g., wind and solar production companies).

The Renewable Electricity Production Tax Credit provides a tax credit for each kilowatt hour (kWh) of electricity produced from qualifying facilities and sold to an unrelated party. Qualifying resources are generally sources of renewable electricity, including wind, biomass, municipal solid waste (including landfill gas and trash), geothermal, hydropower, and marine and hydrokinetic energy. Qualified taxpayers may claim the credit for up to 10 years from the time the facility is placed in service.

Except as otherwise noted, for facilities placed in service after 2021, the IRA ’22 also:

- Revives the Renewable Electricity Production Tax Credit for solar and geothermal energy facilities (it had previously sunset in 2006) for facilities that commence construction before January 1, 2025;
- Repeals the credit reduction and phaseout that applied to wind facilities;
- Applicable to facilities placed in service after 2022, repeals the half-credit reduction for hydropower and marine and hydrokinetic facilities and expands the definition of which facilities qualify as marine and hydrokinetic facilities; and
- Lessens the required reduction of the credit for facilities financed with tax-exempt financing for facilities placed in service after August 16, 2022 (the date of enactment of the IRA ’22).

The election to treat qualified energy property as energy property eligible for the IRC §48 Business Energy Investment Tax Credit is also extended. (IRA ’22 §13101(d); IRC §48(a)(5)(C)(ii))

Base credit amount

For facilities placed in service after 2021, the “base” credit is reduced from 1.5 cents to 0.3 cents per kilowatt hours of electricity produced (2022 inflation adjusted amount is 2.6 cents and 0.52 cents respectively). (IRA ’22 §13101; IRC §45(a))

The rate is not reduced if:

- The facility has a maximum net output of less than 1 megawatt; or
- The construction of the facility began prior to the date that is 60 days after the Secretary of the Treasury publishes guidance related to the wage and apprenticeship requirements discussed immediately below.
  (IRA ’22 §13101; IRC §45(b)(6))

The reduction formula applied to those projects financed with tax-exempt bonds is also revised applicable to facilities placed in service after August 16, 2022. (IRA ’22 §13101(h); IRC §45(b)(3))

Wage and apprenticeship bonus credit

If the taxpayer does not meet one of the exceptions above, taxpayers may qualify for a "bonus" credit rate of 1.5 cents per kilowatt hour (2.6 cents, adjusted for inflation) if the taxpayer ensures that:

- Any laborers and mechanics employed by contractors or subcontractors involved in the construction, repair, or alteration of the facility and for each year during the 10-year credit period are paid at least the prevailing wage rate for the area in which the facility is located; and
- Qualified apprentices perform at least 10% (12.5% in 2023; 15% thereafter) of the project's total labor hours. A taxpayer or contractor/subcontractor that employs at least four individuals to work on the construction of the project must employ at least one qualified apprentice to perform the work.

A taxpayer is deemed to have met the apprenticeship requirements if it requested apprentices from a registered apprenticeship program and was either:

- Denied for reasons other than failure to comply with the programs established standards and requirements; or
- The program did not respond within five business days.
(IRA '22 §13101; IRC §45(b)(7) and (8))

Further guidance must be issued

The U.S. Secretary of Labor is directed to issue guidance on these wage and apprenticeship requirements. We assume that part of this guidance will be information on how to obtain the local prevailing wage rates, which will hopefully provide some type of look-up tool.

The wage and apprenticeship requirements don't take effect until 60 days after the guidance is published.

Curing wage requirement failures

For purposes of this credit, a taxpayer may cure the prevailing wage requirement and still claim the bonus credit rate in a taxable year if the taxpayer:

- Pays the worker the difference between the wages paid and the prevailing wage, plus interest (three times this sum if intentional disregard of the requirement); and
- Pays the Secretary of the Treasury $5,000 ($10,000 if intentional disregard of the requirement) per underpaid worker.
(IRA '22 §13101(f); IRC §45(b)(7)(B))

These payments must be paid within 180 days of notification by the Secretary of the failure. If not, the taxpayer will be ineligible for the bonus credits.

Curing apprenticeship requirement failures

A taxpayer may also "cure" the apprenticeship wage requirements for purposes of this credit by paying the Secretary a penalty equal to $50 ($500 if intentional) multiplied by the total labor hour requirements that were not met. (IRA '22 §13101(f); IRC §45(b)(8)(D)(i)(II)(bb))

Domestic content bonus credit

Applicable to facilities placed in service after December 31, 2022, taxpayers may also increase the amount of their base and wage/apprenticeship bonus credits by an additional 10% if the taxpayer certifies to the Secretary of the Treasury that any steel, iron, or manufactured product that is a

component of the facility was produced in the U.S. (IRA ’22 §13101(g)) A certain “adjusted percentage” of the product must be manufactured in the U.S. as outlined in IRA ’22 §13101(g) and IRC §45(g)(9).

Energy community bonus credits

An additional 10% of the base and wage/apprenticeship bonus credits is available to taxpayers located in an energy community, applicable to facilities placed in service after December 31, 2022. An energy community is defined as:

- A brownfield site (aka specified contaminated real property);
- A metropolitan area that meets specified direct employment or local tax revenues related to the coal, oil, or natural gas industries and an unemployment rate equal to or above the national unemployment rate; or
- A census tract where a coal mine was closed after 1999 or a coal-fired electric generating unit was retired after 2009.

No double benefit

The Renewable Electricity Production Credit cannot be claimed for a facility that produces qualified biogas property if the IRC §48 Energy Credit is allowed for the facility. (IRA ’22 §13102(f)(4); IRC §45(e)(12))

In addition, the amount of the credit is reduced if the project is financed through tax-exempt bonds.

New Clean Electricity Production Credit

Applicable to electricity generation facilities placed in service after 2024, the IRC §45C Production Tax Credit is replaced with a new IRC §45Y Clean Electricity Production Credit. (IRA ’22 §13701) Only U.S. facilities for which the greenhouse gas emissions rate is less than zero qualify for the new credit. The IRS is directed to publish tables with greenhouse emissions rates for different categories of facilities.

Like the Renewable Electricity Production Tax Credit, the Clean Electricity Production Credit:

- Is based on the number of kilowatt hours of electricity produced;
- Is equal to 0.3 cents per kilowatt hour (1.5 cents for small facilities or if the taxpayer meets the prevailing wage and apprenticeship requirements). Both amounts are adjusted for inflation;
- Additional credit is available for facilities located in an energy community and for facilities that qualify for a domestic content bonus credit;
- Credits are reduced for projects financed with tax-exempt bonds; and
- Tax-exempt entities and government/Indian tribe organizations can treat the credit as a tax payment or transfer the credit to an unrelated taxpayer.

The amount of the credit is subject to phase out beginning in 2032, or earlier if the Treasury determines that specified reductions of greenhouse gas emissions from the production of electricity in the U.S. have been met.

Taxpayers are ineligible for the credit if they claim or previously claimed other energy credits for the same facility, including, but not limited to, the IRC §45 Production Tax Credit, the IRC §48 Energy Investment Tax Credit, or the new IRC §48E Clean Electricity Investment Credit.

CLEAN ELECTRICITY PROPERTY CLASSIFIED AS FIVE-YEAR PROPERTY

Energy property under IRC §48 is classified as five-year MACRS property. Applicable to facilities and property placed in service after December 31, 2024, the following property is also treated as five-year MACRS property for depreciation purposes:

- Qualified facilities for purposes of the IRC §45Y Clean Electricity Production Credit;
- Qualified investment property for purposes of the IRC §48E Clean Electricity Investment Credit; and
- Energy storage technology for purposes of the IRC §48E Clean Electricity Investment Credit. (IRA ′22 §13703; IRC §168(e)(3)(B)(viii))

MONETIZING SPECIFIED ENERGY CREDITS

The IRA ′22 allows taxpayers to monetize their credits by either selling them or transferring them.

Selling credits

Applicable to taxable years beginning after December 31, 2022, taxpayers eligible for many of these business energy credits may elect to sell these credits (or a portion thereof) for cash to an unrelated taxpayer (as determined under IRC §267(b) or §707(b)(1)). (IRA ′22 §13801(b); IRC §6418) This will enable the taxpayer to immediately monetize the benefits of these credits. The transferee taxpayer will be treated as the "taxpayer" with respect to the credit(s) transferred.

Sellers will not include the sale of their credits in gross income, nor can the purchaser deduct this expense. (IRC §6418(b)) A credit can only be transferred once.

The ability to sell credits includes, but is not limited to, the:

- IRC §45 Renewable Electricity Production Credit;
- IRC §45Y Clean Electricity Production Credit;
- IRC §48 Energy Investment Credit; and
- IRC §45D Clean Electricity Investment Credit.

See IRC §6418(f) for a complete list of eligible credits. **Note:** The IRC §45W Qualified Clean Commercial Vehicle Credit is not eligible for transfer.

Example of selling credits

PTO, Inc. completed construction on a large project in January 2023 and is eligible to claim $400,000 of Energy Investment Tax Credits under IRC §48 in 2023.

In February 2023, CreditBuyers, Inc. purchased PTO's $400,000 of credits for $350,000.

The $350,000 sale price will produce immediate cash flow for PTO and is excludable from its gross income.

CreditBuyers cannot deduct the $350,000 it paid for PTO's credits, but it will recognize $50,000 of income ($400,000 credit minus $350,000 cost to purchase the credits) when it claims the credits on its own income tax return.

 ©2022

Limitations

Government agencies, Indian tribes, and tax-exempt entities are ineligible to make the election to sell their credits. The seller cannot sell any business credit carryforwards or carrybacks under IRC §39. (IRC §6418(f)(1)(C))

A credit may only be sold/transferred once. (IRC §6418(e)(2))

> ***Comment***
>
> The IRS is given authority to require additional information (including information returns) to prevent duplication, fraud, and/or improper or excessive payments.

Making the election

An irrevocable election must be made by the extended due date for the return for the taxable year for which the credit is determined, but in no event earlier than February 12, 2023 (180 days after August 16, 2022 (the date IRA ’22 was enacted)). (IRC §6418(e)(1))

> ***Comment***
>
> The IRA ’22 does not provide a procedure for making the election — it only provides the due date for the election under IRC §6418(e)(1). The IRS must provide guidance regarding the manner of making the election, which it has not done as of the publication date of these materials.

For purposes of the IRC §45 Renewable Electricity Production Credit and the IRC §45Y Clean Electricity Production Credit, the election must be made separately with respect to each facility for which the credit is claimed and for each taxable year during the 10-year period that the credit may be claimed.

Claiming the credit

The transferred credit is claimed in the first taxable year of the transferee taxpayer ending with, or after, the taxable year of the eligible taxpayer (the transferor) with respect to which the credit was determined. (IRC §6418(d))

> ***Example of claiming purchased credits***
>
> Assume the facts are the same as the previous example where CreditBuyers purchased $400,000 of Energy Investment Tax Credits in February 2023 from PTO, Inc.
>
> Assume further that PTO is a calendar-year taxpayer.
>
> CreditBuyers will claim the tax credit for its taxable year that ends with or contains December 31, 2023. The following scenarios are illustrative:
>
> - If CreditBuyers is also a calendar year-end taxpayer, then it will claim the credits it purchased from PTO on its tax return for the tax year ending December 31, 2023; or
> - If CreditBuyers has an August 31 fiscal year-end, then it will claim the credits on its income tax return for the tax year ending August 31, 2024.

Excessive payments

Taxpayers that claim too much of a credit will be liable for the amount of the excessive payment plus an additional amount equal to 20% of the excessive payment (unless the taxpayer can show

reasonable cause), which is due with the tax return for the year the Secretary of the Treasury determines there is an excessive payment. (IRC §6417(d)(6))

Credits sold by partnerships/S corporations

If the seller is a partnership or S corporation, the election is made at the entity level, and:

- Any amount received for the transfer is treated as tax-exempt income for purposes of IRC §§705 and 1366; and
- A partner's distributive share of the tax-exempt income is based on the partnership's distributive share of the otherwise eligible credit for the tax year.
(IRC §6418(c))

Excessive credit transfers

Transferees that claim excessive credit transfers will be liable for the amount of the excessive payment plus an additional amount equal to 20% of the excessive payment (unless the taxpayer can show reasonable cause), which is due with the tax return for the year the Secretary determines there is an excessive payment. (IRC §6418(g)(2))

Treating the credit as a tax payment

In addition, also beginning with the 2023 taxable year, eligible taxpayers may elect to be treated as having made a payment of tax equal to the value of the credit they would otherwise be eligible for. This essentially turns these otherwise nonrefundable credits into a refundable credit. (IRA '22 §13801(a); IRC §6417(a)) Unfortunately, this option is not available to most for-profit businesses and may only be made for specified credits, including but not limited to:

- A portion of the IRC §30C Alternative Fuel Vehicle Refueling Property Credit;
- The IRC §45 Renewable Electricity Production Credit attributable to facilities originally placed in service after 2022;
- The IRC §45W Qualified Commercial Vehicles Credit (but only for government agencies, Indian tribes, and other tax-exempt entities);
- The IRC §45Y Clean Electricity Production Credit;
- The IRC §48 Energy Investment Credit; and
- The IRC §48E Clean Electricity Investment Credit.

Comment

The purpose of IRC §6417, which allows certain entities to elect to treat some energy credits as tax payments, is to benefit tax-exempt entities. Income tax credits provide little or no benefit to tax-exempt organizations because they don't typically have any income tax liabilities.

By allowing these entities to elect to treat the credits as a tax payment under IRC §6417, they can now receive the same monetary benefit of energy credits that for-profit taxpayers receive.

 ©2022

ADDITIONAL CHANGES TO ENERGY CREDITS

The IRA '22 also:

- Extends, revises, and expands the IRC §48C Qualifying Advanced Energy Project Credit by providing an additional $10 billion in allocations, requiring certification from the Treasury Department, imposing prevailing wage and apprenticeship requirements to claim the full credit amount, and expanding the types of environmental products that may qualify the manufacturer for the credit;
- Extends the following clean fuel credits through December 31, 2024:
  - Biodiesel and Renewable Diesel Credit (IRA '22 §13201(a); IRC §40A);
  - Biodiesel Mixture Excise Credit (IRA '22 §13201(b); IRC §§6426(c)(6), 6427(e)(6)(B));
  - Alternative Fuel and Alternative Fuel Mixture Credits (IRA '22 §13201(c)–(e); IRC §6426(d)(5), (e)(3), and (e)(6));
- Extends the Second-Generation Biofuel Tax Credit through 2025 (IRA '22 §13202; IRC §40(b)(6)(J)(i));
- Enacts the following new credits:
  - A Sustainable Aviation Fuel Credit (IRA '22 §13203; IRC §40B);
  - A Clean Fuel Production Credit (IRA '22 §13704; IRC §45Z);
  - A Credit for Production of Clean Hydrogen (IRA '22 §13204; IRC §45V);
  - An Advanced Manufacturing Production Credit for manufacturers of various alternative energy components (e.g., solar, wind, inverters, qualifying batteries, etc.), applicable to products produced and sold to an unrelated person after 2022 (IRA '22 §13502; IRC §45X); and
  - A Zero-Emission Nuclear Power Production Credit for the production of electricity from a qualified nuclear power facility (IRA '22 §13105; IRC §45U); and
- Extends and expands the Carbon Oxide Sequestration Credit available to coal and natural gas-fired power plants and other large industrial companies for facilities and equipment placed in service after December 31, 2022. (IRA '22 §13104; IRC §45Q)

EXCISE TAX ON STOCK BUYBACKS

Subject to the exceptions listed below, a new 1% excise tax is imposed on the fair market value of any corporate stock that is repurchased by a covered corporation during the taxable year. The new tax is applicable to stock repurchases made after December 31, 2022. (IRA '22 §10201; IRC §4501)

Covered corporation

A covered corporation is a U.S. corporation whose stock is traded on an established securities market. Repurchases by a covered corporation's specified affiliate are also subject to the tax. A specified affiliate is a:

- Corporation more than 50% owned (by vote or value) by the purchasing corporation; or
- Partnership where more than 50% of the capital or profits interests are held by the purchasing corporation.

Special rules apply to repurchases by specified foreign affiliates as well.

What is a repurchase?

A repurchase is:

- A redemption (within the meaning of IRC §317(b)) by the taxpayer or specified affiliate; or
- Any other transaction determined to be economically similar to a redemption by the Secretary of the Treasury.

Comment

Some commentators have noted that the definition of a "repurchase" for purposes of this provision can be applied very broadly and may even apply to mergers and acquisitions, and liquidations if cash consideration is received. We will have to wait to see what guidance the IRS issues in this area.

Tax base

The tax base on which the 1% excise tax is imposed is reduced by the fair market value of any stock issued by the corporation during the taxable year, including stock issued to employees of the corporation or its affiliates, whether or not the stock is used or provided in response to the exercise of a stock option.

Exceptions

The excise tax does not apply to:

- An IRC §368 reorganization in which no gain or loss is recognized by the shareholder(s);
- In instances in which the stock repurchased, or an amount of stock equal to the value of the stock repurchased, is contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan;
- Any case in which the total value of the stock repurchased during the taxable year does not exceed $1 million;
- Repurchases by a securities dealer in the ordinary course of business;
- Repurchases by a regulated investment company (RIC) or real estate investment trust (REIT); and
- If the repurchase is treated as a dividend.

Tax not deductible

The excise tax is not a deductible tax. (IRA '22 §10201(b); IRC §275(a)(6))

Comment

Many commentators are stating that the imposition of this new excise tax will result in corporations issuing more dividends, which may be subject to a lower tax rate at the shareholder level, rather than repurchasing stock from shareholders.

CORPORATE MINIMUM TAX

The IRA '22 imposes a 15% alternative corporate minimum tax on the adjusted financial statement income (generally, book income with specified adjustments) for the taxable year on applicable corporations. This will generally only impact certain C corporations with a three-year

average of annual adjusted financial statement income of $1 billion (although a lower threshold applies to corporations owned by foreign parents). (IRA ’22 §10001 et seq.) Some of the adjustments to book income include using tax depreciation (including bonus depreciation) and special provisions related to equity investment funds.

> ***Comment***
>
> This change was made to address large multinational corporations that pay little if any federal income taxes. It is estimated that this new minimum tax will impact approximately 200 multinational corporations.

NEW EXCISE TAX ON DRUG MANUFACTURERS

The IRA ’22 enacts a new excise tax on manufacturers, producers, or importers of selected drugs for which a negotiated price has been reached between the government and the manufacturer/producer/importer if the manufacturer/producer/importer fails to comply with the negotiated agreement. (IRA ’22 §11003l(a); IRC §5000D) The excise tax ranges from between 65% to 95% depending on the length of noncompliance and is not deductible on the taxpayer’s income tax return. (IRA ’22 §11003l(a); IRC §275(a)(6))

RESEARCH AND DEVELOPMENT

RESEARCH EXPENSES

Under the Tax Cuts and Jobs Act (TCJA), for taxable years beginning after December 31, 2021, specified research or experimental expenditures must be capitalized and amortized over five years (15 years for expenditures which are attributable to research conducted outside the United States). (IRC §174(a)(2)(B); TCJA §13206) Under the TCJA provision, all research expenses are amortized beginning with the midpoint of the taxable year in which such expenses are paid or incurred.

> ***Example of research expenses after December 31, 2021***
>
> Brooksy, Inc. incurred $590,000 of research expenditures during its calendar year ending December 31, 2022. Under the new TCJA provision, Brooksy must amortize its research expenditures over five years (60 months). Brooksy’s 2022 amortization expense for research is calculated as follows:

Research expenditures incurred during the year	$590,000
Amortization period	÷ 60
Monthly deduction	9,833
Deductible months in year expenses are paid or accrued*	× 6
Amortization deduction in 2022	$ 58,998

> * All research expenditures paid or incurred during the year are amortized beginning with the midpoint of the taxable year

Defining research and experimental expenditures

For taxable years beginning before January 1, 2022, it didn’t matter much whether a taxpayer classified an expenditure as an ordinary and necessary business expense under IRC §162 or as

research and experimental (R&E) expenditures under IRC §174 because either way, the taxpayer could deduct the full amount in the year it was incurred.

But, with the TCJA's requirement that research and experimental expenses under IRC §174 must be amortized and capitalized for taxable years beginning after December 31, 2021, the classification becomes very important.

The IRS defines research and experimental expenditures as research and development costs in the experimental or laboratory sense, which include all costs that are incident to the development or improvement of a product. (Treas. Regs. §1.174-2(a)(1))

The regulations do not provide an exhaustive list of what constitutes research and experimental expenditures. However, the regulations provide an example of a business that purchased a building, 50% of which is used in connection with a special research project. The example defines the following expenditures as research expenditures:

- Salaries and wages;
- Heat, light, and power;
- Drawings;
- Models;
- Laboratory materials;
- Attorneys' fees; and
- Depreciation.
  (Treas. Regs. §1.174-4(c))

In addition, the IRS has provided two Revenue Rulings, where it determined that overhead and other indirect costs that are connected to research are classified as research and experimental costs under IRC §174. (Rev. Rul. 73-20; Rev. Rul. 73-275)

R&E costs under IRC §174 distinguished from IRC §41

Qualified research expenses for purposes of the credit for increasing research activities under IRC §41 (commonly known as the R&D Credit) are defined more narrowly than deductible R&E expenditures under IRC §174.

Where Rev. Rul. 73-20 and Rev. Rul. 73-275 provide that overhead costs are classified as R&E expenditures under IRC §174, the IRS has held that depreciation, overhead costs, general and administrative costs, and other indirect expenses are ***not*** qualified research expenses for purposes of the IRC §41 R&D Credit.

Tax professionals can use qualified research expenses under IRC §41 as a starting point to identify R&E expenditures but must go further to identify all R&E expenditures that must be capitalized.

The regulations do provide a list of expenditures that are specifically excluded from the definition of research and experimental expenses under IRC §174:

- The ordinary testing or inspection of materials or products for quality control;
- Efficiency surveys;
- Management studies;
- Consumer surveys;
- Advertising or promotion;
- The acquisition of another's patent, model, production or process; or
- Research in connection with literary, historical, or similar projects.
  (Treas. Regs. §1.174-2(a)(6))

Practice Pointer

Tax professionals should advise their clients that they should reevaluate their expenditures to separate ordinary and necessary business expenses under IRC §162 from research and experimental expenditures under IRC §174.

The AICPA, among many others, has requested additional guidance and regulations from the IRS defining research and experimental expenditures because existing guidance is insufficient. The AICPA letter requesting IRS guidance on this topic can be found at:

Website
https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-aicpa-comment-letter-section-174-research-and-experimental-expenditures-final.pdf

Change of accounting method

In mid-December, 2022, the IRS provided guidance for taxpayers to obtain automatic consent to change their method of accounting for research and experimental (R&E) expenditures under IRC §174. (Rev. Proc. 2023-08)

For taxable years beginning after December 31, 2021, specified R&E expenditures under IRC §174 must be capitalized and amortized over five years (15 years for research conducted outside the United States). (TCJA §13206)

Under the TCJA, the change from deducting R&E expenditures to capitalizing them is defined as a change in accounting method that is applied on a cutoff basis for any R&E expenditures paid or incurred in taxable years beginning after December 31, 2021. The law does not allow for adjustments under IRC §481 to be made.

Rev. Proc. 2023-08 provides an automatic change in method of accounting procedure for taxpayers to comply with IRC §174 by filing a statement with the taxpayer's original federal income tax return for the first taxable year in which the TCJA's IRC §174 changes become effective instead of filing Form 3115, Application for Change in Accounting Method.

Taxpayers who make a change in method of accounting for R&E expenditures *after* their first taxable year in which the TCJA's IRC §174 changes become effective cannot apply the simplified relief provided in Rev. Proc. 2023-08, but instead must file Form 3115 in that subsequent taxable year.

The statement must include specified information. We have created a sample statement, available at:

Website
www.caltax.com/cl-restatement

Only R&E expenditures paid or incurred after December 31, 2021 are accounted for under the new IRC §174 capitalization rules. This is the effect of applying the changes on the cut-off basis. Any items arising before the year of change must still be accounted for under the taxpayer's former method of accounting.

Rev. Proc. 2023-08 provides a transition rule for taxpayer who filed a federal return on or before the Revenue Procedure was published in the Internal Revenue Bulletin for taxable years beginning after December 31, 2021.

The transition rule provides that such taxpayers are deemed to have complied with the IRC §446 method change procedure if the taxpayer properly reported the amount of specified R&E procedures on Part VI of Form 4562, Depreciation and Amortization, filed with their federal income tax return, and properly capitalized and amortized such specified R&E expenditures in accordance with the required IRC §174 method.

Disposition, retirement, or abandonment

Under the TCJA provision in effect for taxable years beginning after December 31, 2021, if any property with respect to an amortized research or development expenditure is disposed of, retired, or abandoned during the five- or 15-year amortization period, then the taxpayer must continue to amortize the expenditure over the applicable amortization period. (IRC §174(d))

Example of disposition, retirement, or abandonment

In 2022, Creed, Inc. incurred $415,000 of research expenses in the development of a new product line for its business but abandoned the project in 2023.

Pursuant to IRC §174 in effect for taxable years beginning after December 31, 2021, the $415,000 of expenditures incurred in 2022 means that their five-year amortization period begins on July 1, 2022 (the midpoint of the year in which the expenditures were paid or incurred).

Despite abandoning the project, Creed can only deduct its expenditures for the failed project by continuing its five-year amortization period; it cannot deduct the unamortized cost in the year the project is abandoned. The same treatment applies if the project is retired or otherwise disposed of.

 ©2022

Special rules

IRC §174, in effect for taxable years beginning after December 31, 2021, contains special rules pertaining to land and improvements, exploration expenditures, and software development expenditures.

Any research expenditures for the acquisition of land or improvements are not subject to the rules of IRC §174. Land and improvements must be depreciated under the rules of IRC §167 (depreciation) or §611 (depletion). (IRC §174(c)(1))

Similarly, the TCJA's amortization rules for research or experimental expenditures do not apply to exploration expenditures to ascertain the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas). (IRC §174(c)(2))

However, any amount paid or incurred in connection with the development of any software is specifically treated as a research or experimental expenditure. (IRC §174(c)(3))

Practice Pointer

Because software development costs are automatically treated as R&D expenses, which must be capitalized and amortized over five years starting in 2022, taxpayers may want to consider purchasing software from others instead of creating their own to avoid the new R&D five-year amortization rules.

R&D credit interplay

Taxpayers must reduce their capitalized research expenditures by the amount of any Research and Development Credits claimed. (IRC §280C(c)(1))

Example of R&D Credit interplay

June Lake Manufacturing (JLM) is a calendar-year C corporation. For the 2022 taxable year, it incurred $195,000 of research expenditures and claimed an R&D Credit of $25,000. JLM's research expenditure that must be amortized over five years is $170,000 ($195,000 - $25,000 credit).

Rules prior to January 1, 2022

For research or development expenditures paid or incurred for taxable years beginning before January 1, 2022, taxpayers can choose to either deduct the expenditures currently or amortize them over their useful life. (IRC §174(a), in effect prior to January 1, 2022)

If the taxpayer elects to amortize its research expenses over their useful life, then the minimum amortization period is five years (60 months). (IRC §174(b), in effect prior to January 1, 2022) The amortization period begins with the month in which the taxpayer first realizes the benefit from the research and experimental expenditures. (IRC §174(b)(1), in effect prior to January 1, 2022) Alternatively, taxpayers could elect an optional 10-year write-off under IRC §59(e) to avoid treatment of the expenses as an AMT adjustment item.

If a taxpayer abandoned, retired, or disposed of a project for which it incurred research and experimental expenditures for a taxable year beginning before January 1, 2022, the taxpayer could deduct their remaining unamortized expenses immediately. (***Dresser Manufacturing Co. v. Comm.*** (1939) U.S. Board of Tax Appeals, Nos. 84795 and 88294; ***Perine Machinery Co. v. Comm.*** (1931) U.S. Board of Tax Appeals, No. 24154)

Comment

Interestingly, a taxpayer that incurs research expenditures for a taxable year beginning before January 1, 2022, and elects to amortize such expenditures must wait until the month in which the taxpayer first realizes a benefit from the expenditure. This date can be in a taxable year after the year the expenditure was paid or incurred.

However, under the TCJA provision, those same research expenditures paid or incurred in a taxable year beginning after December 31, 2021, must be amortized, but the amortization period must begin at the midpoint of the taxable year that the expenditure was paid or incurred. The taxpayer is not required to wait until the taxpayer first realizes a benefit from the expenditure.

California nonconformity

California conforms to the pre-TCJA IRC §174 treatment of research and experimental expenditures. (R&TC §§17024.5, 17201, 23051.5, 24365) Therefore taxpayers may still currently expense their research and experimental expenses on the California return.

R&D CREDITS

Research Credit refund claim

In late 2021, the IRS issued a Chief Counsel Memorandum requiring additional information from taxpayers who file refund claims (aka an amended income tax return) to claim R&D Credits. The purpose of the additional information is to combat fraudulent and overly aggressive R&D Credit refund claims that should be disallowed.

To be considered valid, an R&D Credit refund claim must, at a minimum:

- Identify all the business components to which the Research Credit claim relates for that year;
- For each business component, identify all:
    - Research activities performed;
    - Individuals who performed each research activity; and
    - The information each individual sought to discover; and
- Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year (this may be done using Form 6765, Credit for Increasing Research Activities).
(Chief Counsel Memorandum 20214101F)

The taxpayer must also provide a sworn declaration verifying that the facts provided are accurate. In most cases, the signature on the Forms 1040X or 1120X will satisfy this requirement.

Comment

While the items listed in the last bullet are already required to be provided on Form 6765 when claiming the credit on the original return, the items in the first two bullets are not. This means taxpayers claiming the credit on a refund claim are required to provide far more detailed information than what is required on the original return.

 ©2022

Effective date pushed out and grace period extended

The IRS has extended the effective date for the additional information reporting requirements for R&D Credit refund claims to January 10, 2024. (IR-2021-203, updated September 30, 2022) The original effective date was January 10, 2022.

Additionally, the IRS announced that taxpayers that file refund claims on or after January 10, 2024, without the additional required information will have a 45-day grace period to perfect their claims after receiving a notice from the IRS, which was previously set at only 30 days.

Supporting documentation

A taxpayer does not have to provide supporting documentation at the time they file the claim. However, they should state the supporting facts in a written statement attached to the claim rather than through the production of documents.

If a taxpayer voluntarily provides documents with the claim, the taxpayer must specifically identify where in the documents the facts responsive to each of the five minimum facts listed above can be found. Similarly, if the taxpayer has prepared a credit study, the taxpayer does not need to attach it to the taxpayer's claim. If the taxpayer does attach a credit study, the taxpayer must identify the specific facts contained in the study that the taxpayer contends meet the five foundational information requirements stated above.

Quick Law: Qualified research

To qualify for the credit, a taxpayer's research activities must, among other things, involve a process of experimentation using science with a goal of improving a product or process the taxpayer uses in their business or holds for sale, lease, or license. Activities specifically excluded from qualifying for the credit include:

- Research after commercial production;
- Adaptation of an existing business product or process;
- Foreign research;
- Research funded by the customer; and
- Activities where there is no uncertainty about the taxpayer's method or capability to achieve a desired result.
  (IR-2019-42)

Qualified research must meet the following four tests:

1. **IRC §174 test:** The expenditures connected with the research must be eligible for treatment as expenses under IRC §174, which provides alternative methods of accounting for "research or experimental expenditures" that taxpayers would otherwise capitalize;
2. **Technological in nature test:** The research must be undertaken for the purpose of discovering technological information;
3. **Business component test:** The taxpayer must intend that the information to be discovered be useful in the development of a new or improved business component (e.g., product, process, computer software, technique, formula, or invention) that the taxpayer holds for sale, lease, or license or uses in its trade or business; and
4. **Process of experimentation test:** Substantially all of the research activities must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability, or quality. This test requires the use of the scientific method; simple trial and error is not sufficient.
   (IRC §41(d))

RESEARCH CREDIT AGAINST SMALL BUSINESS PAYROLL TAXES

Applicable to taxable years beginning after December 31, 2022, the $250,000 in available IRC §41 Research Credits that a qualified small business may elect to apply against their employer share of payroll taxes is increased to $500,000. (IRC §41(h)) The first $250,000 of payroll tax credits are applied against the employer's share of Social Security taxes, and the additional $250,000 of payroll tax credits allowed under the IRA '22 are applied against the employer's share of Medicare taxes.

The credit is nonrefundable, but unused credits may be carried forward. (IRC §1311(f)) In addition, any deductions allowed for Social Security and Medicare taxes are not reduced by the amount of the credit claimed.

Qualified small business

A business (other than a tax-exempt organization) qualifies to make this election if it:

- Has gross receipts (reduced for returns and allowances) for the taxable year of less than $5 million (individuals must aggregate gross receipts from all their trades and businesses for this purpose); and
- Did not have gross receipts for any taxable year preceding the five-tax year period that ends with the taxable year.
  (IRC §41(h)(1))

Comment

The ability to claim the Research Credit against payroll taxes provides immediate tax benefits to smaller, start-up businesses that would otherwise not receive the benefit of the Research Credit until years later, when and if they become profitable.

It also takes on added significance given the repeal of the current expensing of IRC §174 research expenses by the TCJA, which requires such expenses to be capitalized and amortized over a five-year period beginning with the 2022 taxable year. Companies that are no longer able to currently deduct these expenses may be looking to see if they can claim the IRC §41 Research Credit in lieu of amortizing them.

Credit limitations

The credit is the smallest of:

- The current-year Research Credit;
- An elected amount up to the $500,000 limit ($250,000 prior to the 2022 taxable year); or
- The general business credit carryforward for the tax year (before the application of the payroll tax credit election for the tax year. **Note:** This limitation does not apply to partnerships or S corporations.

The election

The election must be made on the taxpayer's timely filed income tax return (including extensions) and is made at the entity level. The election may only be revoked with the consent of the Secretary of the Treasury. The election is an annual election, so a business can choose the payroll tax credit one year and an income tax credit the next. The election is made on Section D of Form 6765, Credit for Increasing Research Activities.

Even though taxpayers make the election to claim the credit on their income tax return, the payroll tax credits are calculated on Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, which much be attached to Form 941, Employer's Quarterly Federal Tax Return, Form 943, Employer's Annual Federal Tax Return for Agricultural Employees, or Form 944, Employer's Annual Federal Tax Return.

IRC §179 AND DEPRECIATION

IRC §179 EXPENSING

The IRC §179 expensing limitation is $1 million, and the phaseout threshold is $2.5 million for property placed in service in tax years beginning after December 31, 2017. (IRC §179(b)) These figures are adjusted for inflation annually. The inflation adjusted figures are:

IRC §179 Expensing		
Assets placed in service in tax years beginning after ...	**Expensing limitation**	**Phaseout threshold**
December 31, 2019 (2020 tax year) (Rev. Proc. 2019-44)	$1,040,000	$2,590,000
December 31, 2020 (2021 tax year) (Rev. Proc. 2020-45)	$1,050,000	$2,620,000
December 31, 2021 (2022 tax year) (Rev. Proc. 2021-45)	$1,080,000	$2,700,000
December 31, 2022 (2023 tax year) (Rev. Proc. 2022-38)	$1,160,000	$2,890,000

If the total assets placed in service by the taxpayer during 2022 exceed the expensing limit threshold, then the IRC §179 expense is subject to a dollar-for-dollar limitation.

California nonconformity

California never conformed to the enhanced IRC §179 deduction but continues to have a maximum $25,000 expense limit and a $200,000 phaseout threshold. (R&TC §§17255, 24356)

California never conformed to the federal revocation election or to the federal provision that treats off-the-shelf software as qualifying property for IRC §179. (R&TC §§17255(e) and (f), 24356(b)(6) and (7))

California does not conform to the expansion of the deduction to include purchases of portable heating and air conditioning units and to roofs, HVAC systems, fire protection and alarm systems, and security systems installed in nonresidential property. (R&TC §§17024.5(a), 23051)

BONUS DEPRECIATION

Bonus depreciation is taken after any IRC §179 expense deduction and before regular depreciation.

100% bonus depreciation drops to 80% after December 31, 2022

Full and immediate deduction of 100% of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023, may be claimed as bonus depreciation and a reduced percentage after December 31, 2022. (IRC §168(k))

 ©2022

Bonus Depreciation Rates		
Date placed in service	**Bonus depreciation percentage**	
	Qualified property in general/specified plants	**Longer production period property and certain aircraft**
1/1/2017–9/27/2017	50%	50%
9/28/2017–12/31/2017	100%	100%
2018–2022	100%	100%
2023	80%	100%
2024	60%	80%
2025	40%	60%
2026	20%	40%
2027	None	20%
2028 and thereafter	None	None

Qualified improvement property

Qualified improvement property is eligible for both IRC §179 expensing and bonus depreciation and is defined as 15-year MACRS property. (IRC §168(e)(3)(E)(vii) and (g)(3)(B))

Quick Law: Qualified improvement property

"Qualified improvement property" is any improvement made by the taxpayer to the interior portion of a nonresidential building if the improvement is placed in service after the date the building was first placed in service. (IRC §168(e)(6)(A))

However, qualified improvement property does not include any expenditure attributable to:

- Enlargement of the building;
- Any elevator or escalator; or
- The internal structural framework of the building.

The "made by the taxpayer" phrase was added by the CARES Act. The impact of adding this phrase is that if a taxpayer acquires a building that has qualified improvement property, then none of the property will be treated as qualified improvement property because the taxpayer did not make the improvement. Therefore, the property will be depreciated over 39 years rather than 15 years.

Remember that improvements to a residential rental property are not qualified improvement property.

Used property qualifies for bonus depreciation

For qualified property placed in service after September 27, 2017, bonus depreciation can be claimed for new and used property (subject to an exception for acquisitions from a related party).

To be eligible property, the property must meet either the "original use" requirement (IRC §168(k)(2)(A)(ii)) or the "used property acquisition" requirement. (IRC §168(k)(2)(E)(ii)) Taxpayers cannot claim bonus depreciation when they convert personal use property to business use.

California nonconformity

California has never conformed to federal bonus depreciation. (R&TC §§17250(a)(4), 24349)

Electing out of bonus depreciation

Bonus depreciation **must be claimed** unless a taxpayer makes an election out. (IRC §168(k)(7)) The election applies to a class or classes of property (e.g., property in a three-year class), not to a particular asset within that class. To make an election, attach a statement to a timely filed return (including extensions) indicating the class of property for which you are making the election. (Form 4562 Instructions)

IRC §179 versus bonus depreciation

Specific property

IRC §179 and bonus depreciation are not always available for all property. Specific types of property may dictate which deduction to claim. Consider the following:

- IRC §179 can be claimed for HVAC units, roofs, fire alarms, and security systems purchased for nonresidential property. Bonus depreciation cannot;
- An IRC §179 limitation of $27,000 for 2022 ($28,900 for 2023) applies to sports utility vehicles that are over 6,000 pounds and not more than 14,000 pounds gross vehicle weight and certain larger vehicles;
- For cars and passenger trucks, claiming bonus depreciation means an $19,200 cap in the first year, whereas if IRC §179 is claimed, the deduction is limited to $11,200; and
- Bonus depreciation must be taken on all property in a class, while IRC §179 may be claimed on all or a portion of the cost of one or more items of qualifying property.

Loss or no loss

Determining whether the taxpayer wants to generate a loss can affect whether bonus depreciation or IRC §179 expensing is claimed. The IRC §179 deduction is limited to a taxpayer's net income from the business and cannot create a tax loss. Disallowed IRC §179 expense is carried forward and can be used in a future year.

However, bonus depreciation may create a loss that can offset the taxpayer's income in the current year from other sources.

Combining bonus depreciation and IRC §179 expensing

Bonus depreciation of 100% has been the norm for over four years. The reduced bonus depreciation rate beginning for property placed in service in 2022 will once again give rise to strategic use of bonus depreciation combined with IRC §179 expensing to deliver the greatest depreciation deductions for our clients.

 ©2022

Example of combining bonus depreciation and IRC §179

MDF Makers, Inc. placed $2.5 million of assets in service in 2023 (assume all new assets are 5-year machinery). All assets are eligible for bonus depreciation and IRC §179.

If MDF only used the default bonus depreciation, then it's depreciation deduction would be:

Assets placed in service during 2023	$2,500,000
Bonus depreciation rate	80%
Bonus depreciation deduction	2,000,000
Regular depreciation deduction*	100,000
Total depreciation deduction	$2,100,000

* MDF can also claim regular depreciation for the year on the remaining $500,000 of assets not consumed by bonus depreciation

If MDF elected out of bonus depreciation and only used IRC §179 expensing, then its depreciation deduction would be limited to the $1.16 million expensing limit for the year.

MDF can combine bonus depreciation and IRC §179 to maximize its depreciation deductions:

Assets placed in service during 2023	$2,500,000
IRC §179 expensing limit up to the annual limit	1,160,000
Remaining assets eligible for bonus depreciation	1,340,000
Bonus depreciation rate	80%
Bonus depreciation	1,072,000
Regular depreciation	53,600
Total depreciation and §179 deduction	$2,285,600

CORRECTING DEPRECIATION ERRORS

Depreciation errors made on prior-year returns can be corrected by either filing:

- An amended return (or an administrative adjustment request (AAR) in the case of partnerships that have not elected out of the centralized partnership audit regime (CPAR)); or
- An application for change of accounting method.
  (IRS Publication 946)

As long as the statute of limitations remains open, taxpayers can file an amended return (or an AAR for CPAR partnerships) to correct the following types of depreciation errors:

- Mathematical or posting errors;
- Where the taxpayer has not adopted a permissible method of accounting for depreciation;
- An adjustment in the useful life of a depreciable asset for which depreciation is determined under IRC §167;
- A change in use of an asset in the hands of the same taxpayer;
- Making a late depreciation election or revoking a timely valid depreciation election (including the election out of bonus depreciation); or
- Any change in the placed-in-service date of a depreciable asset.
  (IRS Publication 946)

Generally, taxpayers adopt a method of accounting for depreciation by using a permissible method of determining depreciation when they file their first tax return, or by using the same impermissible method of determining depreciation in two or more consecutively filed tax returns. (Rev. Proc. 2019-43)

If the taxpayer can't (or won't) file an amended return (for example, because the statute of limitations has expired), then the taxpayer must file Form 3115, Application for Change in Accounting Method.

The IRS has provided the following examples of changes in accounting method for depreciation:

- A change from an impermissible method of determining depreciation if the impermissible method was used in two or more consecutively filed tax returns;
- A change in the treatment of an asset from nondepreciable to depreciable or vice versa;
- A change in the depreciable method, period of recovery, or convention of a depreciable asset; or
- A change from not claiming to claiming bonus depreciation if the taxpayer previously did not elect out.
  (IRS Publication 946)

Form 3115, Application for Change in Accounting Method

Under IRC §446, a taxpayer cannot change accounting methods from year to year without permission from the IRS. The taxpayer must file Form 3115, Application for Change in Accounting Method. The taxpayer may also have to make an adjustment to prevent amounts of income or expense from being duplicated or omitted. This is called an IRC §481(a) adjustment.

All IRC §481(a) adjustments are aggregated in the year of change. When all IRC §481(a) adjustments produce a decrease in taxable income, it is known as a "net negative §481(a) adjustment." Conversely, when all IRC §481(a) adjustments produce an increase in taxable income, it is known as a "net positive §481(a) adjustment."

A net negative §481(a) adjustment is taken into account entirely in the year of the change. A net positive §481(a) adjustment is generally taken into account over a period of four years — the year of change and three subsequent years.

When it comes to depreciation, the change from an impermissible method of depreciation to a permissible method of depreciation is an automatic consent change. An automatic consent change is one on which the IRS will automatically grant its consent. A common depreciation scenario results in the year property is sold and the taxpayer (or more appropriately, their tax professional) determined that the taxpayer did not claim all their available depreciation deductions in prior years.

 ©2022

Example of impermissible to permissible depreciation

Natalia sold her residential rental on December 31, 2022. She purchased the property on June 1, 2018, for $200,000 cash, with 80% allocated to the building and 20% to the land. Natalia did not claim depreciation in the prior four years.

The first step is to calculate the depreciation deductions that should have been claimed (the "allowable depreciation") and reduce the basis in the property accordingly.

Depreciation Calculation			
Year	**Depreciable basis**	**Percentage**	**Allowable depreciation**
2018	$160,000	1.970	$3,152
2019	$160,000	3.636	$5,818
2020	$160,000	3.636	$5,818
2021	$160,000	3.636	$5,818
2022	$160,000	3.636	$5,818
Total			$26,424

On the 2022 tax return (the year of the sale), Natalia will claim the $26,424 of depreciation on Schedule E, and the Form 4797, Sales of Business Property, and Schedule D will report the sale, showing the reduced basis of the property $173,576 ($200,000 - $26,424).

Note: There may also be prior-year suspended passive losses that will get released in the year of sale.

✐ **Practice Pointer**

Taxpayers must file Form 3115 in duplicate:

- The original must be attached to the filer's timely filed (including extensions) federal income tax return for the year of the change; and
- A copy of the signed form must be sent to the IRS's Ogden, Utah, processing center. The exact address depends on whether the taxpayer if filing Form 3115 as an automatic or nonautomatic change and whether it is being delivered by mail or private delivery service. Refer to the Form 3115 instructions for the correct address.

The Ogden, Utah, filing copy must be mailed; it cannot be fax-filed.

California conformity

California generally conforms to the federal accounting change method provisions. (R&TC §§17024.5, 23051.5) A federal approval of a change in accounting method/period is deemed to automatically apply for California purposes as long as California conforms to the underlying law on which the request is based. A separate request does not need to be filed with the FTB. (FTB Notice 2020-04) Taxpayers should submit a copy of the approved federal election along with the original California tax return for the taxable year in which the change is in effect.

Taxpayers may request a different election for California purposes if the taxpayer:

- Cannot rely on a federally approved request (e.g., California does not conform to the underlying law);
- Desires to obtain a change different from the federal changes; or
- Desires a change for California tax purposes only.

AUTOMOBILE EXPENSES

STANDARD MILEAGE RATE

The 2022 standard business mileage rate started the year at 58.5 cents but was subsequently increased for the second half of the year to 62.5 cents. (Notice 2021-02; IRS Announcement 2022-13) The 2023 rate is 65.5 cents. (Notice 2023-03)

Federal Mileage Rates				
	2021 (Notice 2021-02)	**01/2022–06/2022 (Notice 2022-03)**	**07/2022–12/2022 (Announcement 2022-13)**	**2023 (Notice 2023-03)**
Business mileage	56 cents	58.5 cents	62.5 cents	65.5 cents
Charitable mileage	14 cents	14 cents	14 cents	14 cents
Medical mileage	16 cents	18 cents	22 cents	22 cents
Moving mileage*	16 cents*	18 cents*	22 cents*	22 cents*
* Federal law only allows a moving expense deduction for active-duty military				

Luxury car caps

2022 Maximum Depreciation Amounts (Rev. Proc. 2022-17)								
	Auto without bonus		Federal auto with bonus		Light truck without bonus		Federal light truck with bonus	
	Federal	**CA**	**Federal**	**CA**	**Federal**	**CA**	**Federal**	**CA**
1st year	$11,200	$3,460	$19,200	N/A	$11,200	$3,960	$19,200	N/A
2nd year	$18,000	$5,600	$18,000	N/A	$18,000	$6,300	$18,000	N/A
3rd year	$10,800	$3,350	$10,800	N/A	$10,800	$3,750	$10,800	N/A
4th year and following	$6,460	$1,975	$6,460	N/A	$6,460	$2,275	$6,460	N/A

Caution

There are a few caution points tax professionals must be aware of regarding bonus depreciation for vehicles:

- Even though used property now qualifies for bonus depreciation, personal vehicles converted to business use do not qualify;
- Business use must be at least 50% to qualify for bonus depreciation; and
- The dollar limits must be reduced proportionately if business or investment use of a vehicle is less than 100%.

ACCOUNTABLE VERSUS NONACCOUNTABLE PLANS

Accountable and nonaccountable plans are types of business expense reimbursement plans between employers and employees. By definition, a plan that contains the following three requirements is an accountable plan:

- The expense paid by the employee must have a business connection and must otherwise be deductible by the employer;
- The employee must be required to substantiate their business expenses to the employer for reimbursement; and
- The arrangement must require the employee to return to the employer, within a reasonable time after receiving reimbursement, any amount paid to the employee in excess of the employee's substantiated expenses.
  (Treas. Regs. §1.62-2(d), (e), and (f))

Practice Pointer

We have created a sample accountable plan that can be downloaded and customized to your needs. Go to:

Website
www.caltax.com/files/2022/sampleap.doc

Any business expense reimbursement paid by an employer to an employee that does not meet these requirements is deemed paid under a nonaccountable plan. (Treas. Regs. §1.62-2(c)(3)) Two of the most common types of nonaccountable plans are auto and cellphone allowances. Because allowances do not require the employee to provide substantiation for the expense, they cannot be classified as accountable plan reimbursements.

Tax reporting

Business expenses paid by an employee and reimbursed by an employer under an accountable plan are tax-neutral to the employee. The employee cannot deduct the reimbursed business expenses on their personal return nor is the reimbursement income to the employee. The reimbursement is not reported on any tax reporting forms issued to the employee.

On the employer's side, the business expenses reimbursed under an accountable plan are deducted based on their purpose. For example, if the employer reimburses an employee for airfare, hotel, and meals, then the employer claims deductions for travel and business meals, subject to whatever limitations are imposed based on the nature of the expense, such as the 50% limitation on the deduction for business meals.

Amounts paid to an employee under a nonaccountable plan, such as an auto allowance, are treated as taxable compensation reported on the employee's W-2 and are deductible as wages by the employer. The amounts are also subject to employment taxes, including Social Security and Medicare taxes. Often, employers will disclose auto allowance-type expenses in box 14 of the employee's W-2, but it's just a disclosure item.

Nonaccountable plans of partners

Partnerships can have nonaccountable plans for their partners as well as their employees. If a partner or a member of an LLC taxed as a partnership receives payments under a nonaccountable plan, then the payments should be classified as guaranteed payments and are subject to self-employment tax.

Failed accountable plan reimbursements

Amounts reimbursed under an accountable plan but that fail one of the accountable plan requirements must be treated as nonaccountable plan reimbursements, which are taxable compensation to the employee and are subject to employment taxes.

Per diem reimbursements

Instead of reimbursing actual travel expenses, employers can rely upon federal *per diem* tables and mileage allowances as part of their accountable plan. (Treas. Regs. §1.62-2(c)(5)) It does not matter if the amount paid to the employee is more or less than the actual expenses. Like other accountable plan reimbursements, amounts received by the employee are not taxable.

The substantiation requirement is relaxed when using *per diem* and mileage allowances, but the employee must still report to the employer (and the employer must maintain), the dates, times, and business purpose of the expenses that gave rise to the *per diem* and mileage allowance reimbursements.

 ©2022

Caution

Self-employed taxpayers are permitted to use *per diem* rates to substantiate their own business meals and incidental expenses incurred when traveling away from home. (Treas. Regs. §1.62-2(d)(1) and (3)) However, they cannot use *per diem* rates to substantiate the amount of lodging expenses — they must provide actual substantiation for those.

The federal *per diem* rates are set by the U.S. General Services Administration (GSA) and differ based on the location of travel. The current rates can be found at the following website:

Website
www.gsa.gov/travel/plan-book/per-diem-rates

TRADE OR BUSINESS EXPENSES

MEALS AND ENTERTAINMENT

Meals and beverages provided by a restaurant are 100% deductible in 2021 and 2022. (TCDTRA §210(a); IRC §274(n)(2)(D)) The deduction for business meals and beverages not provided by a restaurant remains at 50%. All business meals and beverages will revert back to 50% deductible for 2023.

The 100% meals deduction applies to amounts paid or incurred after December 31, 2020, and before January 1, 2023 — in other words, we look to the date of the meal, not the tax year of the business claiming the deduction.

A "restaurant" means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the restaurant's premises. A restaurant does not include a business that primarily sells prepackaged food or beverages not for immediate consumption, such as:

- A grocery store;
- Specialty food store;
- Beer, wine, or liquor store;
- Drugstore;
- Convenience store;
- Newsstand; or
- A vending machine or kiosk.
  (Notice 2021-25)

Example of determining which deduction applies

Hangry, Inc. is a fiscal-year filer with a June 30 tax year-end. For its tax year ended June 30, 2023, Hangry must distinguish meals provided by a restaurant based on the date the meal was paid or incurred because:

- If the meal was paid or incurred from July 1, 2022, through December 31, 2022, then the deduction is 100%; and
- If the meal was paid or incurred from January 1, 2023, or later, then the deduction is only 50%.

Employer eating facilities

Employers cannot treat either of the following as a restaurant for purposes of the 100% meals deduction:

- An eating facility located on the business premises and used in furnishing meals excluded from an employee's gross income under IRC §119; or
- An employer-operated eating facility treated as a *de minimis* fringe benefit under IRC §132(e)(2), even if the eating facility is operated by a third party under contract with the employer. (Notice 2021-25)

Meals deduction when using *per diem* rates

The meal portion of a *per diem* allowance is treated as attributable to food or beverages provided by a restaurant. (IRS Notice 2021-63) This means that the meals portion of the *per diem* rate paid to an employee is 100% deductible if paid after December 31, 2020, and before January 1, 2023.

Notice 2021-63 applies to allowances for lodging, meal and incidental expenses, or meal or incidental expenses only paid by an employer. For self-employed taxpayers, it applies to *per diem* rates for meal and incidental expenses.

California nonconformity

California does not conform to the current federal rules for meals and entertainment. For California purposes, business meals and entertainment are 50% deductible. (R&TC §17024.5) California's treatment of meals and entertainment is the same as the federal government's pre-TCJA rules. California does not conform to the 100% deduction for restaurant meals.

***Per Diem* Rates**				
	10/1/2021–9/30/2022 (Notice 2021-52)		**10/1/2022–9/30/2023 (Notice 2022-44)**	
	Regular rate	**High-cost location rate**	**Regular rate**	**High-cost location rate**
Total *per diem* rate (lodging, meals, and incidental expenses combined)	$202	$296	$204	$297
Meals portion of *per diem* rate	$64	$74	$64	$74
Meals portion of *per diem* rate for transportation industry	$69	$74	$69	$74

 ©2022

Meals and Entertainment Expenses		
Expense	**Federal**	**California**
Client entertainment, such as: • Sporting event tickets; • Theater tickets; • Golf outings; and • Yacht excursions; etc. Client meals in conjunction with entertainment, not purchased separately from the entertainment	0% deductible	50% deductible
Client meals (directly related to a business meeting)	50% deductible (100% deductible 1/1/21–12/31/22 if provided by a restaurant)	50% deductible
Meals for employees while traveling for business	50% deductible (100% deductible 1/1/21–12/31/22 if provided by a restaurant)	50% deductible
Meals provided for the convenience of the employer, such as: • Tax season meals in office; • Employee meals on boat charter; • Employee meals at seminars; and • Office coffee, water, and snacks	50% deductible (1/1/18–12/31/25) (100% deductible 1/1/21–12/31/22 if provided by a restaurant) 0% deductible (after 12/31/25)	100% deductible if they qualify as *de minimis* fringe benefit; 50% deductible if they don't qualify as *de minimis* fringe benefit
Holiday parties, company picnics, and other occasional employee appreciation events	100% deductible	100% deductible

NET OPERATING LOSSES

The net operating loss (NOL) rules underwent two major changes in the last few years: First, the TCJA fundamentally altered the NOL for losses generated in taxable years beginning after December 31, 2017. Second, in an effort to help taxpayers put more money back into their pockets quickly due to the COVID-19 pandemic, the CARES Act rolled back some of the biggest NOL provisions of the TCJA, but only temporarily.

NOLs in 2021 and beyond

For taxable years beginning after December 31, 2020, the NOL deduction is equal to the sum of:

- The aggregate NOL carryovers of NOLs generated in taxable years beginning before January 1, 2018; plus
- The lesser of:
  - The aggregate amount of NOL carryovers from NOLs arising in taxable years beginning after December 31, 2017; or
  - 80% of the excess (if any) of:
    - Taxable income computed without regard to NOLs, IRC §199A, and IRC §250 deductions; over
    - The aggregate amount of NOL carryovers from pre-2018 taxable years.

(IRC §172(a)(2))

The following chart summarizes the NOL rules based on the taxable year the NOL was generated.

Federal/California Comparison of NOL Treatment by Year Generated			
Year NOL generated	**Carryback**	**Taxable income limitation**	**Carryforward**
Pre-2018 taxable years (Pre-TCJA)	**Federal:** Two years (five years for farm losses) **CA:** Two years for 2013–20	**Federal:** 100% of taxable income (even if carried over to future years) **CA:** 100% of taxable income	**Federal:** 20 years **CA:** 20 years (extended for periods of suspension)
2018–2020 taxable years California suspends 2020 NOL deductions for all taxpayers other than those that fall below the $1 million modified AGI, net business income or taxable income limits	**Federal:** Five years **CA:** Two-year carryback for NOLs incurred in 2018. No carrybacks for NOLs incurred after 2018	**Federal:** Claimed on pre-2021 taxable year return: 100% of taxable income Carried over to post-2020 taxable year: 80% taxable income limitation **CA:** 100% of taxable income	**Federal:** Indefinite **CA:** 20 years (extended for periods of suspension, but only for those NOLs not claimed due to suspension)
Post-2020 taxable years (TCJA as modified by CARES Act) California suspends 2021 NOL deductions for all taxpayers other than those that fall below the $1 million modified AGI, net business income or taxable income limits	**Federal:** None **CA:** None	**Federal:** 80% taxable income limitation **CA:** 100% taxable income limitation	**Federal:** Indefinite **CA:** 20 years (extended for periods of suspension, but only for those NOLs not claimed due to suspension)

California nonconformity

Currently California does not allow carrybacks for post-2018 NOLs (two-year carryback for 2018 NOLs) and does not have an 80% taxable income limitation. California's carryforward is limited to 20 years. (R&TC §§17276, 17276.21, 17276.22, 19131.5, 24416, 24416.21, 24416.22)

EXCESS BUSINESS LOSSES

Noncorporate taxpayers can only deduct business losses up to an annual inflation-adjusted threshold. (IRC §461(l)) Business losses in excess of the threshold are carried forward to a future year as a net operating loss. The excess business loss rules apply for taxable years beginning after December 31, 2020, and before January 1, 2029. (IRC §461(l)(1))

Calculating excess business loss

Under IRC §461(l), an excess business loss is defined as the excess of:

- Business deductions (determined without the excess business loss limitation); over
- The sum of:
  - Gross business income or gain for the taxable year; plus
  - $250,000 (or $500,000 for married taxpayers filing jointly) (adjusted for inflation, as shown in the chart below).

Excess Business Loss Threshold		
	2022 (Rev. Proc. 2021-45)	**2023 (Rev. Proc. 2022-38)**
Single filers	$270,000	$289,000
Joint filers	$540,000	$578,000

When calculating the excess business loss:

- Exclude NOLs, IRC §199A, and capital loss deductions from the business deductions used to calculate the excess business loss;
- Exclude any deductions, gross income, or gains attributable to any trade or business of performing services as an employee from the excess business loss computation, so wages will not be considered business income; and
- Limit the capital gains included in the excess business loss computation to the lesser of:
  - Capital gain net income solely attributable to gains and losses from a trade or business; or
  - The taxpayer's capital gain net income.

  (IRC §461(l)(3))

Flowthroughs calculated at the individual level

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. (IRC §461(l)(4)) Each partner's distributive share and each S corporation shareholder's *pro rata* share of items of income, gain, deduction, or loss of the partnership or S corporation is taken into account in applying the limitation under the provision for the taxable year of the partnership or S corporation. (IRC §461(l)(3)(A)(ii)(I))

Other deferral provisions applied first

The excess business loss rules of IRC §461(l) apply after the application of:

- Basis rules for S corporations and partnerships (IRC §§704(b), 1366);
- The at-risk rules under IRC §465; and
- The passive activity loss rules of IRC §469. (IRC §461(l)(6))

Therefore, losses suspended in the current tax year under the passive loss rules do not have an effect in the current year. Any prior-year suspended losses that are released in the current year do have an effect on the amount of excess business loss in the current year.

Brief history of excess business loss limitations

The TCJA originally created the excess business loss limitation provisions and made them effective for taxable years beginning after December 31, 2017, and before January 1, 2026. (IRC §461(l))

At the start of the COVID-19 pandemic, the CARES Act retroactively delayed the implementation of the TCJA's excess business loss provisions. (IRC §461(l)) Under the CARES Act, the excess business loss provisions only applied for taxable years beginning after December 31, 2020, and before January 1, 2026. Any taxpayer whose business losses were limited in 2018 and 2019 were required to go back and amend those returns and reverse the application of the excess business loss limitations.

The ARPA modified the excess business loss limitations again by extending the limitation on excess business losses for an additional year, through 2026. (ARPA §9041; IRC §461(l)(1)) The IRA '22 extended the limitation for an additional two years, through 2028.

California conformity

California has conformed to the federal excess business loss provisions, with some fairly significant modifications. (R&TC §17560.5) California's excess business loss rules went into effect for the 2019 taxable year. See page 7-7 for details.

BUSINESS INTEREST EXPENSE LIMITATION

Since its enactment by the TCJA, many taxpayers have yet to feel the impact of the business interest expense limitation that went into effect in 2018. (IRC §163(j)) However, for the reasons discussed here, more taxpayers found themselves subject to the business interest expense limitation in 2021, and the trend will continue in 2022 and beyond.

In a nutshell, for post-2017 tax years, for most taxpayers the net business interest expense deduction is generally limited to 30% of business "adjusted taxable income" plus business interest income (50% during the 2019 and 2020 tax years thanks to COVID-19 relief legislation). Unused expenses may be carried over indefinitely.

Adjusted taxable income is essentially the taxpayer's taxable income before the business interest expense limitation, with various additions such as NOLs, the IRC §199A deduction, and depreciation (for pre-2022 tax years), and subtractions such as certain taxable gains. (IRC §163(j)(8); Treas. Regs. §1.163(j)-1(b)(1))

 ©2022

Cap kicked in at lower thresholds starting in 2021

During 2019 and 2020, because of changes made by the CARES Act (CARES Act §2306), the limitation only applied for most taxpayers if the taxpayer's business interest expenses exceeded 50% of "adjusted taxable income" plus business interest income. In other words, the business interest expense deduction was capped at 50% of adjusted taxable income plus business interest income.

Depreciation add-back repealed starting in 2022

Prior to the 2022 taxable year, taxpayers could add back any depreciation deduction, including bonus depreciation, for purposes of calculating their adjusted taxable income amount. For many taxpayers, this significantly increased their adjusted taxable income threshold, thereby eliminating, or at least minimizing, their business interest expense limitation. Beginning with the 2022 taxable year, this "addition adjustment" is no longer allowed.

Example of expanded interest expense limitation

For simplicity's sake, assume that Coffee Grinders, Inc. did not qualify for the small business exemption (discussed below) and had for each of the 2020 through 2022 taxable years:

- $15,000 in business interest expenses;
- $40,000 of adjusted taxable income, which in 2020 and 2021 included an $18,000 depreciation deduction expense add-back; and
- $0 in business interest income.

Applying the rules listed above, Coffee Grinders would calculate its business interest expense limitation as follows:

- **2020:** No limitation because the cap is $20,000 (50% of $40,000 adjusted taxable income), which is more than the $15,000 of Coffee Grinder's business interest expense.
- **2021:** Coffee Grinder's business interest expense is limited to $12,000 (30% × $40,000 adjusted taxable income). The remaining $3,000 interest expense is carried over to 2022.
- **2022:** Coffee Grinders may no longer add back its depreciation deduction in computing its adjusted taxable income, which is now $22,000 ($40,000 - $18,000). Its business interest expense is limited to $6,600 (30% × $22,000). Coffee Grinders may carry over $11,400 ($3,000 from 2021 + $8,400 from 2022) in business interest expense to 2023.

Research expense capitalization

As we discussed beginning on page 3-23, absent a legislative change, research expenses may no longer be currently deducted and must be amortized over a 60-month period. For taxpayers with significant research expenses, this will increase the amount of their ATI in the first year (as a result of reducing the amount of expenses that may be deducted) but will reduce the amount of their ATI in the subsequent tax years when the balance is amortized.

Avoiding the limitation

There are two major exemptions/exceptions from the limitation, which allow taxpayers to claim a full deduction regardless of their adjusted taxable income or business interest income amounts. These are the:

- Small business exemption; and
- "Excepted businesses" exception that applies to real property trades or businesses and farming businesses that elect out of the limitation.

Small business exemption

Taxpayers, other than tax shelters, that have average annual gross receipts (less returns and allowances) for the prior three taxable years of $25 million or less are exempt from the business interest expense limitation. The $25 million amount is adjusted for inflation and is $27 million for 2022 ($29 million for 2023). (Rev. Procs. 2021-45, 2022-38)

For individual taxpayers, all gross receipts are counted, including investment income. However, inherently personal amounts are excluded, including but not limited to W-2 wages, Social Security or disability benefits, and personal injury awards or settlements. The regulations do not specifically state that retirement benefits would be excluded, but if W-2 wages and Social Security benefits are "inherently personal," then it's highly likely that retirement benefits should likewise be treated as inherently personal.

Caution

Taxpayers that are partners or shareholders in other entities must include their distributive share of the other entity's gross receipts in their $27/$29 million threshold and must aggregate the receipts from certain related entities. This means taxpayers that are partners/shareholders in multiple passthrough entities might find themselves exceeding the $27/$29 million threshold.

Many small businesses ineligible

Tax shelters are ineligible for the small business exemption. The definition of "tax shelter" for purposes of IRC §163(j) includes many average small businesses.

For purposes of the business interest limitation, a tax shelter includes a "syndicate," which is any partnership or other entity (other than a C corporation) if more than 35% of the entity's losses during the taxable year are *actually* allocated to limited partners or limited entrepreneurs. (IRC §§461(i)(3), 461(k)(4), 1256(e)(3)(B); Treas. Regs. §1.163(j)-2(d)(1))

This means that any partnership or S corporation, including LLCs taxed as a partnership or S corporation, that *actually allocates* more than 35% of its losses to limited partners or passive S corporation shareholders is defined as a tax shelter for purposes of the business interest expense limitation rules.

However, an interest in an entity is not considered held by a limited partner or a limited entrepreneur if the individual directly owns an interest in the entity and:

- Actively participates in the management of the entity during the period at issue;
- Has a spouse, child, grandchild, or parent who actively participates in the management of the entity during the period at issue; or
- Actively participated in the management of the entity for a minimum of five years. (IRC §1256(e)(3)(C))

 ©2022

Whether a taxpayer "actively participates" in management of the entity is not formally defined. Rather, it is based on the facts and circumstances of each individual taxpayer.

Tax shelter workaround

Passthrough entities incurring losses in off years are likely to be labeled a tax shelter. To avoid treating normally profitable entities as a tax shelter simply because they experience an "off year," taxpayers may elect to use the allocations made in the immediately preceding taxable year instead of using the current taxable year's allocations. (Treas. Regs. §1.448-2(b)(2)(iii)(B))

The election is made annually, is irrevocable, and must be made on a timely filed original federal tax return, including extensions. The election is made at the entity level by attaching a statement to the return, stating that the taxpayer is making the election under Treas. Regs. §1.448-2(b)(2)(iii)(B).

Comment

This election is not only available for taxpayers trying to qualify for the small business exemption from the business interest expense limitation, but for all situations in which IRC §461(i) comes into play, such as allowing a small business that would normally be treated as an ineligible tax shelter to qualify to use the cash method of accounting.

Excepted businesses

Real estate and farming businesses may make an irrevocable election to be excepted from the business interest limitation rules, but the election comes with a trade-off: Electing businesses must forego using regular MACRS (including bonus depreciation) for all future tax years and must use the alternative depreciation system (ADS) for purposes of computing their general tax liability.

This means that property will be depreciated over a longer life span using the straight-line method, and no bonus depreciation may be claimed for any qualified improvement property. This applies to:

- The year the election is made and to all subsequent tax years; and
- To both property held by the taxpayer prior to making the election ("existing property") as well as property purchased during and after the election year ("newly acquired" property).

The change from MACRS to ADS for existing property held by the taxpayer prior to the election year is considered a "change in use." (Rev. Proc. 2019-08) This means that the depreciation does not need to be recomputed. Rather the remaining depreciable amount is depreciated over the remaining ADS period. No change of accounting method is required.

The table below illustrates the "cost," in terms of a longer depreciable life for taxpayers that make the election and must use the ADS.

"Cost" of Making Election				
	Depreciation before the election		**Depreciation after the election**	
Asset category	**MACRS depreciable life**	**Eligible for bonus depreciation**	**ADS depreciable life**	**Eligible for bonus depreciation**
Nonresidential real property	39 years	No	40 years	No
Residential rental property	27.5 years	No	30 years*	No
Qualified improvement property	15 years (TCJA technical correction enacted as part of the CARES Act)	Yes (retroactive to tax years beginning after 12/31/2017)	20 years	No
Other tangible property	5–10 years; 10 years for any tree or vine bearing fruits or nuts	Yes	Generally 5–15 years; 20 years for any tree or vine bearing fruits or nuts	No
* As originally passed, the TCJA required 40-year ADS for residential rental property placed in service prior to 2018. The Taxpayer Certainty and Disaster Tax Relief Act (TCDTRA), passed as part of the Consolidated Appropriations Act of 2021, clarified that 30-year ADS applies residential rental property, no matter when the property was placed in service (TCDTRA §202)				

Comment

There is nothing in the regulations that would disallow an electing business to use IRC §179 expensing.

California nonconformity

California does not conform to the IRC §163(j) business interest expense limitation. Taxpayers may fully deduct their business interest expenses on their California return. (R&TC §§17024.5, 17201, 23051.5, 24344)

REPORTING SALT WORKAROUND ON BUSINESS RETURN

Many states have passed state and local tax (SALT) workaround legislation, and we have received many questions from tax professionals asking where they should report the passthrough entity taxes on their S corporation or partnership returns.

The tax is assessed against the entity

IRS Notice 2020-75, which is where the IRS gave its blessing for SALT workaround legislation, provides that:

- If specified state and local income tax payments are imposed directly on a partnership or an S corporation on its income (even if the passthrough entity must elect to be taxed directly); and
- The income taxes are actually paid by the partnership or S corporation; then
- The entity can deduct the taxes in computing its nonseparately stated income or loss for the tax year (reported on each owner's Schedule K-1, generally on line 1).

So, because the SALT workaround legislation is a tax imposed directly on, and paid by, the passthrough entity, you must deduct the SALT workaround payments in the same place you would any other deductible state and local taxes:

- **On 2021 Form 1120-S:** Page 1, line 12, Taxes and licenses; and
- **On 2021 Form 1065:** Page 1, line 14, Taxes and licenses.

Is reporting different for rental real estate entities?

One variation of this question we have received is in the case of rental real estate entities. If the passthrough entity has no activities other than rental real estate, they typically deduct state and local taxes on Form 8825, Rental Real Estate Income and Expense of a Partnership or an S corporation. The question is whether the passthrough entity taxes should likewise be reported on Form 8825 or on page 1 of the Form 1065, U.S. Return of Partnership Income, or Form 1120-S, U.S. Income Tax Return for an S Corporation.

The instructions to Forms 1065 and 1120-S both direct taxpayers to deduct state and local taxes on page 1 of the respective forms unless the taxes are allocable to a rental activity. If the taxes are allocable to a rental activity, then they should be deducted on Form 8825.

So, where a passthrough entity's only activities are rental activities, then all state and local taxes, including the passthrough entity taxes, should be reported on Form 8825. If a passthrough entity has both rental and nonrental activities, then the taxpayer must allocate the state and local taxes among its activities and must report the share of taxes allocated to its rental activities on Form 8825 and the remainder on page 1 of either the Form 1065 or 1120S.

✐ Practice Pointer

The IRS does not provide a method of allocating state and local taxes among real estate and non-real estate activities. As such, taxpayers should use any reasonable allocation method.

Is reporting different for investment partnerships?

Like real estate entities, if the passthrough entity has no activities other than investment activities, then state and local taxes must be reported on Schedule K, line 13d and on Schedule K-1, Box 13W. (Form 1065 Instructions)

Comment

For simplicity, the discussion above addresses passthrough entities that have only real estate or only investment activities. Taxpayers who have a combination of an operating business, rental activities, and investment activities would potentially report some of their state and local taxes in all three locations: on Form 1065, page 1, on Form 8825, and on Schedule K.

California conformity

California passed Assembly Bill 150 (AB 150) in 2021 for its version of the SALT workaround. See page 9-1 for a full discussion of AB 150 and the passthrough entity elective tax.

Spidell Publishing has created a multistate passthrough entity elective tax summary chart which outlines the states that have enacted their own passthrough entity tax, who may make the election, the tax base and tax rate, election procedures, and owner tax benefits. The chart can be found at the following link:

Website
www.caltax.com/files/2022/peetchart.pdf

BUSINESS START-UP EXPENSES

Once a trade or business begins, the taxpayer can deduct all of its ordinary and necessary business expenses. (IRC §162) However, the point at which a trade or business begins is often a date after which the business began incurring expenses, such as legal fees incurred to incorporate or organize with a state's secretary of state office.

Before a trade or business begins, business expenses must be capitalized. (IRC §195) Then, once the trade or business begins, the business can deduct up to $5,000 of the capitalized expenses, and the remainder must be amortized over 180 months.

The $5,000 amount is reduced dollar for dollar by the amount of aggregate start-up expenses exceeding $50,000. So, if the taxpayer incurs $53,000 worth of start-up expenses, they may only deduct $2,000 in start-up costs and must amortize the remaining $51,000 over 180 months, beginning with the month the business commences operations.

Start-up expenses are those paid or incurred in connection with:

- Investigating the creation or acquisition of an active trade or business;
- Creating an active trade or business; or
- Any activity engaged in for profit and for the production of income before the day on which the active trade or business begins.

The expenses must also be ones that would qualify as a deduction under IRC §162 if the business was in actual operation (e.g., salaries, rents, training costs, etc.). Interest, taxes, and research expenses do not qualify as a start-up expense.

Divergent Tax Court cases

The Tax Court issued two differing opinions dealing with the start of a trade or business in 2022.

Loss for an organic farmer

The first case, ***Antonyan v. Comm.*** (TCM 2021-138) dealt with a taxpayer who purchased 10 acres of land in 2012 with the intention of developing it into farmland to be rented out to organic farmers.

The taxpayer claimed that his business began in 2015 when he started developing the land. The Tax Court sided with the IRS and disallowed the taxpayer's business expense deductions for 2015 because the taxpayer hadn't completed construction on any structures, obtained the USDA

 ©2022

certification, nor installed any irrigation systems necessary for the farming activities. Further, the taxpayer failed to produce any credible evidence to demonstrate that he was actively managing and engaging with potential customers to rent the property.

Victory for technology start-up companies

The second case, ***Kellet v. Comm.*** (TCM 2022-62) produced a surprising taxpayer victory that should be received very favorably for technology start-up companies. In ***Kellet***, the Tax Court ruled that a taxpayer could deduct some of his internet start-up company's start-up and ordinary and necessary business expenses in 2015 even though the business didn't generate revenues until 2019, more than three years after it went "live" on the internet.

The decision provides unexpected answers to some very important questions:

- When does an internet start-up company actually begin?
- What software development costs can be expensed and when?

The court's decision is an important acknowledgement that many internet start-up companies cannot monetize their business activities until after they have built a strong reputation among a large enough audience.

Mr. Kellet's business was an information technology website that provided a single user-friendly software interface to access a variety of demographic, social, and economic data from numerous sources. The website enabled investment bankers, economists, journalists, investment management firms, market research firms, etc., to analyze the data and create charts, tables, etc., to use in their businesses.

The taxpayer hired software engineers to develop the website by modifying open-source software to develop the interactive features of the website.

The taxpayer envisioned at least four ways to make money from his business:

- Selling advertising space to third parties;
- Implementing a "paywall" and charging a monthly fee for access to certain features of the website;
- Selling personalized charts and reports of information from the website; and
- Licensing data from the website to other companies.

However, he initially put his efforts into perfecting and promoting the business, convinced he could maximize long-term profit by cultivating confidence and dependence among users and advertisers before monetizing the business. The website did not even have a mechanism to collect revenues when it first went live.

The IRS disallowed the taxpayer's expenses for software engineering, marketing, internet, and cellphone costs deducted on his 2015 return, claiming that his "active trade or business" had not actually begun in 2015 because it had no revenue nor any means to generate revenue during 2015.

The Tax Court recognized that prior case law dealing with more brick-and-mortar-type scenarios did not fit the taxpayer's business model, which was based upon the assumption that none of his revenue strategies would succeed until the business built up its rapport with users and advertisers. To do this, the business prioritized web traffic over revenue by charging no user fees and marketing the site to institutional customers.

The court sided with the taxpayer and held that even though the taxpayer made no attempt to earn revenue in 2015, his business began providing the services for which it was organized, with an eye to long-term profit, once he launched the website, which was at the end of September 2015.

HEMP BUSINESSES NOT SUBJECT TO IRC §280E

On their FAQs page for the cannabis industry, the IRS has clarified that IRC §280E does not apply to businesses legally growing and selling hemp that contains 0.3% or less of THC. (www.irs.gov/businesses/small-businesses-self-employed/marijuana-industry-frequently-asked-questions)

The 2018 Farm Bill defined hemp as "the plant Cannabis sativa L. and any part of that plant, including the seeds thereof and all derivatives, extracts, cannabinoids, isomers, acids, salts, and salts of isomers, whether growing or not, with a delta-9 tetrahydrocannabinol concentration of not more than 0.3% on a dry weight basis."

Hemp was also removed from the Controlled Substances Act and is no longer considered to be a Schedule I substance. Businesses growing and selling hemp may deduct expenses and are not subject to the IRC §280E limitation.

CORPORATIONS

CORRECTING INADVERTENT S CORPORATION TERMINATIONS WITHOUT A PRIVATE LETTER RULING

The IRS has issued Revenue Procedure 2022-19, which allows S corporations and their shareholders to resolve six specific inadvertent S corporation terminations without requesting a private letter ruling. The revenue procedure also applies to:

- Situations where an S corporation election was filed, but the entity did not meet the S corporation requirements at the time of filing; and
- Qualified subchapter S (QSub) elections.

The six specific areas for which the IRS will allow an entity to fix their inadvertent S corporation terminations are:

1. Violation of the one class of stock requirement through agreements that are not a governing instrument of the S corporation;
2. Disproportionate distributions;
3. Inadvertent errors or omissions on Form 2553, Election by a Small Business Corporation, or Form 8869, Qualified Subchapter S Subsidiary Election;
4. Missing IRS acceptance letters;
5. Filing a federal income tax return inconsistent with the S corporation or QSub election; and
6. Where the entity has provisions in its governing documents that violate S corporation requirements.

If an inadvertent S corporation termination does not fall within one of these six areas, then a private letter ruling must be filed with the IRS to correct the inadvertent termination.

Comment

We will not discuss all six of the inadvertent termination areas in these materials. We will focus only on the first two. The remaining four contain voluminous guidance that will not apply to most taxpayers.

 ©2022

Nongoverning instrument agreements

S corporations can only have one class of stock: common stock with identical rights to distributions and liquidation proceeds. (IRC §1361(b)(1)(D); Treas. Regs. §1.1361-1(l)(1)) S corporations can, however, have voting and nonvoting common stock without violating this rule.

Only outstanding shares of stock are relevant when determining whether a corporation has one class of stock. (Treas. Regs. §1.1361-1(l)(1)) For example, a corporation whose governing documents allow it to issue common stock and preferred stock can still make an S corporation election as long as it does not have any outstanding preferred stock at the time it makes its S election or at any time during which the S election is in effect.

Occasionally, an S corporation and its shareholders can enter into agreements that are not part of the entity's governing documents that inadvertently create a second class of stock. As long as the principal purpose of the agreement was not to circumvent the one class of stock requirement, then Revenue Procedure 2022-19 will not treat such agreements as having created a second class of stock.

Disproportionate distributions

Disproportionate distributions are not treated as creating a second class of stock as long as the governing documents of the corporation provide for identical distribution and liquidation rights. (Treas. Regs. §1.1361-1(l)(2)(i)) It does not matter if the distributions are actual, constructive, or deemed distributions or if they differ in timing.

The IRS recognizes that the language in the Treasury Regulations is unclear regarding this provision. As such, Revenue Procedure 2022-19 clearly states that the governing documents of the corporation control whether identical distribution and liquidation rights exist and that it will not issue any private letter rulings to determine whether a disproportionate distribution relating to an actual, constructive, or deemed distribution created a second class of stock. This includes distributions that are issued at different times.

State elective tax laws

The revenue procedure does not specifically address state laws that have been passed pursuant to IRS Notice 2020-75 that are designed to circumvent the $10,000 state and local tax (SALT) itemized deduction limitation.

While each state is different, generally, the entity makes a state tax payment that is deductible on the entity's federal return (but not state return), and then the owners receive a state tax credit for their distributive share of the state tax payments.

Some of the state laws designed to circumvent the $10,000 SALT limitation are elective, and not all shareholders are eligible or required to participate. So, if a passthrough elective tax election is made pursuant to state law, but not all S corporation shareholders participate, is a second class of stock created when the corporation makes a state tax payment that provides a benefit for only some shareholders?

Because participation in a passthrough entity tax election is not one of the corporation's governing instruments, and because the IRS will not issue a private letter ruling on this subject, it is possible that an S corporation that makes a passthrough entity tax election where not all shareholders participate may not create an S election termination pursuant to Revenue Procedure 2022-19.

CONSTRUCTIVE DIVIDENDS AND REASONABLE COMPENSATION

Over three court cases and many years fighting the IRS, husband and wife owners of a chain of day care centers got hit with tax deficiencies and civil fraud penalties totaling more than $1.4 million. (***Hacker v. Comm.***, TCM 2022-16) The majority of the tax deficiencies were the result of the taxpayers not paying themselves salaries and wages for the services performed for their S corporation and for using their S corporation as a piggy bank.

The taxpayers, through their S corporation, owned and operated six day care centers in the Tulsa, Oklahoma, area with about 90 employees. For the 2004 through 2008 tax years at issue, the taxpayers did not receive any salary or wages from the business. The taxpayers, along with their three adult children, used corporate credit cards for business and nonbusiness expenses, all of which were paid by the corporation. The corporation also paid the balances due on the entire family's personal credit card charges for items such as jewelry and luxury vacations, as well as on car loans for a Hummer, a Lexus, and a Cadillac.

Not-so-creative bookkeeping

The taxpayers paid a CPA firm for bookkeeping and tax services and later hired an internal bookkeeper. The taxpayers provided bank and credit card statements to the bookkeepers but never made any effort to distinguish between business and personal expenses. Both the CPA firm and the internal bookkeeper used an asset account called "A/R-Officer" as a dumping ground for suspected personal expenses.

From the beginning of 2004 through the end of 2007, the "A/R-Officer" account had grown from $236,189 to $1,332,066. The taxpayers never made any repayments against the "A/R-Officer" account.

On audit, the IRS imputed wages to the taxpayers totaling over $1.1 million for the five years at issue and determined that the taxpayers received constructive dividends of over $1.7 million. The constructive dividends included the balance of the "A/R-Officer" account along with many other adjustments.

Lessons to be learned

There are a couple of key lessons to be learned from this Tax Court case that likely hit too close to home for many tax professionals. After all, who hasn't had (or currently has) a business client with terrible record keeping that tries to turn every expense into a business deduction? It doesn't take an insightful Practice Pointer to know that these clients should be fired at the earliest opportunity.

Lesson 1

Your client's financial statements are their own responsibility. Even if you are the bookkeeper, if they aren't willing to identify which expenses are business and which are personal, then the client isn't worth your time or the stress they are guaranteed to cause.

Lesson 2

The taxpayers in the current case were unable to advance any argument against the IRS's determination that they had imputed wages of over $1.1 million. Taxpayers who at least pay themselves a wage can make an argument that the wages were reasonable. In this case, the taxpayers paid themselves nothing and had no leg to stand on.

Reasonable compensation audits

Even though the ***Hacker*** case dealt with taxable years 2004 through 2008, the IRS has indicated that reasonable compensation audits will be on the rise. Be sure to discuss with your clients who aren't paying themselves wages (or are paying themselves very little wages) that they are required to pay reasonable salaries and wages for the services they perform for their own corporations.

Lesson 3

Creating an asset account on the balance sheet for loans to a shareholder instead of treating personal expenses properly — as a dividend (for C corporations) or a distribution (for S corporations, partnerships, and LLCs taxed as S corporations or partnerships) — doesn't solve any problems.

The taxpayers in the ***Hacker*** case ended up with $1.7 million of underreported dividend income, plus heavy civil fraud penalties. A constructive dividend arises when a corporation confers an economic benefit upon a shareholder without expectation of repayment, and the corporation on the date of the deemed distribution had current or accumulated earnings and profits. (See ***Welle v. Comm.*** (2013) 140 TC 420, 422) The shareholder need not receive the dividend directly and must include in gross income payments the corporation made on the shareholder's behalf. (See ***Epstein v. Comm.*** (1969) 53 TC 459, 474; ***Vlach v. Comm.***, TCM 2013-116)

In determining whether a shareholder received a constructive dividend, the courts will consider whether the payments benefited the shareholder personally rather than furthering the interest of the corporation (***Hagaman v. Comm.*** (Sixth Cir. 1992) 958 F.2d 684)

The taxpayers in the ***Hacker*** case created an "A/R-Officer" account but never evidenced the receivables with a note and never made any payments against the balance.

IRS TARGETING C CORPORATIONS THAT ZERO-OUT PROFITS

Many closely held C corporations pay their shareholder-employees' bonuses at the end of each year to zero-out or nearly zero-out their profits. C corporations typically want to zero-out their profits to avoid double-taxation.

> ***Comment***
>
> Bonuses paid to shareholder-employees are subject to payroll taxes. Instead of using bonuses to zero-out profits, some C corporations have come up with other mechanisms to try and zero-out their profits without incurring payroll taxes. This includes paying extra rent where the corporation rents a building from the shareholders or by creating fictional expenses, such as "management fees" that are paid to the shareholders.
>
> In these scenarios, the corporation will typically still claim a deduction for the payments, but the payments are not subject to payroll taxes because they are not run through payroll.

The IRS has been challenging C corporations that zero-out their profits during audits. The IRS and the Tax Court will look at whether:

- The corporation has a history of paying (or not paying) dividends to its shareholders; and
- The payments (either bonuses or other creative payment alternatives) are paid in roughly the same proportion as share ownership.
  (See, e.g., ***Aspro, Inc. v. Comm.*** (April 26, 2022) U.S. Court of Appeals, Eighth Circuit, Case No. 21-1996)

The second bullet point is a particular focal point for the IRS because the Treasury Regulations provide that:

*"Any amount paid in the form of compensation, but not in fact as the purchase of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or **bear a close relationship to the stock holdings of the officers or employees**…the excessive payments are a distribution of earnings upon the stock [emphasis added]." (Treas. Regs. §1.162-7(b)(1))*

Proper substantiation

Just because a corporation has zeroed-out its profits through bonuses does not automatically mean that the bonus will be reclassified as a dividend. In another recent case, a corporation engaged a CPA firm to prepare an analysis of the shareholder-employee's historical compensation. (***Clary Hood, Inc. v. Comm.***, TCM 2022-15) The analysis performed by the CPA firm used publicly available industry specific compensation data in its findings and recommendations.

The sole shareholder had undercompensated himself to ensure his corporation had enough operating cash to survive some difficult years. To offset the years the corporation undercompensated the shareholder, the corporation paid the shareholder large year-end bonuses for the tax years at issue.

The Tax Court ultimately ruled mostly in the taxpayer's favor, finding that a significant portion (but not all) of the bonuses paid to the shareholder-employee were reasonable.

 ©2022

ACCUMULATED EARNINGS TAX

One of the stated purposes of the TCJA's reduction of the corporate tax rate to 21% was to encourage business activity and expansion in the U.S. and to discourage the shifting of business development and expansion overseas. The hope was that this increased investment would create more U.S. jobs and hopefully increase wages.

What the corporate rate reduction was not designed to do was to encourage corporations to accumulate earnings at the corporate level so that shareholders could avoid the imposition of taxes paid on dividends.

To make sure that corporations do not do just that, the Internal Revenue Code has a tax provision that subjects corporations to a 20% accumulated earnings tax, unless the corporation can demonstrate that it has a legitimate business reason to hold on to earnings in excess of their required operating expenses. (IRC §531 et seq.)

Are audits on the rise?

The accumulated earnings tax has been around since the mid-1950s, and very few of us have ever had an experience with this tax penalty. However, with the 16% spread between the corporate tax rate and the highest individual tax rate, many corporations and their shareholders would rather see the income retained at the corporate level than passed through to the shareholders. And while this is not wrong per se, corporations must document the business purposes for retaining the earnings to avoid an accumulated earnings tax assessment.

☑ Planning Pointer

C corporation clients that accumulate earnings beyond the reasonable needs of the business should be advised to document in their board of director meeting minutes that the corporation is accumulating earnings for a specific reason (or set of reasons). If the taxpayer is audited by the IRS and the accumulated earnings tax becomes an audit issue, the taxpayer will have contemporaneous records (in the form of board of director meeting minutes) documenting why it was accumulating earnings.

Legitimate reasons to accumulate income include:

- Debt retirement;
- Business expansion and plant replacement;
- Acquisition of another business by purchase of stock or assets;
- Working capital;
- Investments or loans to suppliers or customers necessary to maintain the corporation's business; and
- Reasonably anticipated product liability losses.
  (Treas. Regs. §1.537-2)

Nonacceptable reasons for the accumulation of earnings and profits include:

- Loans to shareholders and expenditures for their personal benefit;
- Loans to others that have no reasonable connection to the business;
- Loans to a related corporation;
- Investments that are not related to the business; and
- Any accumulations to provide for unrealistic hazards.

How does the tax work?

With certain limited exceptions, the tax is imposed against corporations formed or availed of for the purpose of avoiding the income tax with respect to their shareholders or shareholders of any other corporation by permitting earnings and profits to accumulate instead of being distributed. (IRC §532)

The starting point for calculating accumulated taxable income is a corporation's taxable income, with adjustments for federal taxes, charitable contributions, net operating losses, and capital losses, among others pursuant to IRC §535(b), minus the sum of the dividends paid deduction and the accumulated earnings credit. (IRC §535(c))

The accumulated earnings credit is the amount of a corporation's accumulated earnings and profits for the taxable year as are retained for the reasonable needs of the business. Corporations are permitted a minimum credit of $250,000 ($150,000 in the case of businesses in the fields of health, law, engineering, architecture, accounting, actuarial sciences, performing arts, or consulting). The credit can be increased if the taxpayer can show a business purpose for accumulating more than $250,000 ($150,000 for specified businesses just listed).

Example of computing accumulated earnings tax

C Corp.'s taxable income is $1,823,200. Its only tax attribute that is subject to adjustment under IRC §535 is federal income tax of $382,872, which is allowed as a deduction in arriving at accumulated taxable income. Assuming C Corp. is only permitted the minimum accumulated earnings credit of $250,000, its accumulated earnings tax would be calculated as follows:

Taxable income	$1,823,200
Federal income tax	(382,872)
Accumulated earnings credit	(250,000)
Accumulated taxable income	1,190,328
Accumulated earnings tax rate	20%
Accumulated earnings tax	$ 238,066

If C Corp. can prove a business purpose for accumulating earnings beyond the minimum earnings credit of $250,000, then that higher amount becomes its accumulated earnings credit. The goal for any corporation is to prove that all of its accumulated earnings are for reasonable business needs and thus increase its credit to the point where the corporation has zero accumulated taxable income.

Unless the corporation can prove otherwise, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid the income tax with respect to the shareholders. (IRC §533(a))

In most instances, the burden is on the IRS to show that all or any part of a taxpayer's earnings and profit has been permitted to accumulate beyond the reasonable needs of the business. (IRC §534) However, if the corporation is a holding or investment company, the burden shifts to the taxpayer to show that the income was not accumulated for the purpose of avoiding tax with respect to the corporation's shareholders. (IRC §533(b))

Consent dividends

IRC §565 provides relief to corporations that accumulated earnings beyond their reasonable needs through the use of consent dividends. Consent dividends are phantom dividends that are reported by the corporation on Form 972, Consent of Shareholder to Include Specific Amount in Gross Income. Form 972 informs the IRS that the C corporation's shareholders agree to report dividend income on their own income tax returns even though they did not receive any actual dividends.

If consent dividends are issued, they are treated as:

- Distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation; and
- Contributed to the capital of the corporation by the shareholder on such day.

Example of consent dividends

Using the facts from the previous example, in order to avoid the accumulated earnings tax, C Corp. must issue consent dividends by filing Form 972, and its shareholders must agree to include $1,190,328 in their income (the amount of C Corp.'s accumulated taxable income). By doing so, the shareholders will report dividends in this amount and will also increase the basis of their stock in C Corp. by this amount.

PARTNERSHIPS

CPAR: PARTNER-LEVEL ADJUSTMENTS

Under the centralized partnership audit regime (CPAR) partnership-related adjustments are determined at the partnership level and any tax, interest and/or penalties attributable to the adjustments are generally assessed and collected at the partnership level. (IRC §6221(a))

If the partnership is assessed the tax, the tax rate is the highest tax bracket for individuals for the reviewed year under IRC §1 for ordinary income (currently 37%), although modifications may be allowed to reduce the rate for C corporation partners or for capital gains. (IRC §6225(c))

Instead of the partnership paying any taxes assessed as a result of the audit, the partnership can push out the adjustments to its reviewed year partners. CPAR partnerships can also push out adjustments made as a result of an administrative adjustment request.

Form 8986, Partner's Share of Adjustment(s) to Partnership-Related Item(s)

Form 8986 is used by CPAR partnerships to furnish and transmit each partner's share of adjustments to partnership-related items when a push-out election has been made.

When a partnership makes the push-out election, the adjustments to the reviewed year (the year to which the adjustments relate) are pushed out to the partners *who were partners during the reviewed year*. (IRC §6226(a)(2)) The reviewed year partners must then recalculate their reviewed-year tax liability incorporating the pushed-out adjustments and pay the additional tax or claim a credit on their current year income tax return.

Example of reviewed-year partners

The RAPC partnership had four partners in 2020, Raj, Alice, Pierre, and Charlotte. In 2021, Raj retired, leaving only Alice, Pierre, and Charlotte as partners. In 2022, RAPC filed an administrative adjustment for the 2020 reviewed year and made a push-out election.

The RAPC partnership will issue Forms 8986 to Raj, Alice, Pierre, and Charlotte for their respective share of the adjustments because they were the partners in 2020. Each of the four reviewed-year partners will report their share of the adjustments on their 2022 income tax returns.

Comment

It may be helpful to think of Form 8986 as a substitute for an amended K-1. CPAR partnerships do not file amended returns and therefore do not provide amended federal K-1s to partners.

The key difference is that partners report Form 8986 adjustments in the year they receive the Form 8986, even though the adjustments are from an earlier tax year.

What does a partner do with Form 8986 issued to them?

A partner who receives a Form 8986 from a partnership reporting the partner's share of the partnership's administrative adjustment request must use the Form 8986 to complete Form 8978, Partner's Additional Reporting Year Tax. Form 8978 calculates the partner's additional tax liability for the tax year within which the partner was furnished the Form 8986. The Form 8978 is attached to the partner's Form 1040.

Partnerships must report the date the partnership furnishes the Forms 8986 to their partners. This date is reported on Form 8986, Part II, Item G. Each partner must report their share of the administrative adjustment request on their own income tax return in the tax year within which this date falls.

Example of partner receiving Form 8986

Gary is one of the partners of Partnership P. Partnership P is subject to CPAR.

On December 10, 2022, Partnership P files Form 1065X to make an administrative adjustment request for its 2021 tax year. On Form 8986, Part II, Item G, Partnership P reports that it furnished the Forms 8986 to the partners on December 30, 2022.

Gary must report his share of the partnership's administrative adjustment request on Form 8978 and attach it to his 2022 Form 1040, and pay any resulting tax.

Alternatively, assume Partnership P doesn't issue Forms 8986 until January 5, 2023. In this scenario, Form 8986, Part II, Item G must use the date January 5, 2023, and Gary will report his share of the partnership's administrative adjustment request on Form 8978 and attach it to his 2023 Form 1040.

Form 8978, Partner's Additional Reporting Tax Year

Partners must prepare Form 8978, and Schedule A to Form 8978, to report the partnership adjustments provided to the partner on Form 8986. Form 8978 is attached to the partner's personal

income tax return for the tax year that coincides with the date reported on Form 8986, Part II, Item G (the date Form 8986 was provided to the partner).

Practice Pointer

Form 8978 is not used by partners that are themselves passthrough entities. Instead, partners who are themselves passthrough entities must file Form 8985, Pass-Through Statement — Transmittal/ Partnership Adjustment Tracking Report, to either:

- Calculate an imputed underpayment of tax using the Form 8986 it received; or
- Make its own push-out election to pass through adjustments to its owners or beneficiaries.

Passthrough partners must file Form 8985 whether the passthrough partner decides to calculate its own imputed underpayment of tax or make its own push-out election. In other words, if a passthrough entity receives a Form 8986 because it is the partner of a CPAR partnership, it must always file Form 8985.

Reporting partnership tax adjustments on Form 1040 or Form 1120

The partners must compute any additional or decreased tax liability that should have been reported for the partner's affected year as if the partnership return was prepared correctly. The computation of the increased or decreased tax liability for the affected year must be attached as a separate statement to Form 8978. The increase/decrease for the affected year(s) is reported on Form 8978, line 14.

Additional tax

Any additional tax due as a result of the Form 8978 adjustments are reported on:

- Form 1040, line 16 for individuals. Check box 3, enter the amount of the liability, and "8978" in the space next to the box; or
- Form 1120, Schedule J, line 2 for corporations. On the dotted line next to line 2, enter "FROM FORM 8978" and the amount. Attach Form 8978.

Decreased tax

If total adjustments for the partner's affected year result in a decreased tax liability for the reviewed year, the decrease is reported on:

- Form 1040, Schedule 3, line 6l; or
- Form 1120, Schedule J, line 6. On the dotted line next to line 6, enter "FROM FORM 8978" and the amount.

Comment

A decrease in tax liability creates a nonrefundable credit.

✐ **Practice Pointer**

Assume you are preparing a client's 2022 personal returns, and the client received a Form 8986 pertaining to their 2020 year. Here's how you would compute the tax on the 2022 return:

1. Open the 2022 tax software and make all entries for the 2022 return except for data from the Form 8986;
2. Open the client's 2020 file. Save it to a new file name. Take note of the total tax liability before the Form 8986 information. Add the income from the Form 8986. Compute the increase in tax;
3. Complete the 2022 Form 8978 using:
   a. The original 2020 file;
   b. The new 2020 file to use recomputed tax from step 2; and
   c. The Form 8986;
4. Be sure the increase in 2020 tax from step 2 appears on Form 8978, line 13 as well as Form 1040, line 16 (or on Form 1040, Schedule 3, line 6l if there is a decrease in tax) (as shown above); and
5. The calculation of the recomputed tax from step 2 must be attached to Form 8978, so attach a copy of both the originally filed 2020 Form 1040 as well as the recomputed 2020 Form 1040 to your client's 2022 income tax return.

Example of preparing 1040 with Form 8978

Philippe received a Form 8986 in 2022 pertaining to the 2021 tax year. His 2021 return before the Form 8986 showed a net tax liability of $10,000. After adding the additional income, the 2021 liability is $13,000. Therefore, there's an increased tax liability of $3,000.

His 2022 return before the Form 8986 has a net tax liability of $11,500. After adding the $3,000 increase from 2021, his total net tax liability for 2022 is $14,500. This is computed on Form 8978 and carried to the 1040.

Penalties and interest

Form 8978, Parts II and III, require the taxpayer to compute and enter the amounts of penalties and interest. In the instructions to the form, the IRS notes that these amounts are not entered on Form 1040. However, the IRS states that the taxpayer should add these amounts to any amounts owing and pay these amounts to the IRS.

✐ **Practice Pointer**

One of the downsides to the push-out method is that the interest rate is two points higher than the prevailing standard rate.

The instructions to the form provide the method for computing the interest and penalties.

All affected years

Form 8978 has multiple columns for multiple years. The calculations require a recomputation of the partner's tax beginning with the reviewed year and continuing through each subsequent year until the year the statement is received.

Practice Pointer

Thus, if the change to the reviewed year causes a change in a carryover to another year, the additional tax in that other year must be computed, entered on the Form 8978, and added to the tax in the reporting year.

IRC §754 ELECTION

Final regulations on IRC §754 election

The IRS has issued final regulations regarding the method of making a valid IRC §754 election. (TD 9963, available at: www.federalregister.gov/d/2022-16271)

The final regulations removed the requirement contained in the 2017 proposed regulations that a valid IRC §754 election must be signed by one of the partners. Under the final regulations, a valid IRC §754 election must be attached to a timely filed partnership return (including extensions) for the taxable year during which the distribution or transfer occurs. (Treas. Regs. §1.754-1(b))

The statement must:

- State the name and address of the partnership; and
- Contain a declaration that the partnership elects to apply the provisions of IRC §§734(b) and 743(b).

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

15. What is true about the new Qualified Commercial Clean Vehicle Credit?

    a) The credit is capped at $4,000
    b) The credit is equal to 15% of the vehicle's basis
    c) The credit may be transferred to the dealer at the time the vehicle is purchased
    d) The credit can't be claimed for a vehicle for which the Clean Vehicle Credit was claimed

16. How has IRA '22 impacted the Energy Investment Tax Credit under IRC §48?

    a) The phaseouts of the credit are retroactively repealed
    b) It is extended until 2035
    c) For property placed in service after 2022, it is expanded to include wind technology
    d) For property placed in service after 2021, there is a base credit that starts at 2% for most eligible property

17. What are among the revisions to business energy credits under the Inflation Reduction Act?

    a) For purposes of the Renewable Electricity Production Credit, qualifying facilities are limited to wind and geothermal
    b) An energy project that receives an allocation of the environmental justice solar and wind capacity limitation from the Secretary of the Treasury that is located in a low-income community is eligible for an additional 10% Energy Credit
    c) The New Energy Efficient Home Credit available to eligible contractors and manufactured home manufacturers is increased to a maximum of $2,500 per unit
    d) The Alternative Fuel Vehicle Refueling Property Credit is extended through 2033

18. Which statement correctly describes issues related to a Research Credit refund claim?

    a) A refund claim must identify all research activities performed but not the individuals who performed them
    b) Taxpayers that file incomplete refund claims after January 10, 2024, will have 45 days in which to perfect their claims after being notified by the IRS
    c) Taxpayers must provide supporting documentation when they file a refund claim
    d) The IRS has extended the date required for the additional information reporting for refund claims to January 10, 2023

19. As pertains to the four-part test for purposes of determining eligibility for the Research Credit, which test states that the taxpayer must intend that the information to be discovered be useful in the development of a product, a process, computer software, or technique?
    a) Business component test
    b) Technological in nature test
    c) Process of experimentation test
    d) IRC §174 test
20. Whether to claim IRC §179 expensing or bonus depreciation can depend on the type of property the taxpayer is dealing with. Based on this, which of the following is correct?
    a) Bonus depreciation may create a tax loss, but IRC §179 cannot
    b) Bonus depreciation may be claimed for HVAC units
    c) There is an IRC §179 limitation of $26,200 for 2022 for sports utility vehicles over 5,000 pounds
    d) Both onus depreciation and §179 must be taken on all property in a class
21. Which statement correctly describes information issued by the IRS regarding meals and entertainment?
    a) Through December 31, 2022, there is a 100% deduction for business meals and beverages provided by a restaurant
    b) Food and beverages must be consumed on a restaurant's premises for the 100% meals deduction to apply
    c) For purposes of the 100% meal deduction, a restaurant includes a specialty food store
    d) An employer-operated eating facility is considered a restaurant as long as it is operated by a third party
22. Based on the asset category, what are among the consequences of making an IRC §163(j) election?
    a) For residential rental property, 30 years ADS applies
    b) Nonresidential real property is eligible for bonus depreciation if the election is made
    c) Qualified improvement property is eligible for bonus depreciation if an election is made
    d) An electing business may not claim IRC §179 expensing
23. What are among the details of corporate accumulated earnings?
    a) A corporation may not retain income for purposes of debt retirement
    b) Using consent dividends is a way that corporations can get relief from the accumulated earnings tax if they have accumulated earnings that are more than their reasonable needs
    c) The accumulated earnings credit is the amount of a corporation's accumulated earnings and profits retained for the business's reasonable needs, which is a minimum of $200,000
    d) The burden is on the corporation to prove to the IRS that they have not accumulated earnings and profits beyond their reasonable needs

SOLUTIONS TO REVIEW QUESTIONS

15. What is true about the new Qualified Commercial Clean Vehicle Credit? **(Page 3-7)**

    a) Incorrect. The cap is $40,000, or $7,500 for a vehicle under 14,000 pounds.
    b) Incorrect. The credit is equal to the lesser of 15% of the vehicle's basis or the excess of the vehicle's purchase price over the cost of a comparable vehicle that is powered by gas or diesel fuel.
    c) Incorrect. The credit can't be transferred to the dealer when purchased.
    d) Correct. This is correct, plus any other credit or deduction for the vehicle must be reduced by the amount of this credit.

16. How has IRA '22 impacted the Energy Investment Tax Credit under IRC §48? **(Page 3-13)**

    a) Correct. If property meets the wage and apprenticeship requirements, taxpayers may claim the full 30% credit for property placed in service in 2022.
    b) Incorrect. The extension is for one year for properties beginning construction before January 1, 2025. For geothermal heat pump property, the extension applies to property beginning construction before January 1, 2035.
    c) Incorrect. The expansion of the credit extends to energy storage technology, qualified biogas property, microgrid controllers, and interconnection property.
    d) Incorrect. The base credit starts at 6% for most property.

17. What are among the revisions to business energy credits under the Inflation Reduction Act? **(Page 3-14)**

    a) Incorrect. A qualifying facility is one that is a source of renewable electricity, including wind, biomass, municipal solid waste, geothermal, hydropower, and marine and hydrokinetic energy.
    b) Correct. A low-income community is defined under the IRC §45 New Markets Credit, or the project may be on Indian land.
    c) Incorrect. The maximum increase is to $5,000 per unit for eligible single family homes or manufactured new homes that are certified as Zero Energy Ready Homes.
    d) Incorrect. It is extended through 2032.

18. Which statement correctly describes issues related to a Research Credit refund claim? **(Page 3-29)**

    a) Incorrect. The taxpayer must identify who performed the activities, what they were hoping to discover, as well as all business components to which the credit relates.
    b) Correct. The time period to perfect the claims was originally 30 days.
    c) Incorrect. Supporting documentation is not required, but the taxpayer may provide a written statement attached to the claim.
    d) Incorrect. The extension is until January 10, 2024.

 ©2022

19. As pertains to the four-part test for purposes of determining eligibility for the Research Credit, which test states that the taxpayer must intend that the information to be discovered be useful in the development of a product, a process, computer software, or technique? **(Page 3-30)**

    a) Correct. The taxpayer must demonstrate the intention to discover information that is useful to the development of a new or improved business component.
    b) Incorrect. This test states that the activity must be intended to discover information that is technological.
    c) Incorrect. This test describes the process designed to evaluate alternatives to achieve a result where the capability of the method of achieving that result is uncertain at the outset. Trial and error is not considered sufficient.
    d) Incorrect. The expenditures for research must be eligible for treatment as expenses under IRC §174.

20. Whether to claim IRC §179 expensing or bonus depreciation can depend on the type of property the taxpayer is dealing with. Based on this, which of the following is correct? **(Page 3-34)**

    a) Correct. A §179 deduction is limited to the taxpayer's net business income.
    b) Incorrect. Bonus depreciation does not apply to HVAC units, roofs, fire alarms, or security systems for nonresidential property but §179 expensing does.
    c) Incorrect. The limitation for 2022 is $27,000 for sports utility vehicles over 6,000 pounds and not more than 14,000 pounds gross vehicle weight.
    d) Incorrect. IRC §179 may be claimed for a portion of the cost of one or more items.

21. Which statement correctly describes information issued by the IRS regarding meals and entertainment? **(Page 3-41)**

    a) Correct. All business meals and beverages go back to the 50% deduction rate in 2023.
    b) Incorrect. The 100% deduction applies provided the restaurant is a business that prepares and sells food or beverages to retails customers for immediate consumption, whether or not the food/beverages are eaten on the premises.
    c) Incorrect. A restaurant doesn't include any business that sells prepackaged food.
    d) Incorrect. Even if the facility is operated by a third party under contract with the employer, it is not considered a restaurant for purposes of the deduction.

22. Based on the asset category, what are among the consequences of making an IRC §163(j) election? **(Page 3-50)**

    a) Correct. Under the Consolidated Appropriations Act of 2021, 30-year ADS depreciation will apply no matter when the property was placed in service.
    b) Incorrect. Whether or not the election is made, nonresidential real property is not eligible for bonus depreciation.
    c) Incorrect. If the election is not made, bonus depreciation applies, but if it is made, there is no bonus depreciation.
    d) Incorrect. The regulations do not disallow §179 expensing for an electing business.

 ©2022

23. What are among the details of corporate accumulated earnings? **(Page 3-61)**

    a) Incorrect. Debt retirement is considered an acceptable reason for retaining income.
    b) Correct. Consent dividends are considered phantom dividends whereby the shareholders agree to report dividend income on their own income tax returns, although they did not receive any actual dividends.
    c) Incorrect. The minimum credit is $250,000, or $150,000 for businesses in the fields of health, law, engineering, architecture, accounting, actuarial sciences, performing arts, or consulting.
    d) Incorrect. The burden is on the IRS to prove that the corporation has accumulated earnings and profits in excess of their needs unless the corporation is a holding or investment company.

Chapter 4

Real Estate

REAL ESTATE

SALE OF RESIDENCE

Taxpayers can exclude up to $250,000 from the sale of a residence ($500,000 for a married couple filing jointly). (IRC §121(a); Treas. Regs. §1.121-1(c)(1)) To be eligible for the full exclusion, taxpayers must have owned and used the home as their principal residence for two out of the five years immediately preceding the date of sale.

The following list includes the most common rules that apply to the home sale exclusion:

- Taxpayers cannot claim the home sale exclusion if they previously claimed the home sale exclusion on a qualifying sale within two years from the date of the current sale (Treas. Regs. §1.121-2(a)(3)(i));
- The taxpayer's residence does not have to be real estate (it can be a houseboat, motorhome, etc.), and the home does not have to be in the United States;
- The ownership and use tests can be met at different times and do not have to be a single two-year block (Treas. Regs. §1.121-2(a)(3); Rev. Rul. 80-172, 1980-2 CB 56);
- For married couples, both spouses must meet the two-year use test, but only one spouse must meet the two-year ownership test (IRC §121(b)(2));
- Married couples who file separately can each qualify for up to a $250,000 exclusion on their MFS returns;
- The exclusion is applied per taxpayer, not per residence — for example, a property with three unmarried owners who all meet the two-out-of-five-year tests can each claim an exclusion of up to $250,000 against their individual share of the gain;
- Taxpayers whose home had periods of use where the home was not used as the taxpayer's principal residence may have a reduced exclusion (nonqualified use), discussed below; and
- Taxpayers who are unable to meet the two-out-of-five-year tests can claim a reduced exclusion if the reason for the home sale was due to:
  - A work-related move;
  - A health-related move; or
  - Unforeseen circumstances.

  (Treas. Regs. §1.121-3(c), (d) and (e))

Comment

The home sale rules contain many rules applicable to unique home sale situations, such as homes sold through divorce, installment sales and repossessions, where vacant land is sold as part of the home sale, selling partial interests in a home, and where the home contained a mix of business and personal use, among others.

The bullet point items listed above are some of the more common issues taxpayers may run across when selling their home.

NONQUALIFIED USE

Nonqualified use is commonly an issue for taxpayers who moved into a home originally purchased as a vacation home, or convert a rental to a residence and then subsequently sell the

property. These taxpayers are no longer able to move into these properties for two years before selling and automatically claim a full §121 exclusion. They must grapple with nonqualified use issues. Gain that is allocated to nonqualified use does not qualify for the §121 exclusion.

The amount of gain allocated to periods of nonqualified use is the total gain multiplied by a fraction: The numerator is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer, and the denominator is the period the taxpayer owned the property.

$$\text{Gain} \times \frac{\text{Period of nonqualified use}}{\text{Total period of ownership}} = \text{Nonqualified gain}$$

COUNTING PERIODS OF NONQUALIFIED USE

A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. (IRC §121(b)(4)) Nonqualified use does not include:

- Any portion of the five-year qualifying period, which is after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period) (this exception allows the taxpayer up to a three-year period in which to sell the principal residence after moving out of it, thereby still meeting the two-out-of-five-year requirement, and still be able to claim the full $250,000/$500,000 exclusion);
- Any period (not to exceed an aggregate period of ten years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty (as defined in IRC §121(d)(9)(C)); and
- Any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in the regulations, unforeseen circumstances.

 ©2022

Example #1 of rental converted to residence

Paulette owns a home on Lake Michigan that she purchased on June 30, 2007. She used the home as a vacation home until she retired, and she turned it into her principal residence on June 30, 2019.

Paulette sold the home on November 1, 2022, for a gain of $710,000.

Paulette's nonqualified use is 10½ years (126 months) covering the period January 1, 2009 (when the nonqualified use rules became effective) until June 30, 2019, when she moved into the home.

Using the calculation above, Paulette calculates her nonqualified gain as:

$$\underset{(\$710{,}000)}{\text{Gain}} \times \frac{\text{Period of nonqualified use (126 months)}}{\text{Total period of ownership (184 months)}} = \underset{(\$486{,}196)}{\text{Nonqualified gain}}$$

Paulette calculates her home sale exclusion as follows:

Total gain	$710,000
Less: Nonqualified gain	(486,196)
Qualified gain	$223,804

Paulette can exclude $223,804 of her total gain under the IRC §121 home sale exclusion rules.

It's important to recognize that for taxpayers whose gain is large enough, it's possible that even after accounting for nonqualified gain, a taxpayer can be left with enough qualified gain that they are able to use the full $250,000 ($500,000 for MFJ) home sale exclusion.

DEPRECIATION RECAPTURE

The home sale exclusion does not apply to any portion of gain attributable to post-May 6, 1997, depreciation. Post-May 6, 1997, depreciation must be recaptured and included in the taxpayer's gross income. The gain attributable to post-May 6, 1997, depreciation recapture is not taken into account in determining the amount of gain allocated to nonqualified use.

Example #2 of rental converted to residence

Jose buys a property on January 1, 2018, for $600,000 and uses it as a rental property for two years, claiming $30,000 of depreciation deductions. Thus, his adjusted basis is $570,000. On January 1, 2020, Jose converts the property to his principal residence when the fair market value is still $600,000. On January 1, 2022, Jose moves out. He sells the property for $800,000 on January 1, 2023.

Sale price	$800,000
Basis	570,000
Gain	$230,000

The $30,000 gain attributable to the deduction for depreciation is recaptured. Of the remaining $200,000 gain, 40% is nonqualified use (two years nonqualified out of five years total ownership). Gain attributable to nonqualified use is $80,000 (40% of $200,000).

As such, the remaining $200,000 gain is taxed as follows:

Gain	$200,000
Reduction for nonqualified use	(80,000)
Remaining gain	120,000
IRC §121 exclusion amount	(120,000)
Gain after exclusion	0
Nonqualified gain	80,000
Total recognized gain	$80,000

INHERITED RESIDENCE

The loss on the sale of an inherited residence can be claimed as either a capital loss or as a nondeductible personal loss. (Chief Counsel Memorandum 1998-012) Factors that must be considered include:

- Who "owns" the house: the estate or the heir?
- How was the house used or intended to be used after the decedent's death?

Why a loss?

Upon death, the decedent's assets (including their residence) receive a basis step-up to fair market value. (IRC §1014) If the decedent's home is sold fairly soon after death, the sale will often result in a tax loss after repairs, real estate commissions, and closing costs are factored in.

Ownership and use

The first question to ask is: Does the home pass to the estate or to the heir directly? If it's held by the estate, IRS Publication 559, Survivors, Executors and Administrators, provides the following guidance:

If the estate is the legal owner of a decedent's residence and the personal representative sells it in the course of administration, the tax treatment of gain or loss depends on how the estate holds or uses the former residence. For example, if, as the personal representative, you intend to realize the value of the house through sale, the residence is a capital asset held for investment and gain or loss is capital gain or loss (which may be deductible). This is the case even though it was the decedent's personal residence and even if you didn't rent it out.

If, however, the house isn't held for business or investment use (for example, if you intend to permit a beneficiary to live in the residence rent-free and then distribute it to the beneficiary to live in), and you later

 ©2022

decide to sell the residence without first converting it to business or investment use, any gain is capital gain, but a loss is a nondeductible personal loss.

If title passes directly to the heir, then the facts and circumstances need to be examined to determine if the heir held the property for investment purposes or used it as a personal residence. If the latter, then any loss arising from the sale is a nondeductible personal loss.

California conformity

California generally conforms to the IRC §121 gain exclusion, with special "use" rules for taxpayers who serve in the Peace Corps. (R&TC §17152)

SALE OF REAL ESTATE: ORDINARY INCOME OR CAPITAL GAIN

When real estate is sold for a gain, taxpayers want capital gain treatment. Long-term capital gains are taxed at a lower rate than ordinary income, and the gain is not subject to self-employment tax. On the other hand, when real estate is sold for a loss, they want ordinary loss treatment. Ordinary losses can be used to offset ordinary income from other sources.

MUSSELWHITE v. COMM.

Problems arise when taxpayers want to massage the facts in the middle of the game to suit their current needs. One detailed Tax Court case this year illustrates the scenario perfectly.

The taxpayer was a member of an LLC that owned multiple parcels of real estate. (***Musselwhite v. Comm.***, TCM 2022-57) The LLC was set up during the mid-2000's real estate boom and reported that its principal business activity was "investment" and its product or service was "property" on its income tax returns. Additionally, its real estate holdings were listed on Schedule L, Balance Sheet per Books, as "other investments" and not as inventory for most of the LLC's existence.

After it became apparent that the properties in its portfolio had lost the vast majority of their value after the real estate crash of that period, the LLC began reporting its real estate holdings as "inventory." As the Tax Court said in its opinion, the reclassification of the real estate on its balance sheet from other investments to inventory was the taxpayer's purported "ticket" to classifying the loss as ordinary.

The LLC distributed four parcels of real estate to the taxpayer, which he sold four months later, reporting an ordinary loss in excess of $1 million. The taxpayer reported the loss on Schedule C, which he used to offset his roughly $1.2 million of income from his personal injury law practice.

Interestingly, the LLC also distributed a condominium to the taxpayer at the same time it distributed the four other parcels of real estate. The condominium was immediately sold and was reported by the taxpayer as a capital loss of $137,780 on his income tax return. Coincidentally, the taxpayer had other capital gains of $108,500 the same year.

On audit, the IRS reclassified the ordinary losses on the sale of the four parcels of real estate as capital losses and limited his net capital losses to $3,000 for the year at issue.

Ordinary income versus capital gain

Whether gains or losses are treated as capital depends on whether the asset that was sold is "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." (IRC §1221(a)(1))

The U.S. Supreme Court has defined the term "primarily" as used above to mean "of first importance" or "principally." (***Malat v. Riddell*** (1966) 383 U.S. 569, 572) The determination of whether property is held primarily for sale to customers in the ordinary course of a trade or business (and can therefore be classified as ordinary income or loss) is a factual determination, and the burden of proof is on the taxpayer. (See ***Pasqualini v. Comm.*** (1994) 103 T.C. 1, 6; ***Maddux Constr. Co. v. Comm.*** (1970) 54 T.C. 1278, 1284)

The Tax Court in the ***Musselwhite*** case applied eight factors to determine whether the taxpayer held the four parcels of real estate primarily for sale to customers in the ordinary course of a trade or business. The following chart details the eight factors and the court's determination as to each:

<table>
<tr><th colspan="4">Eight Factors Applied by Tax Court</th></tr>
<tr><th colspan="2">Factor</th><th>Court's holding</th><th>In favor of …</th></tr>
<tr><td>1</td><td>The purpose for which the property was acquired</td><td rowspan="2">The taxpayer had no intention of developing the lots after they were distributed to him from the LLC and did not undertake any development activities during the four months he held the properties.</td><td>IRS</td></tr>
<tr><td>2</td><td>The purpose for which the property was held</td><td>IRS</td></tr>
<tr><td>3</td><td>Improvements, and their extent, made to the property by the taxpayer</td><td>The only improvements to the lots were undertaken by the LLC three and a half years prior to them being distributed to the taxpayer.</td><td>IRS</td></tr>
<tr><td>4</td><td>The frequency, number, and continuity of sales</td><td>Sales by the LLC were infrequent and reported as capital gain (loss) in prior years. The taxpayer had no other real estate sales reported on Schedule C of his personal returns.</td><td>IRS</td></tr>
<tr><td>5</td><td>The extent and substantiality of the transaction</td><td>The taxpayer only held the parcels for four months between the LLC distribution and sale and had few other real estate sales personally over many years.</td><td>IRS</td></tr>
<tr><td>6</td><td>The nature and extent of the taxpayer's business</td><td>The taxpayer's everyday business was as a personal injury attorney, and he was not engaged in the development of real estate other than through his LLC described as an "investment" business.</td><td>IRS</td></tr>
<tr><td>7</td><td>The extent of advertising or lack thereof</td><td rowspan="2">Upon distribution of the properties, the taxpayer engaged a broker to advertise the lots for sale.</td><td>Taxpayer</td></tr>
<tr><td>8</td><td>The listing of the property for sale directly or through a broker</td><td>Taxpayer</td></tr>
</table>

The Tax Court ultimately held that the facts of the case weighed overwhelmingly in the IRS's favor and upheld the IRS's determination that the sale of the four parcels of real property were capital losses.

Comment

The eight factors relied upon by the Tax Court are applied in both the Fourth and Sixth Circuit Courts of Appeals. Other courts may apply different factors, but all seek to address the same factual question: whether the property sold was held primarily for sale to customers in the ordinary course of a trade or business.

California conformity

When an LLC doing business in California sells a parcel of real estate, the LLC's gross receipts used to calculate its LLC fee depends on whether the LLC is a dealer in real property. See page 9-40 for more information.

HOME OFFICE

Remote work has become the norm for an increasing portion of the workforce, and it's important to understand which workers can claim what deductions for home office expenses. Below is a list of FAQs you can use for quick reference.

Q1: Can employees claim the home office deduction on their federal return?

A1: Generally, no. The TCJA suspended 2% miscellaneous itemized deductions for tax years 2018 through 2025. (IRC §67(g)) Unreimbursed employee expenses, including home office expenses, are 2% miscellaneous itemized deductions. The vast majority of employees fall into this category and therefore cannot deduct home office expenses during this time period.

Only a very small group of employees can deduct unreimbursed business expenses, including home office expenses, above–the-line:

- Qualified performing artists (one limitation here is that the taxpayer's AGI can't exceed $16,000, even if married filing jointly);
- Fee-basis state or local government officials;
- Employees with impairment-related work expenses; and
- Qualified K-12 educators (limited to $300 for 2022).
  (IRC §62(a)(2))

Q2: Is there a way employers can help cover their employees' increased expenses?

A2: Businesses that want to benefit their employees can offer accountable plans. An accountable plan reimburses employees for their out-of-pocket business expenses, including an employee's direct home office expenses. If an employee's business expenses are reimbursed under an employer's written accountable plan, then the employer can fully deduct the business expenses, and the employee does not recognize income for the reimbursed expenses.

Alternatively, employers can offer nonaccountable plans to their employees where the employee receives a fixed dollar amount to help compensate them for their home office expense without the employee having to provide substantiation. This type of nonaccountable plan is most often seen with auto allowances for employees. Payments to an employee under a nonaccountable plan are deductible by an employer (and taxable to the employee) as wages.

Accountable and nonaccountable plans are discussed in more detail at page 3-39.

If an employer pays rent to the employee, then the employee must report rental income. However, the employee is prohibited from deducting rental expenses against their rental income. (IRC §280A(c)(6))

Q3: Can an independent contractor/sole proprietor deduct their home office expense?

A3: Yes. Sole proprietors (including independent contractors and statutory employees) who report their business income and expenses on Schedule C can deduct their home office expenses directly on Schedule C. However, if they charge rent to their customer directly, the independent contractor/sole proprietor is prohibited from claiming the rental expenses. (IRC §280A(c)(6); Senate Finance Committee Report, Tax Reform Act of 1986 (P.L. 99-514))

Q4: Can an S corporation owner/employee deduct their home office expenses?

A4: S corporation owners/employees are treated as employees for purposes of claiming unreimbursed employee business expenses. Therefore, home office expenses of an S corporation owner are disallowed due to the elimination of 2% miscellaneous itemized deductions.

Q5: What happens if a shareholder rents out their home office to the S corporation?

A5: Some tax professionals prefer to have the S corporation rent the home office space from the S corporation owner. However, this method is less desirable than the accountable plan option discussed above because the rental income paid by the S corporation must be included in the owner/employee's income as rental income reported on Schedule E.

Also, under the self-rental rules, the rental income received by the shareholder who materially participates in the S corporation business is considered nonpassive income, while rental losses are still classified as passive. (Treas. Regs. §1.469-2(f)(6)) And remember, the S corporation shareholder is still an "employee," so the IRC §280A(c)(6) limitations still apply, meaning that the S corporation is still limited to claiming only those items that would be deductible on Schedule A (mortgage interest and property taxes).

Q6: Can a partner deduct their home office expenses related to their work performed for the partnership?

A6: Unlike S corporation owners/employees, partners can deduct their unreimbursed partner expenses directly against their flowthrough income from the partnership on Schedule E, page 2. Partners should ensure that their partnership agreement specifically states that these expenses will not be reimbursed by the partnership before claiming them.

A partner's unreimbursed expenses are fully deductible against both federal income taxes and self-employment taxes.

Q7: Does depreciation recapture apply when a taxpayer who claims a home office deduction sells their home?

A7: Taxpayers who use the regular method to compute their home office deduction by deducting actual expenses, which includes depreciation, must account for depreciation recapture when they sell their home. Because depreciation recapture is required if depreciation is "allowable," the depreciation recapture applies even if the taxpayer didn't actually claim a depreciation deduction. However, taxpayers who use the simplified method of computing the home office deduction are not subject to depreciation recapture. (Rev. Proc. 2013-13; IRS webpage "Simplified Option for Home Office Deduction")

 ©2022

Home office requirements

In order to qualify to deduct expenses for business use of a home, the taxpayer must use part of their home:

- Exclusively and regularly as their principal place of business;
- Exclusively and regularly as a place where they meet or deal with patients, clients, or customers in the normal course of their trade or business;
- In the case of a separate structure that is not attached to the taxpayer's home, the separate structure must be used in connection with the taxpayer's trade or business;
- On a regular basis for the storage of inventory or samples;
- For rental use; or
- As a day care facility.
  (IRS Publication 587)

Whether a taxpayer's home is their principal place of business is determined by reviewing all the facts and circumstances. At a minimum, the taxpayer must meet the following two requirements:

1. The home must be used exclusively and regularly for administrative or management activities of the trade or business; and
2. The taxpayer has no other fixed location where they conduct substantial administrative or management activities of the trade or business.

The taxpayer is not required to spend most of their time in their home office in order to meet the principal place of business test. For example, a taxpayer who is a sole proprietor handyman may spend most of his time working in his customers' homes, but if his home office is the principal location where he schedules appointments and performs other administrative or management activities, then his home meets the principal place of business test.

Taxpayers who do not meet the principal place of business test can still claim the home office deduction if they meet with patients, clients, or customers in their home, but only if:

- The taxpayer physically meets with patients, clients, or customers at their home (merely meeting with clients by telephone or video conference while sitting at home doesn't qualify); and
- The taxpayer's home is substantial and integral to the conduct of their trade or business.
  (Prop. Treas. Regs. §1.280A-2(c))

Using the home only for occasional meetings does not qualify.

California nonconformity

California does not conform to the suspension of the miscellaneous itemized deductions. (R&TC §§17024.5, 17076) Taxpayers can claim an unreimbursed employee expense deduction on the California return for their home office deductions.

REAL ESTATE PROFESSIONALS

SEZONOV v. COMM.

An Ohio couple became the latest victims to lose their real estate professional case before the Tax Court. (***Sezonov v. Comm.***, TCM 2022-40) The taxpayers, neither of whom were employed in real

estate trades or businesses, attempted to deduct losses from two Florida residential rental properties by classifying themselves as real estate professionals.

The taxpayer-husband owned a single member LLC that operated an HVAC wholesale business, and the taxpayer-wife was not employed beyond the time she spent on their two out-of-state rental properties. They had no other passive income.

The taxpayers in ***Sezonov*** were unable to prove that either of them met the real estate professional tests. Neither spouse was employed in a real property trade or business, nor did they meet the 750-hour requirement.

The taxpayers did not maintain contemporaneous records to substantiate the hours they spent on their two rental properties. The taxpayer-wife prepared an estimated time log in 2019 in preparation for their Tax Court trial — six years after the first year at issue. Unsurprisingly, the Tax Court found the estimated time logs to be unclear and excessive in several respects.

PASSIVE ACTIVITY

Rental real estate is, per se, passive, and therefore, losses generated from rental real estate are nondeductible (with the limited exception of a maximum $25,000 deduction for active participation). However, "real estate professionals" may deduct rental real estate losses against their ordinary income. (IRC §469(c)(7))

A taxpayer qualifies as a real estate professional for a tax year if they meet both of the following tests:

- More than one half of the personal services the taxpayer performs during the tax year are performed in real property trades or businesses; and
- The taxpayer performs more than 750 hours of service during the tax year in real property trades or businesses.
  (IRC §469(c)(7)(B))

In the case of a joint return, spouses cannot combine the time each spends separately to satisfy the thresholds. (IRC §469(c)(7)(B))

The term "real property trade or business" means any real property business involved in:

- Development or redevelopment;
- Construction or reconstruction;
- Acquisition;
- Conversion;
- Rental or leasing;
- Operations or management; or
- Brokerage.
  (IRC §469(c)(7)(C))

California nonconformity

California does not conform to the special exemption from application of the passive loss rules for real estate professionals. (R&TC §§17561(a), 24692(b))

MATERIAL PARTICIPATION

If the taxpayer meets the more-than-half-time and the 750-hour tests, the taxpayer is a real estate professional, but may only deduct losses against ordinary income with respect to rental real estate activities in which the real estate professional materially participates.

Comment

It's at this point that most taxpayers, and even many tax professionals, fail in their analysis. A taxpayer can meet the more-than-one-half of their services test and the 750-hour test and be classified as a real estate professional.

However, they still aren't eligible to deduct losses from their rental activities unless they additionally meet the material participation test for each of their rental activities. Far too many taxpayers ignore the material participation part of the analysis.

Whereas the taxpayer may meet the half-time and 750-hour requirements based on other real estate activities, the taxpayer must meet the material participation requirement based solely on their rental real estate activities.

A taxpayer materially participates in an activity for a given tax year if the taxpayer meets at least one of the following seven tests:

- The taxpayer participates in the activity for more than 500 hours;
- The taxpayer's participation constitutes substantially all of the participation in such activity of all individuals (including nonowners);
- The taxpayer participates more than 100 hours, and such participation is not less than the participation of any other individual;
- The activity is a significant participation activity under Treas. Regs. §1.469-5T(c), and the taxpayer's aggregate participation in all significant participation activities exceeds 500 hours;
- The taxpayer materially participated in the activity in any five of the last 10 taxable years;
- The activity is a personal service activity under Treas. Regs. §1.469-5T(d), and the taxpayer materially participated in the activity for any three taxable years preceding the current tax year; or
- Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year.
  (Treas. Regs. §1.469-5T)

THE SINGLE-ACTIVITY ELECTION

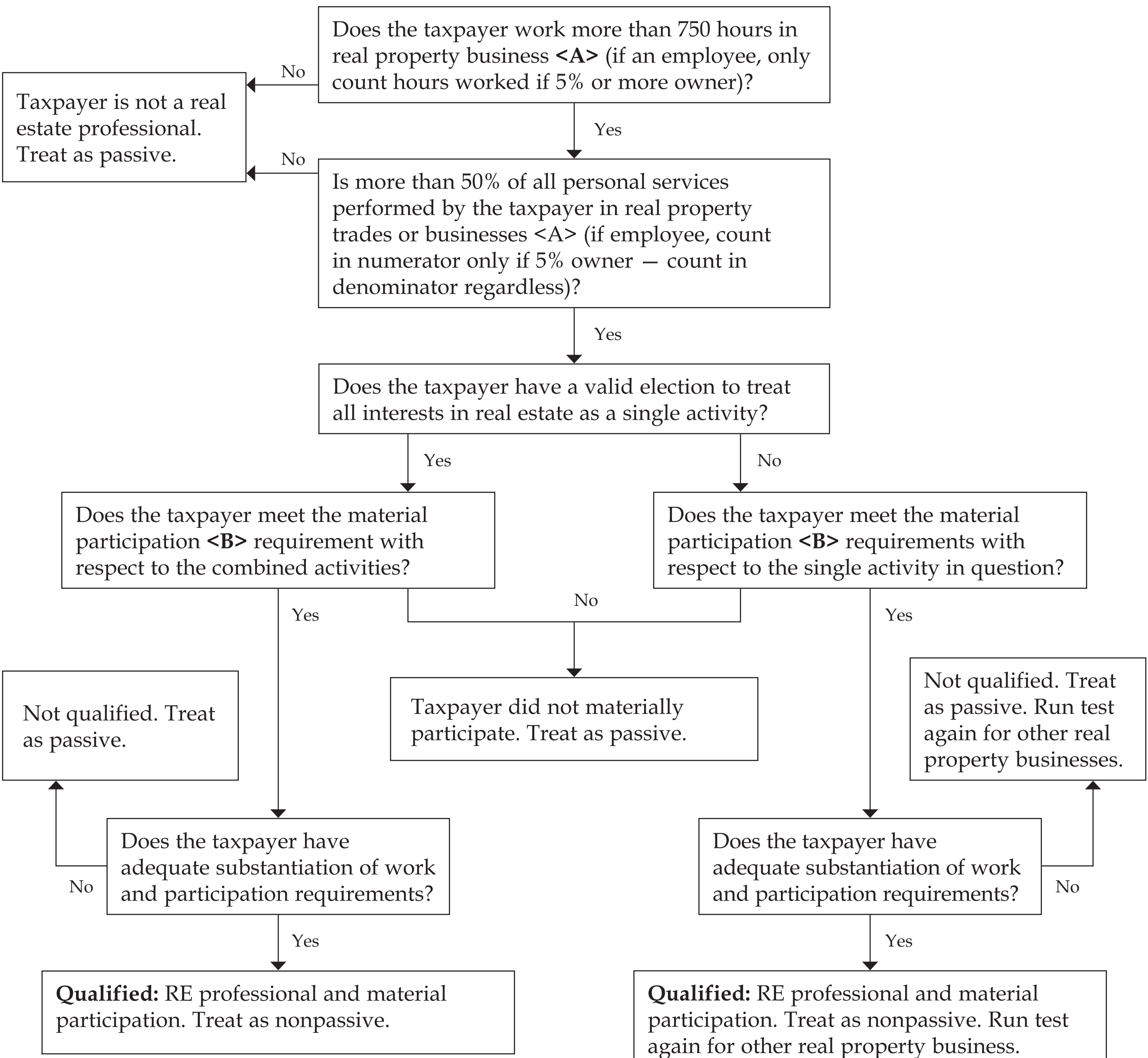
A taxpayer who satisfies both the real estate professional and material participation tests above may deduct the full amount of their losses. (Treas. Regs. §1.469-9(e)(1)) In assessing a taxpayer's material participation, each rental property is treated as a separate activity unless the taxpayer makes an election to treat all rental activities as a single activity (the single-activity election). (IRC §469(c)(7)(A))

The single-activity election permits a taxpayer to treat all interests in rental real estate as one activity, thereby creating a single, bigger activity, and one for which it will be easier to meet the material participation test. The election is binding for the tax year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer. The election is made by filing a statement with the taxpayer's original income tax return. (IRC §469(c)(7); Treas. Regs. §1.469-9(g)(3)) Simply aggregating losses from various rental activities and reporting them on the tax return is not a sufficient election.

Sample single-activity election

Pursuant to IRC §469(c)(7)(A) and Treasury Regulation §1.469-9, the taxpayer hereby elects to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity for the tax year ended December 31, 20XX, and subsequent tax years. The taxpayer hereby declares themself a qualifying taxpayer for the tax year ended December 31, 20XX.

Real Estate Professional Flowchart



<A> Real property businesses include:

- Development Rental
- Redevelopment Operation
- Construction Management
- Reconstruction Brokerage
- Acquisition
- Conversion

<B> To materially participate you must meet one of the following tests:

1. Spend more than 500 hours in the activity
2. Perform substantially all the work in the activity
3. Spend more than 100 hours in the activity, and no one else does more
4. Spend more then 100 hours and aggregate more than 500 hours in significant participation activities
5. Materially participate in the activity any 5 of the last 10 years
6. The activity is a personal service activity
7. Facts and circumstances support regular, continuous, and substantial participation

Note: Limited partners may only use tests 1, 5, and 6

SCHEDULE E REPORTING ISSUES

We all have multiple clients who own Schedule E rental properties, and those rental properties often generate tax losses for our clients. If our client is not a real estate professional and therefore is subject to the passive loss limitation rules, the first thing tax professionals often look at when their client's Schedule E rental property generates a tax loss is the client's adjusted gross income.

If the taxpayer's AGI is $100,000 or less, then our client may be able to deduct up to $25,000 of their Schedule E rental losses, even if our client has no other passive income. (IRC §469(i)) The $25,000 maximum amount is reduced when the taxpayer's AGI exceeds $100,000 and is fully phased out once their AGI reaches $150,000. The maximum allowable losses as well as the phase out are reduced by half for married taxpayers who file separately and live apart for the entire tax year. (IRC §469(i)(5))

However, as tax professionals, our inquiry cannot end there. There are two additional items we must address that are often overlooked:

- Did the client actively participate in the rental activity?
- Is the average rental period greater than seven days?

✐ Practice Pointer

The reason these two questions are often overlooked is because professional tax software often sets its default setting to assume that the answer to both of these questions is "yes." However, if the answer to either question is "no," then the taxpayer cannot deduct any of their losses against other nonpassive income, even if their AGI is below the $150,000 phaseout range.

ACTIVE PARTICIPATION

The active participation standard is easier to satisfy than the material participation standard. In order to meet the active participation standard, the taxpayer must simply participate in the rental activity in a significant way, including making management decisions or arranging for others to provide services (such as hiring the plumber to fix a leak), approving new tenants, setting rental policies and terms, and approving capital expenditures and repairs. (***Madler v. Comm.***, TCM 1998-112)

Example of active participation

Jim and Jane are siblings, and each owns 50% of a residential rental property they inherited when their mother died. They use a management company for the day-to-day rental activity.

Jim is the main contact with the management company. He approves rental applications, pays the semi-annual property tax bill, makes the monthly mortgage payments, and he approves any major expenditures proposed by the management company. Jane cashes a monthly check she receives.

In this scenario, Jim actively participates in the rental activity, but Jane does not.

A taxpayer cannot satisfy the active participation standard if their ownership in the rental activity drops below 10% at any point during the year. (IRC §469(i)(6)(A))

AVERAGE RENTAL PERIOD

If the taxpayer's average rental period is seven days or less, then the rental property is technically removed from the Code's definition of "rental activity." (Treas. Regs. §1.469-1T(e)(3)(ii)(A)) And if the rental property is not technically a "rental activity," then the taxpayer cannot deduct their losses against other nonpassive income, even if the taxpayer's AGI is less than $150,000.

Caution

This can be an issue for taxpayers renting out their homes via Airbnb and VRBO. If their average rental period is seven days or less, they cannot claim the $25,000 passive loss for rental real estate against nonpassive income.

One California taxpayer in a recent case tried arguing that even though the renters of their vacation rental property rented the property for an average of seven days or less, the management company that managed the property on the taxpayer's behalf was the true tenant. (***Eger v. U.S.*** (August 13, 2020) U.S. Court of Appeals, Ninth Circuit, Case No. 19-17022) Because the management company was hired to manage the property the entire year, the taxpayer argued that the average rental period was greater than seven days. The Ninth Circuit Court of Appeals, in upholding the district court decision, held that the average rental period is based on the actual renters, not the management company.

PERSONAL PROPERTY RENTALS

Real estate rental activities must be distinguished from personal property rental activities. Renting out personal property, such as machinery and equipment or even personal cars and recreational vehicles, should not be reported on Schedule E, Supplemental Income and Loss (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.).

Rental income is only reported on Schedule E if it is from renting real estate. Instead, personal property rental income must be reported in one of two places:

- Schedule C, Profit or Loss From Business, if the taxpayer is in the trade or business of renting personal property; or
- Schedule 1, Additional Income and Adjustments to Income, if the taxpayer is not in the trade or business of renting personal property.

Unlike Schedule E, where each unique real estate rental must be reported on its own separate column of that form, personal property rentals, whether reported on Schedule 1 or Schedule C, can be combined into a single reporting unit.

Example of personal property rentals

Preston owns 50 large inflatable toys, such as bounce houses, that he rents out for kids' birthday parties. Preston has four employees who help with deliveries and pickups as well as cleaning and repairs. He also has two dedicated vehicles and trailers that are used in the business.

Additionally, Preston is an avid camper and owns an RV and a travel trailer that he uses personally. When he isn't using them, he rents them out through a smart phone app, which helps cover his cost of ownership.

Preston is in the trade or business of renting bounce houses and must report his income and expenses on Schedule C, and he is subject to self-employment tax on his earnings.

Preston is not in the trade or business of renting his personal RV and travel trailer, so he must report his rental income and expenses on Schedule 1 and is not subject to self-employment taxes on his earnings.

✐ **Practice Pointer**

The IRS defines a residence as a single-family house, condominium, cooperative, mobile home, motor home, boat, or houseboat, as long as it contains cooking, sleeping, and restroom facilities. (Treas. Regs. §1.121-1(b)(1))

Clients who, like Preston in the previous example, generate rental income from an RV, travel trailer, or boat can be subject to the vacation home rules if the personal property being rented meets the definition of a residence, and the taxpayer uses the personal property for personal purposes for the greater of 14 days or 10% of the total days it was rented to others.

SCHEDULE 1 REPORTING

For those taxpayers who have rental income from personal property, but whose rental activity has not risen to the level of a trade or business, their gross rental income must be reported on Schedule 1, line 8k and deductible rental expenses (including depreciation) on Schedule 1, line 24b.

Comment

Schedule 1, line 8k asks for "Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property." Line 24b asks for "Deductible expenses related to income reported on line 8k from the rental of personal property engaged in for profit." These lines ask for totals only. Neither line requires any details or itemization.

Line 8k flows to Form 1040, line 8 and becomes part of total income. Line 24b flows to Form 1040, line 10 as an adjustment to income.

PASSIVE ACTIVITY RULES

Taxpayers who have personal property rental income and expenses that must be reported on Schedule 1 are subject to the passive activity loss rules under IRC §469. As such, if the activity is

passive, losses generated from the personal property rental activity are only deductible to the extent the taxpayer has other passive income. (IRC §469(a))

Example of Schedule 1 reporting of personal property rental

Helen inherited farm equipment when her uncle passed away in 2021. Instead of selling the equipment, she decided to lease it at a rate of $400 per month. The equipment was leased for 10 months during 2022 but broke down and required repairs totaling $6,000. The rental activity is passive to Helen.

For the 2022 tax year, Helen will report $4,000 of personal property rental income on Schedule 1, line 8b ($400 per month × 10 months) and will report $6,000 of personal property rental expenses on Schedule 1, line 24b.

Helen has no other passive activities, so her 2022 rental losses of $2,000 ($6,000 - $4,000) are disallowed under the passive activity loss rules. The special rule that allows taxpayers to deduct up to $25,000 of losses against their ordinary income is only available for rental real estate activities. (IRC §469(i))

DELAWARE STATUTORY TRUSTS

Delaware statutory trusts (DSTs) have been around for decades, but it wasn't until the IRS issued Revenue Ruling 2004-86 that DSTs really started to become popular as a real estate investment tool. The revenue ruling held:

- DSTs that meet certain requirements detailed in the revenue ruling are investment trusts that are classified as trusts for federal tax purposes; and
- A taxpayer may exchange real property for an interest in a DST using the like-kind exchange rules of IRC §1031.

WHAT IS A DST?

DSTs are a form of business trust, which is essentially an unincorporated corporation. DSTs are formed as private governing agreements under which either:

- Property (real, tangible, and intangible) is held, managed, administered, invested, and/or operated; or
- Business or professional activities for profit are carried on by one or more trustees for the benefit of the trustor entitled to a beneficial interest in the trust property.
  (Tit. 12 Del. Code §3801)

Although a DST is formed in Delaware, it can operate anywhere. For example, California recognizes business trusts, but it does not authorize the formation of business trusts by statute.

Some of the key features of DSTs include:

- Unlimited number of investors are permitted;
- Investors own a percentage of the trust that owns the property, but not the property itself;
- The DST is the mortgage holder for real property, not the individual investors;
- There are no investor guarantees;
- DST management makes all decisions with no investor involvement; and
- Investors have no voting rights.
  (Tit. 12 Del. Code §§3801–3824)

ELIGIBLE INVESTORS

DST investors must be accredited. (SEC Rule 501 of Regulation D (§230.500(a))) An accredited investor is a person who:

- Has annual income exceeding $200,000 ($300,000 if combined with a spouse's) for at least two years with the expectation that the income will continue or increase in the coming year; or
- Has a net worth exceeding $1 million (either individually or jointly with their spouse).

INCOME TAX REPORTING

Like a tenancy in common (TIC), a taxpayer who owns an interest in a real estate DST, such as a commercial building, will report their share of rental income and expenses on Schedule E.

Example of income tax reporting for DST rental income

Brett owns 1.02% of a DST, and the DST owns a 500-unit apartment complex in New Jersey. At the end of the year, the DST provides Brett with a P&L and balance sheet reflecting the annual result of operations of the apartment building.

When Brett files her income tax return for the year, she will report 1.02% of the income and expenses of the DST the same way she would if she owned a 1.02% interest in a tenancy in common.

BENEFITS OF A DST INVESTMENT

DSTs can be very popular real estate investment vehicles for seasoned real estate investors who no longer want to actively participate in the management of their properties. For these investors, a DST can:

- Keep the investor in real estate without the management headache;
- Create cashflow without taxable income potentially (because, like other real estate investments, depreciation can potentially wipe out taxable income while the property produces positive cash flow);
- Keep building wealth in assets that historically appreciate in value; and
- Create leverage with other DST owners to invest in larger properties that the investor alone would not be able to purchase.

LIKE-KIND EXCHANGES

The TCJA limited qualified IRC §1031 exchanges to exchanges of real property. (IRC §1031(a)) Thus, for example, a property owner who hates managing his own rental property cannot exchange his interest in real estate for a limited partnership interest.

Certain joint undertakings or contractual arrangements may create a separate entity for federal tax purposes and therefore may be classified as either a partnership or a corporation. Whether the joint ownership of real estate will be treated as a partnership or corporation depends on whether the joint ownership functions as a separate business entity or merely investment co-ownership. If the interests are treated as a co-ownership and not a separate business entity, taxpayers owning those interests may still exchange them in a transaction qualifying for like-kind exchange treatment. If the ownership of the fractional interests qualifies as a business, like-kind exchange treatment is not permitted.

TIC VERSUS DST LIKE-KIND EXCHANGE

Tenants in common (TIC) like-kind exchanges under IRC §1031 essentially allow taxpayers to either join forces with other investors to buy a replacement property and/or to buy into an existing investment arrangement. However, taxpayers must be careful that any TIC like-kind exchange doesn't violate the §1031 prohibition against investing in a partnership interest.

Revenue Procedure 2002-22 clarifies the parameters necessary for a TIC interest to be treated as an interest in real estate (like-kind property) rather than an interest in a partnership (not like-kind property). Among other rules:

- Each TIC owner must hold title to the property;
- There can be no more than 35 co-owners;
- The group cannot file a partnership or corporation tax return or conduct business under a common name;
- Co-owners must retain the right to hire or fire managers, sell the property, or refinance the property (these decisions must be made unanimously, so one TIC owner can block the majority's will); and
- Co-owners must share profits and losses proportionately.

Revenue Ruling 2004-86 sanctioned the use of DSTs for like-kind exchanges as long as the DST does not violate specified prohibitions, commonly referred to as the "seven deadly sins." These prohibit the DST from the following activities:

- Entering into new leases or renegotiating current leases;
- Making additional capital contributions;
- Renegotiating the current loan or obtaining a new loan;
- Reinvesting the proceeds from any sale;
- Capital expenditures beyond normal maintenance items;
- Investing cash between distribution dates in anything other than short-term securities; and
- Failing to distribute cash to the owners, other than required reserves.

To avoid the seven deadly sins and to make the venture more attractive, commercial leases involving DSTs usually have the trustee enter into a master lease agreement with a core tenant who then sublets the building or building units.

Additionally, large reserves are put aside at the initial offering so that additional loans or financing are not required to cover additional costs. The properties invested in tend to be newer or recently remodeled so that large expenditures beyond normal maintenance are not required.

The following chart provides an overview of the advantages and disadvantages of like-kind exchanges using a TIC versus DST.

Comparison of DST and TIC 1031s		
	DST structure	**TIC structure**
IRS guidance	Rev. Rul. 2004-86	Rev. Proc. 2002-22
Number of investors	Unlimited, thereby making investments in larger properties more plausible	Unlimited (but if more than 35, then the TIC interest is not deemed to be an interest in real property and is ineligible for §1031 exchange treatment)
Ownership	Percentage of beneficial ownership DST that owns real property	Undivided tenant-in-common interest in real property
Investors receive property deed	No	Yes
Investors form SMLLCs	One (the DST). Makes financing much more attractive to lenders	Each TIC owner can form their own SMLLC to hold their interest
Major decisions regarding property	No voting rights. Trustee makes all decisions. Not appropriate for those who like more hands-on involvement	Equal voting rights and unanimous approval required. Essentially gives one tenant the veto power over all decisions
Number of borrowers	One (the DST). Makes financing much more attractive to lenders	Unlimited
Liability for DST obligations	None	Yes, unless a SMLLC is formed. If formed, California taxpayers must pay, at a minimum, $800 annual tax, not to mention the costs to establish the SMLLC
QBI	Yes, if QBI requirements are met	Yes, if QBI requirements are met

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

24. Gain from a sale or exchange under IRC §121 is limited for nonqualified use. An accurate factor of nonqualified use is best described in which choice?

    a) A period of nonqualified use pertains to any period after January 1, 2008, in which the property isn't used by the taxpayer as their principal residence
    b) Nonqualified use does not include any period (not more than an aggregate five-year period) when the taxpayer or their spouse is serving on qualified official extended duty
    c) Nonqualified use does not include any three-year period where the taxpayer is temporarily absent due to a change in place of employment, health, or unforeseen circumstances
    d) Any portion of the five-year qualifying period that is after the last date the property is used as the taxpayer's or their spouse's principal residence is not considered nonqualified use

25. Which of these statements regarding home office expenses is true?

    a) In general, most employees can claim the home office deduction on their federal return
    b) If an employee gets reimbursed for their business expenses under an employer's accountable plan, the employer can deduct the business expense
    c) Payments to an employee under a nonaccountable plan to help compensate them for their home office expenses are not taxable to the employee
    d) S corporation owners and partners can deduct their unreimbursed expenses against their flowthrough income

26. What are among the factors to consider regarding Schedule E rental properties?

    a) A taxpayer may be able to deduct their Schedule E rental losses against other nonpassive income as long as their AGI is below $200,000
    b) For purposes of a rental activity, the active participation standard is higher than the material participation standard
    c) If a property for rent is not considered a "rental activity," the taxpayer may not deduct losses against other nonpassive income, even if their AGI is under the threshold under IRC §469(i)
    d) If a taxpayer's average rental period is under 14 days, the rental property is not considered a "rental activity" in the Tax Code

 ©2022

SOLUTIONS TO REVIEW QUESTIONS

24. Gain from a sale or exchange under IRC §121 is limited for nonqualified use. An accurate factor of nonqualified use is best described in which choice? **(Page 4-2)**

    a) Incorrect. Nonqualified use pertains to any period after January 1, 2009.
    b) Incorrect. The aggregate period cannot be more than ten years.
    c) Incorrect. The time period cannot exceed two years.
    d) Correct. This provides the taxpayer up to three years in which to sell the principal residence after moving out.

25. Which of these statements regarding home office expenses is true? **(Page 4-7)**

    a) Incorrect. These expenses are typically not deductible due to the elimination of 2% miscellaneous itemized deductions.
    b) Correct. The employee also is not taxed on the reimbursement.
    c) Incorrect. Payments under a nonaccountable plan are considered wages, taxable to the employee.
    d) Incorrect. Although partners can deduct these expenses on Schedule E, S corporation owners are treated as employee for purposes of these expenses, and they are disallowed due to the elimination of 2% miscellaneous itemized deductions.

26. What are among the factors to consider regarding Schedule E rental properties? **(Page 4-14)**

    a) Incorrect. AGI must be under $150,000. The maximum reduction is phased out between AGI of $100,000 to $150,000.
    b) Incorrect. The material participation standard is higher.
    c) Correct. To be considered a rental activity, the average rental period must exceed 7 days. If the property is a rental activity, as long as the taxpayer's AGI is less than $150,000, losses may be deducted against other nonpassive income.
    d) Incorrect. If the average rental period is seven days or less, it is removed from the Code's definition of rental activity.

 ©2022

This page intentionally left blank.

Chapter 5

Practice and Procedures

PRACTICE AND PROCEDURES

PTINs

PTIN RENEWAL

The IRS is processing PTIN renewals for the 2023 filing season. Anyone who prepares, or assists in preparing, federal returns for compensation must have a valid PTIN and must renew before preparing tax returns in a new calendar year.

Website
www.irs.gov/Tax-Professionals/PTIN-Requirements-for-Tax-Return-Preparers

PTIN fees

The PTIN renewal fee for 2023 is $30.75. (IR-2022-190; Treas. Regs. §300.13)

Data security plan

Remember, when renewing your PTIN, the IRS requires tax professionals to confirm that their firm has a written data security plan in place (also known as a written information security plan or WISP).

The IRS provides two helpful data security publications to help tax professionals understand and implement their data security plan requirements:

- Publication 5293, Protect Your Clients; Protect Yourself; and
- Publication 5708, Creating a Written Information Security Plan for your Tax & Accounting Practice.

The publications are available at:

Website
Publication 5293: www.irs.gov/pub/irs-pdf/p5293.pdf
Publication 5708: www.irs.gov/pub/irs-pdf/p5708.pdf

Publication 5708 also includes a sample written information security plan (WISP) that can be customized for your firm's needs.

FORMS AND FILING UPDATE

1099-K REPORTING THRESHOLD

The American Rescue Plan Act (ARPA) reduced the threshold under which third-party settlement organizations (e.g., credit card companies, PayPal, Venmo, etc.) must file Form 1099-K, Payment Card and Third-Party Network Transactions, from $20,000 and 200 transactions per payee to $600, regardless of the number of transactions. (IRC §6050W(e); ARPA §9674) In late December 2022, the IRS announced the reduced threshold applies to transactions settled after December 31, 2022, not December 31, 2021. (Notice 2023-10)

We have prepared a client letter that addresses the reduced 1099-K reporting threshold, with a focus on how it can catch gig workers off-guard. The client letter is available at:

> 💻 **Website**
> www.caltax.com/cl-gigeconomy

> ***Comment***
>
> The lower 1099-K reporting threshold will catch many taxpayers with hobby income and those with gig economy jobs, such as personal property rentals, unprepared. Hobby activities are discussed on page 1-10 and personal property rentals are discussed on page 4-14.

1099-NEC AND 1099-K DOUBLE REPORTING

Taxpayers often receive both a 1099-NEC and 1099-K reporting the same payments and then don't know what to do about the double reporting.

Form 1099-K is issued to a taxpayer by their credit card processing companies if the taxpayer received qualified credit card-type payments in excess of the applicable thresholds. Starting in the 2022 taxable year (1099-Ks issued by January 31, 2023), a taxpayer meets the reporting threshold if they received gross payments of $600 or more, regardless of the number of transactions. (IRC §6050W(e); ARPA §9674)

Form 1099-NEC generally must be filed if a business pays a service provider who is not an employee at least $600 during the year. However, the instructions to Form 1099-NEC specifically state:

*"Payments made with a credit card or payment card and certain other types of payments, including third-party network transactions, must be reported on Form 1099-K by the payment settlement entity under section 6050W and are **not subject to reporting on Form 1099-NEC** [emphasis added]."*

> ✏ **Practice Pointer**
>
> The instructions to Form 1099-NEC just quoted indicate that if a vendor is paid exclusively via third-party network transactions (such as credit cards), then the payor is relieved of its 1099-NEC/1099-MISC filing requirements.

How to address the double reporting on an income tax return

Now that we have established that a taxpayer should not receive both a 1099-K and a 1099-NEC for the same payments, it would be naïve of us to assume that all issuers of 1099-NECs are aware of this rule.

If you have the same payments reported on Form 1099-K and Form 1099-NEC, we recommend reporting the full amount of the payments on your return, then backing out the double payments as a separate expense item. This process will help avoid the IRS's automated underreporter notices.

It also wouldn't hurt to contact the 1099-NEC issuer to let them know of their error so that you aren't faced with the same problem year over year. It would be even better if you can get the payor to issue a corrected 1099-NEC, but payors aren't always the most helpful when it comes to issuing corrected information returns.

 ©2022

Preparing a 1099-NEC when some payments were made by credit card

On the other side of the equation are clients who are the ones issuing the 1099-NEC. How much should be reported to the recipient when the payor makes some payments using a credit card and some payments not on a credit card?

The event that triggers 1099-NEC reporting is the payment to a service provider that takes the taxpayer to the $600 threshold for the year. So, if any payment to that service provider, no matter how small, won't be reported on Form 1099-K, then the payor must issue a 1099-NEC.

Example of 1099-NEC reporting

Joanna is a sole proprietor tax preparer. She hires a night cleaning service for her office at a rate of $200 per month ($2,400 per year) in 2022. The cleaning service provides Joanna with a monthly invoice that she usually pays by credit card. However, there were two months that she paid her cleaning service invoice by check.

Joanna's payments to the cleaning service meet the $600 threshold for filing Form 1099-NEC, so if any amount paid will not be reported on Form 1099-K, she must report the balance on Form 1099-NEC. A worksheet to track payments may be helpful, such as:

Total paid to service provider	$2,400
Amount paid by credit card[1]	(2,000)
Amount Joanna must report on Form 1099-NEC	$ 400

[1] Reported on Form 1099-K by credit card company

INFORMATION RETURNS INTAKE SYSTEM

The IRS has launched its new Information Returns Intake System (IRIS), which will run alongside and ultimately replace in 2024 the current Filing Information Returns Electronically system. But in its National Public Liaison Practitioner Meeting on November 17, the IRS announced that tax professionals will be able to use the IRS's new IRIS web portal to submit 1099 series forms beginning January 9.

Tax professionals can begin their IRIS application for the new system at the following website:

Website
www.irs.gov/tax-professionals/iris-application-for-tcc

The IRIS portal will allow taxpayers to perform the following tasks at no cost:

- Electronically prepare (create, edit, and view) and file Forms 1099 series without using software or a service provider;
- Download and print the recipient copy of Forms 1099 for distribution to payees;
- Maintain a record of completed, filed, and distributed Forms 1099;
- Perform basic validation of 1099 data before submission;
- File up to 100 forms per submission;
- Participate in the Combined Federal/State Filing Program;
- Request automatic extensions; and
- File certain corrected information returns.
  (IRS Publication 5717, Information Returns Intake System (IRIS) Taxpayer Portal User Guide)

Publication 5717 provides a complete list of 1099 forms available to file through the IRIS system for the 2022 tax year as well as a guide to complete the IRIS application online. Publication 5717 is available at:

Website
www.irs.gov/pub/irs-pdf/p5717.pdf

CORPORATE TRANSPARENCY ACT

The Treasury Department has issued final regulations regarding the new beneficial ownership reporting information requirement enacted by the Corporate Transparency Act of 2019 (CTA). (31 CFR Part 1010, RIN 1506-AB49)

The CTA requires companies to provide specified information about themselves and their individual beneficial owners (defined below) to the Financial Crimes Enforcement Network (FinCEN) of the U.S. Treasury Department. (P.L. 116-283, §6401 et seq; 31 U.S.C. §5336)

Comment

FinCEN estimates that there are over 30 million existing entities that will have to comply with these new requirements, and going forward over 3 million new entities will be required to file reports each year.

FinCEN has not yet released the forms that must be filed, nor indicated how this information should be filed.

The good, the bad, and the ugly

The good news is that:

- Many larger companies are exempt from these reporting requirements;
- The regulations will not go into effect until January 1, 2024; and
- Entities in existence as of January 1, 2024, will have until January 1, 2025, before they must file their first report.

The bad news is that reporting companies will be responsible for obtaining and reporting personal information regarding their "beneficial owners" (defined below) and will be responsible for updating information with FinCEN on an ongoing basis.

The ugly news is that failure to comply with the reporting requirements, including by providing false or fraudulent beneficial ownership information, may result in:

- A $500 per day civil penalty; and
- Criminal penalties of up to $10,000 and/or imprisonment of up to two years. (31 U.S.C. §5336(h))

The penalty can be imposed against both the beneficial owner and the person who completes the report if they willfully provided false information.

Who must report?

A reporting company is:

- A domestic corporation, LLC, including a single member LLC, or an entity created by filing documents with a secretary of state's office or similar office (e.g., limited partnerships, limited liability partnerships, and business trusts in most states); and
- A foreign corporation, LLC, or other entity formed under the law of another country and registered to do business in any state or tribal jurisdiction by the filing of a document with a secretary of state or similar office.
(Treas. Regs. §1010.380(c))

Caution

The vast majority of small and medium-sized businesses that form with a state's secretary of state's office will be subject to the Corporate Transparency Act's reporting requirements to FinCEN.

Start familiarizing yourself with these new requirements now, educate your clients as to what information they need to start gathering, and work with your clients to set up systems to track this information on an ongoing basis so that when the January 1, 2025, filing deadline hits, you and your clients will be ready.

Who doesn't have to report?

The reporting rules do not currently apply to general partnerships or most trusts, large operating companies, or highly regulated companies. There are over 23 exemptions including, but not limited to:

- Public accounting firms (registered under Sec. 102 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7212));
- Security dealers or brokers;
- Investment companies and advisers;
- Venture capital fund advisers;
- Commodity Exchange Act registered entities;
- Insurance companies and state-licensed insurance providers;
- Tax-exempt organizations and certain entities providing financial assistance to such entities;
- Large operating companies (defined as an entity with 20 full-time U.S. employees (aggregation rules do not apply) with a U.S. physical office that filed a federal income tax return in the prior year with more than $5 million in U.S. gross receipts or sales (determined on a consolidated basis for taxpayers filing consolidated returns);
- SEC reporting issuers;
- Entities formed by and acting on behalf of a governmental entity;
- Banks, credit unions, depository institution holding companies, and money-transmitting businesses;
- Commodity Exchange Act registered entities;
- Public utilities; and
- Inactive entities, which are those entities:
  - In existence on or before January 1, 2020;
  - Not engaged in active business;
  - Not owned by a foreign person (directly, indirectly, wholly or partially);
  - That have not experienced any change in ownership in the last 12 months;
  - That have not sent or received any funds in an amount greater than $1,000 in the preceding 12-month period; and
  - That do not otherwise hold any kind of type of assets (domestically or abroad), including any ownership interest in any corporation, LLC, or similar entity.

  (Treas. Regs. §1010.380(c))

Beneficial owners

For purposes of these new reporting requirements, a reporting entity's beneficial owner(s) is any individual who, directly or indirectly, either:

- Exercises substantial control over the reporting company; or
- Owns or controls at least 25% of the reporting company's ownership interests. (Treas. Regs. §1010.380(d))

A beneficial owner does not include corporate or other entity owners.

> ***Comment***
>
> It's important to understand that beneficial ownership is much broader than the owners of record who may receive a K-1 from a passthrough entity or who may be listed on Form 1125-E, Compensation of Officers, or Schedule B-1, Information on Certain Shareholders, of an S corporation.

Substantial control

An individual has substantial control if the individual:

- Is a senior officer of the reporting company (president, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other office (regardless of official title) who performs a similar function);
- Has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body);
- Directs, determines, or has substantial influence over important matters affecting the reporting company, including but not limited to:
    - The nature, scope, and attributes of the company's business, including the sale, lease, mortgage or other transfer of any of the company's principal assets;
    - The reorganization, dissolution, or merger of the company;
    - Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the company's operating budget;
    - The selection or termination of the company's business lines or ventures, or geographical focus;
    - Senior officer compensation schemes and incentive programs;
    - The entry into, termination of, or the fulfillment of significant contracts;
    - Amendments to any of the company's governance documents (e.g., articles of incorporation or bylaws, significant policies or procedures; or
    - Has any other form of substantial control over the company.

  (Treas. Regs. §1010.380(d)(1))

An individual's substantial control can be exercised directly or indirectly. The regulations provide a much more expansive definition of control than is normally applied in the tax world. An individual may directly or indirectly exercise substantial control over a reporting company through a variety of means, including through:

- Board representation;
- Ownership or control of a majority of the voting power or rights of the reporting company;
- Rights associated with any financing arrangement or interest in a company;
- Control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company;
- Arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or
- Any other contract, arrangement, understanding, relationship, or otherwise.
  (Treas. Regs. §1010.380(d)(2))

Ownership interest

An individual may directly or indirectly own or control an ownership interest (as defined by Treas. Regs. §1010.380(d)(2)(i)) in a reporting company through a variety of means, including but not limited to:

- Joint ownership with one or more other persons of an undivided interest in such ownership interest;
- Through control of such ownership interest owned by another individual acting as a nominee, intermediary, custodian, or agent on behalf of such individual (e.g., parent/guardian of minor child or disabled person);
- With respect to a trust (or similar arrangement):
  - Acting as a trustee of a trust or other individual with the authority to dispose of trust assets;
  - Being a beneficiary of a trust, who is the sole permissible recipient of trust income and principal or who has the right to demand a distribution of or withdraw substantially of the trust assets; or
  - As a grantor or settlor of a trust, who can revoke the trust or withdraw the trust assets; or
- Through ownership or control of one more intermediary entities or ownership or control of the ownership interests of any such entities, that separately or collectively own or control ownership interest of the reporting company.
  (Treas. Regs. §1010.380(d)(3))

In determining whether an individual owns or controls 25% of the ownership interests of a reporting company, the ownership interests of the reporting company include all ownership interests of any class or type, and the percentage of such ownership interests that an individual owns or controls is determined by aggregating all of the individual's ownership interests in comparison to the undiluted ownership interests of the company. For entities such as partnerships and LLCs that issue capital or profits interests, the ownership interest is based on the individual's share of the entity's capital and profits interests. For entities that issue stock, the individual's share is based on the greater of the individual's percentage of the voting or value of ownership interests.

Exceptions

The following are not beneficial owners:

- A minor child (under state law) as long as the reporting entity provides the required information for the parent or legal guardian;
- An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual. **Note:** According to the preamble to the regulations, most tax professionals will likely fall into this exception;
- An employee of the reporting company, acting solely as an employee and not as a senior officer as long as their control or economic benefit from the entity derives solely from their employment status;
- An individual whose only interest in the company is a future interest through right of inheritance; and
- A creditor of a reporting company.
  (Treas. Regs. §1010.380(d)(4))

What must be reported?

In its initial report, the reporting company must provide the following information about itself:

- Its full legal name;
- Any of the company's trade or "doing business as" names;
- Its complete current address (if the company's principal place of business is outside the U.S., the street address of the primary location in the U.S. where the reporting company conducts business);
- The state, tribal, or foreign jurisdiction where the company was formed;
- For a foreign reporting company, the state or tribal jurisdiction where the company first registered; and
- The company's taxpayer identification number (TIN), including an EIN. If the foreign reporting company has not been issued a U.S. TIN, a TIN issued by the foreign jurisdiction and the name of the foreign jurisdiction.
(Treas. Regs. §1010.380(b))

The company must also report the following information for its beneficial owners and, for entities formed after 2023 only, for its company applicant as well:

- The individual's full legal name and date of birth;
- A complete current residential address (if the company applicant is a business, the business address of the company applicant can be provided);
- A unique identifying number and the issuing jurisdiction from one of the following nonexpired documents issued to the individual:
    - U.S. passport;
    - State, local, or government of Indian tribe identification card;
    - State driver's license; or
    - If the individual doesn't have any of the above, a foreign passport; and
- An image of one of the documents listed above.

FinCEN identifier (in lieu identifier)

In lieu of providing the information above in a report, a reporting company or beneficial owner can apply to FinCEN to obtain a unique FinCEN identifier. (Treas. Regs. §1010.380(b)(4)) The company/owner must supply the same information listed above, but on the beneficial ownership report that is actually filed, the FinCEN identifier would be supplied in lieu of the above-listed information. The CTA established this process as a way to protect the owner's and entity's privacy and to prevent this information from being easily accessed if the system is hacked.

If the individual's or company's information changes in any manner (see upcoming "Updated report" information), they must provide updates or corrections as noted below.

Due dates

Initial report

For entities in existence prior to January 1, 2024, the initial report must be filed by January 1, 2025. FinCEN will provide details about how the report should be filed. (Treas. Regs. §1010.380(a))

For domestic entities formed or foreign entities registered after 2023, the reporting company must file the initial report within 30 calendar days of the earlier of the date on which:

- It receives actual notice that its creation has become effective or that it is registered to do business; or
- The secretary of state (or similar office) provides public notice that the reporting company has been created or registered to do business.

Entities that no longer qualify for an exemption must file an initial report within 30 calendar days after the date that it no longer qualifies for the exemption.

Corrected report

A reporting company must file a corrected report if any report was inaccurate when filed and remains inaccurate. The company must file the report within 30 calendar days after the date on which the reporting company becomes aware or has reason to know of the inaccuracy. A penalty for failing to comply with the beneficial ownership reporting requirements will not be imposed if the corrected report is filed within 90 calendar days after the date the inaccurate report was filed. (Treas. Regs. §1010.380(a)(3))

Updated report

Reporting companies must file an updated report with FinCEN if there is any change to the information reported on the initial report concerning the reporting company or any of its beneficial owners. The report must be filed within 30 calendar days of when the change occurs.

For deceased beneficial owners, the 30-day period begins to run when the estate of the deceased is settled. The updated report must report any new beneficial owners, if applicable.

✐ Practice Pointer

This is going to be a big trap for reporting companies, which must rely on their owners to report to them whenever there is a change in their ownership interests, or if any of the previously reported beneficial owners sells their interest, changes jobs, moves, remarries, divorces, dies, etc.

For example, if a beneficial owner divorces, changes her name back to her maiden name, and moves, the reporting company will have to provide her "new" name, address, and a new passport or driver's license showing her new name and address. A change will also have to be reported when a minor child who is a beneficial owner reaches the age of majority or if an entity newly qualifies for an exemption and is no longer considered a "reporting company."

We've prepared a client letter that outlines the information clients should provide you. You may also want to consider adding questions to your annual organizer asking whether there were any changes that impacted the entity's beneficial owners.

 ©2022

SCHEDULES K-2/K-3

In mid-January 2022, the IRS revised its Forms 1065 and 1120-S instructions to state that even domestic partnerships and S corporations with no foreign activities or foreign partners may have to complete and file the new Schedules K-2 and K-3:

- Schedule K-2 (Form 1065), Partners' Distributive Share Items — International;
- Schedule K-3 (Form 1065), Partners' Share of Income, Deductions, Credits, etc. — International;
- Schedule K-2 (Form 1120-S), Shareholder's Pro Rata Share Items — International; and
- Schedule K-3 (Form 1120-S), Shareholder's Pro Rata Share of Income, Deductions, Credits, etc. — International.

Comment

The IRS provided some transitional relief for the 2021 tax year only with respect to the Schedule K-2/K-3 filing requirements.

The 2022 Schedule K-2/K-3 draft instructions provide a new domestic filing exception that will relieve many, if not most, small domestic partnerships from the Schedule K-2/K-3 filing requirements. The domestic filing exception is discussed on page 5-12.

Who must file?

Partnerships and S corporations must file Schedules K-2 and K-3 if they have any foreign activity, or if any of their partners or shareholders have foreign activity, unless the partnership meets the domestic filing exception, discussed on page 5-12. For example, if an S corporation shareholder will be claiming a Foreign Tax Credit by filing Form 1116 on their personal income tax return, then the S corporation must generally file Schedules K-2 and K-3.

Checklist of Who Must File Schedules K-2 and K-3	
Partnerships and S corporations must file Schedules K-2 and K-3 if they have any foreign partners/shareholders or other foreign activity, including but not limited to …	
☐	Holding assets located in a foreign jurisdiction
☐	Employing remote employees who reside in a foreign country
☐	Investing in foreign businesses either directly or indirectly by investing in a U.S. partnership/corporation that has foreign investments
☐	Investing in any mutual funds that have international investments
☐	Contracting for any research activities outside the U.S.
☐	Partnerships/S corporations with any direct or indirect partners/shareholders that have any direct foreign investments or invest in any mutual fund with any international investments (unless the partners/shareholders are all individuals and they all qualify and elect out of filing Form 1116, discussed below)
☐	Partnerships that have any partners/spouses who are nonresident aliens

New domestic filing exception to Schedules K-2/K-3 for 2022

The updated draft Schedule K-2/K-3 instructions for the 2022 taxable year provide a new domestic filing exception for partnerships and S corporations. The exception states that partnerships and S corporations are not required to complete Schedules K-2 and K-3 if:

- The partnership/S corporation has no or limited foreign activity;
- All partners/shareholders are U.S. citizens or resident aliens;
- The partnership/S corporation sends specific notification to the partners by January 15; and
- No partners/shareholders specifically request Schedule K-3 from the entity by February 15.

U.S. citizens or resident aliens

The draft Schedule K-2/K-3 instructions for S corporations do not specify that shareholders must be U.S. citizens or resident aliens. However, under IRC §1361(b)(1)(B), only individuals who are U.S. citizens or residents, and certain trusts and tax-exempt organizations, are eligible S corporation shareholders. Because of this, the Schedule K-2/K-3 instructions did not need to specifically state this requirement in order to bring the partnership and S corporation domestic filing exceptions into parity with one another.

Domestic partnerships and S corporations

Domestic partnerships and S corporations are those that are created or organized in the United States or under the law of the United States or any state. (IRC §7701(a)(4))

No or limited foreign activity

No foreign activity means that the partnership or S corporation does not have any of the following:

- Foreign income taxes paid or accrued (as defined in IRC §901 and its regulations);
- Foreign-source income or loss (as determined in IRC §§861 through 865, and IRC §904(h), and their regulations);
- Ownership interest in a foreign partnership (as defined in IRC §7701(a)(2) and (5))
- Ownership interest in a foreign corporation (as defined in IRC §7701(a)(3) and (5)); or
- Ownership interest in a foreign entity that is treated as a disregarded entity (as defined in Treas. Regs. §301.7701-3).

If the partnership or S corporation has foreign activity, then the entity still meets the exception for filing Schedules K-2 and K-3 if the foreign activity is limited to:

- Passive category foreign income (determined without regard to the high-taxed income exception under IRC §904(d)(2)(B)(iii));
- Upon which not more than $300 of foreign income taxes allowable as a credit under IRC §901 are treated as paid or accrued by the partnership; and
- Such income and taxes are shown on a payee statement (as defined in IRC §6724(d)(2)) that is furnished or treated as furnished to the partnership or S corporation (such as a Form 1099-DIV).

 ©2022

All partners are U.S. citizens or resident aliens

In order to meet the exception for filing Schedules K-2 and K-3, during the tax year, all the direct partners in the domestic partnership must be:

- Individuals who are U.S. citizens;
- Individuals who are resident aliens (as defined in IRC §7701(b)(1)(A) and its regulations);
- Domestic decedents' estates (that is, decedents' estates that are not foreign estates as defined in IRC §7701(a)(31)(A)) with solely U.S. citizen and/or resident alien individual beneficiaries;
- Domestic grantor trusts (that is, trusts described under IRC §§671 through 678) that are not foreign trusts as defined in IRC §7701(a)(31)(B)) and that have solely U.S. citizen and/or resident alien individual grantors and solely U.S. citizen and/or resident alien individual beneficiaries;
- Domestic nongrantor trusts (that is, trusts subject to tax under IRC §641 that are not foreign trusts as defined in IRC §7701(a)(31)(B)) with solely U.S. citizen and/or resident alien individual beneficiaries;
- S corporations with a sole shareholder; or
- Single-member LLCs, where the LLC's sole member is one of the persons listed here as an eligible partner.

✐ Practice Pointer

Partnerships are only required to look to their direct partners to determine if they meet the domestic filing exception. Direct partners are those that actually receive a K-1 from the partnership.

The list of eligible partners does not include any entities other than domestic trusts and estates, S corporations with a sole shareholder, and single-member LLCs where the sole member is otherwise an eligible partner. As such, if a partnership has even one direct partner that is another partnership, corporation, or non-SMLLC, then the partnership cannot meet the domestic filing exception for Schedules K-2 and K-3.

Only individuals who are U.S. citizens or residents, and certain trusts and tax-exempt organizations, are eligible S corporation shareholders. Because of this, the draft Schedule K-2/K-3 instructions do specifically contain language stating that S corporation shareholders must be U.S. citizens or resident aliens.

Partner/shareholder notification

Partners/shareholders must be notified that they will not receive Schedule K-3 from the partnership/S corporation unless the partners/shareholders request the schedule.

The notification must be furnished no later than the date the entity provides Schedules K-1 to its partners/shareholders. The notice can be provided as an attachment to the K-1.

Sample partner/shareholder notification

We have prepared the following sample notification for your use. It is also available at:

Website
www.caltax.com/cl-k2k3notification

Dear Partner/Shareholder,

Pursuant to IRS requirements, [name of partnership/S corporation] has opted to not file Schedules K-2 and K-3 with its income tax returns because it meets an exception to filing these schedules. Schedules K-2 and K-3 are lengthy foreign information reporting forms that can significantly increase [the partnership's/S corporation's] income tax preparation costs and could delay delivery of your Schedule K-1. If prepared, Schedules K-2 and K-3 would be filed with the IRS by [the partnership/S corporation], and Schedule K-3 would be provided to you to assist you in filing your Form 1040.

[The partnership/S corporation] can only meet a Schedule K-2/K-3 filing exception if it has no, or limited, foreign activity. As such, because a filing exception is met, we do not believe that filing these schedules will have a material impact on the income tax returns of [the partners/shareholders].

However, [the partnership/S corporation] is required to provide Schedule K-3 to any partner who requests it. Because we do not believe that preparation of Schedule K-3 will have a material impact on your personal income tax filings, at [name of partnership/S corporation]'s discretion, we may pass along the additional cost of preparing Schedule K-3 to any [partner/shareholder] who requests that it be prepared.

Sincerely,

[Managing partner/S corporation officer]

Partner/shareholder request for Schedule K-3

If any partner/shareholder requests Schedule K-3 from the entity by the date that is one month before the partnership/S corporation files its income tax return, then the entity is required to file Schedules K-2 and K-3 with the IRS and furnish Schedules K-3 to all partners/shareholders.

If any partner/shareholder requests Schedule K-3 after the date that is one month before the entity files its income tax return, then the partnership/S corporation must prepare Schedule K-3 only for the requesting partner.

Form 1116 exemption exception

In addition to the domestic filing exception, domestic partnerships and S corporations are not required to complete Schedules K-2 and K-3 if all partners/shareholders are eligible for the Form 1116, Foreign Tax Credit, filing exemption, discussed immediately below, and if the entity receives notification of the partners'/shareholders' eligibility for such exemption by the date that is one month before the entity's filing deadline (not including extensions) (February 15, 2023, for calendar-year partnerships and S corporations).

If the entity receives notification from only some of the partners/shareholders that they are eligible for the Form 1116 exemption, then the entity need not complete Schedules K-3 for those exempt partners/shareholders but must complete the Schedules K-2 and K-3 with respect to the other partners/shareholders to the extent that the entity does not qualify for the domestic filing exception.

 ©2022

Form 1116 filing exemption

Not all partners and shareholders who might be eligible for the Foreign Tax Credit will actually file Form 1116. Individuals who have less than $300 ($600 MFJ) in creditable foreign taxes paid on qualified passive income may elect to claim the credit without filing Form 1116. The election out of filing Form 1116 is only available to individual taxpayers.

The individual can only make the election if they receive the information regarding the foreign taxes on a payee statement (e.g., Form 1099-DIV). Taxpayers who make the election cannot claim any credit carryovers.

Why the new schedules?

The K-2 and K-3 schedules were designed to ensure that required information is being reported consistently to make tracking foreign tax attributes easier for entity owners, and more importantly, the IRS. Requiring entities to report items in a standardized format will allow the IRS to automate their review of these returns rather than having to review each of these returns manually.

The main motivator for requiring most domestic entities to file these forms is to assist their direct or indirect (for multitier entities) partners or shareholders who complete the Form 1116, Foreign Tax Credit. To accurately complete Form 1116, taxpayers need information from all entities in which they have an ownership interest, even if the entity has no foreign activities.

In order to accurately report a taxpayer's Foreign Tax Credit, Form 1116 requires, among other items:

- Gross income from foreign sources;
- Gross income from all sources;
- The partner/shareholder's share of the entity's assets; and
- A breakdown of the foreign-source income by country and specific category:
  - IRC §951A category income;
  - Foreign branch category income;
  - Passive category income;
  - General category income;
  - IRC §901(j) category income;
  - Certain income resourced by treaty; and
  - Lump-sum distributions.

Completing the K-2 and K-3

Examples

The first example illustrates a simple scenario of a partnership with no foreign-source income, no assets generating foreign-source income, and no foreign taxes paid or accrued.

Example of completing Schedules K-2 and K-3 for domestic LLC with no foreign activities

ABC, LLC is taxed as a partnership and owns a single rental property (an apartment building) inside the United States. All partners are U.S. citizens and residents. In 2022, the LLC has the following income and expenses reported on its Form 1065:

Form 8825	
Gross rents	$5,000,000
Rental operating expenses (not including interest)	(2,950,000)
Interest expense from rental activity	(200,000)
Depreciation expense	(175,000)
Schedule K	
Interest income on U.S. bank account	1,800
Charitable contributions	(2,300)
Net income[1]	$1,674,500

[1] Reported on Form 1065, page 1, line 1 of Analysis of Net Income (loss)

Additionally, the LLC's balance sheet (Form 1065, Schedule L) is as follows:

	Beginning of tax year		**End of tax year**	
	(a)	**(b)**	**(c)**	**(d)**
Cash		$420,000		$390,000
Other current assets		$52,000		$48,000
Buildings, dep. assets	$6,825,000		$6,825,000	
Less: accumulated dep.	$2,100,000	$4,725,000	$2,275,000	$4,550,000
Land		$3,000,000		$3,000,000
Total assets		$8,197,000		$7,988,000
Loans payable		$5,525,000		$5,260,000
Partner capital accounts		$2,672,000		$2,728,000
Total liabilities, capital		$8,197,000		$7,988,000

The completed Schedule K-2 for ABC, LLC and Schedule K-3 for Joe Jones, a 33.33% member of ABC, LLC are available at:

Website
www.caltax.com/files/2022/examplek2k3.pdf

Despite the new domestic filing exception for filing Schedules K-2 and K-3 starting with the 2022 taxable year, the ABC, LLC still must file the schedules if any partner requests that they be filed or they fail to meet all of the domestic filing exception requirements.

The next example illustrates how the information provided on the K-3 to a partner will impact their computation of the Foreign Tax Credit on Form 1116. For purposes of computing the Foreign Tax Credit, a partner/shareholder may need to know the total U.S. foreign-source income as well as the partner's distributive share of the average of the beginning-of-year and end-of-year inside basis in the partnership's assets. (Treas. Regs. §1.861-9(g)(2)(i)(A)) These are the asset values reported on Schedules K-2/K-3, Part III.

 ©2022

The partner will use their distributive share of the partnership's average inside basis in its assets to compute their interest expense, which will be used to reduce their foreign-source taxable income for purposes of computing the Foreign Tax Credit.

Example of domestic passthrough K-2/K-3 requirement

Dawn and Jo are both U.S. citizens and are 50/50 partners in the D-J Partnership. In 2022, D-J had no foreign-source income, had no foreign partners, did not own any assets that generated foreign-source income, and did not pay or accrue any foreign taxes.

In 2022, Dawn paid $2,500 of foreign income taxes on $12,000 of passive category income, which was reported to Dawn on a qualified payee statement (Form 1099-DIV). Dawn does not pay or accrue any other foreign taxes and has no other foreign-source income.

Dawn must complete Form 1116 to claim a Foreign Tax Credit because she does not qualify for the exception to filing the form.

Dawn's distributive share of the average of the beginning-of-year and end-of-year inside basis of D-J's assets is $100,000, and Dawn's share of those assets is $50,000. Not including Dawn's distributive share of D-J's assets, the basis of Dawn's other business assets is $45,000 ($10,000 of which generates foreign-source income and $35,000 of which generates U.S.-source income.)

Dawn has interest expense of $7,000, and D-J does not have any interest expense.

Dawn has passive category foreign-source taxable income before interest expense of $12,000, and her effective U.S. tax rate is 22%. Dawn's interest expense must be apportioned between U.S.-source and foreign-source income ratably based on the average asset basis of her U.S.-source and foreign-source assets.

The following calculations, which mimic the calculation from Form 1116, compare the calculation of Dawn's Foreign Tax Credit with and without taking into account her distributive share of D-J's assets.

Example of domestic passthrough K-2/K-3 requirement (continued)

	Without D-J's assets	With D-J's assets
Interest expense	$ 7,000	$ 7,000
Assets generating foreign-source income	× 10,000	× 10,000
Average asset basis	÷ 45,000[1]	÷ 95,000[2]
Interest expense that reduces foreign-source gross income	$ 1,556	$ 736

[1] Outside D-J only
[2] Inside and outside D-J

Therefore, Dawn's foreign-source taxable income is:

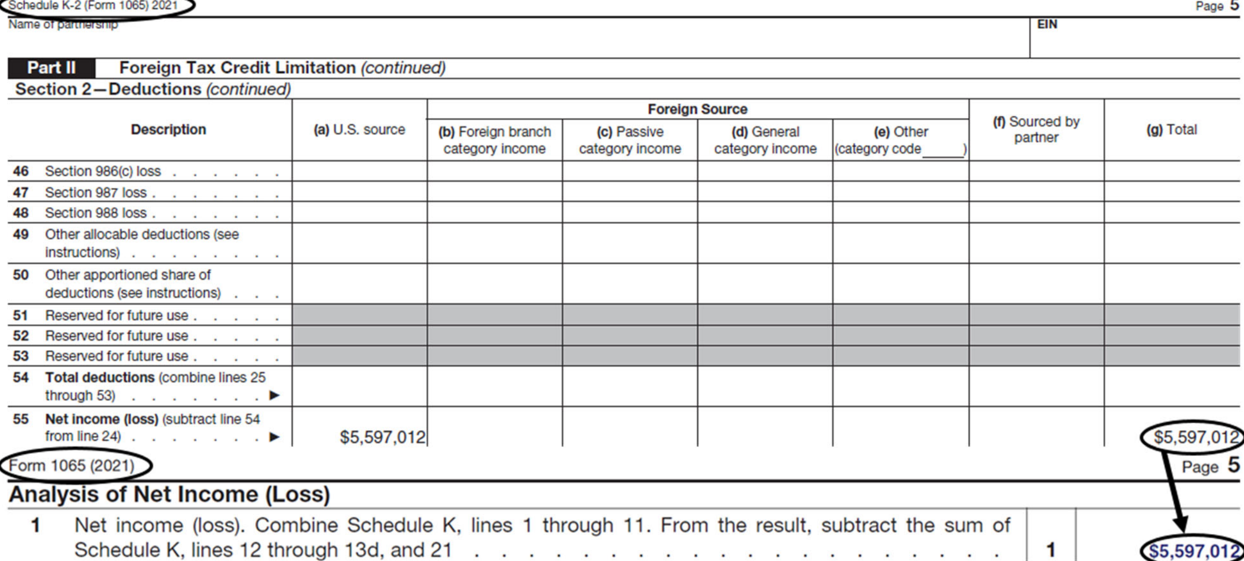
	Without D-J's assets	With D-J's assets
Foreign-source taxable income before interest expense	$12,000	$12,000
Interest expense that reduces foreign-source gross income[1]	- 1,556	- 736
Foreign-source taxable income	$10,444	$11,264
Effective U.S. tax rate	× 22%	× 22%
Allowable Foreign Tax Credit	$ 2,298	$ 2,478
Additional Foreign Tax Credit allowed[2]	$180	

[1] Calculated in previous step
[2] Utilizing D-J's asset information reported on Schedule K-3 if Dawn uses all of her assets computing the credit

The importance of line 55

Schedule K-2, Part II, line 55 is a key "check" figure when preparing Schedule K-2; it must match:

- Form 1065, Schedule K, Analysis of Net Income (Loss), Line 1; or
- Form 1120-S, Schedule K, Line 18, Income (Loss) Reconciliation.



Schedule K-2 (Form 1065) 2021 Page 5

Name of partnership EIN

Part II Foreign Tax Credit Limitation *(continued)*

Section 2—Deductions *(continued)*

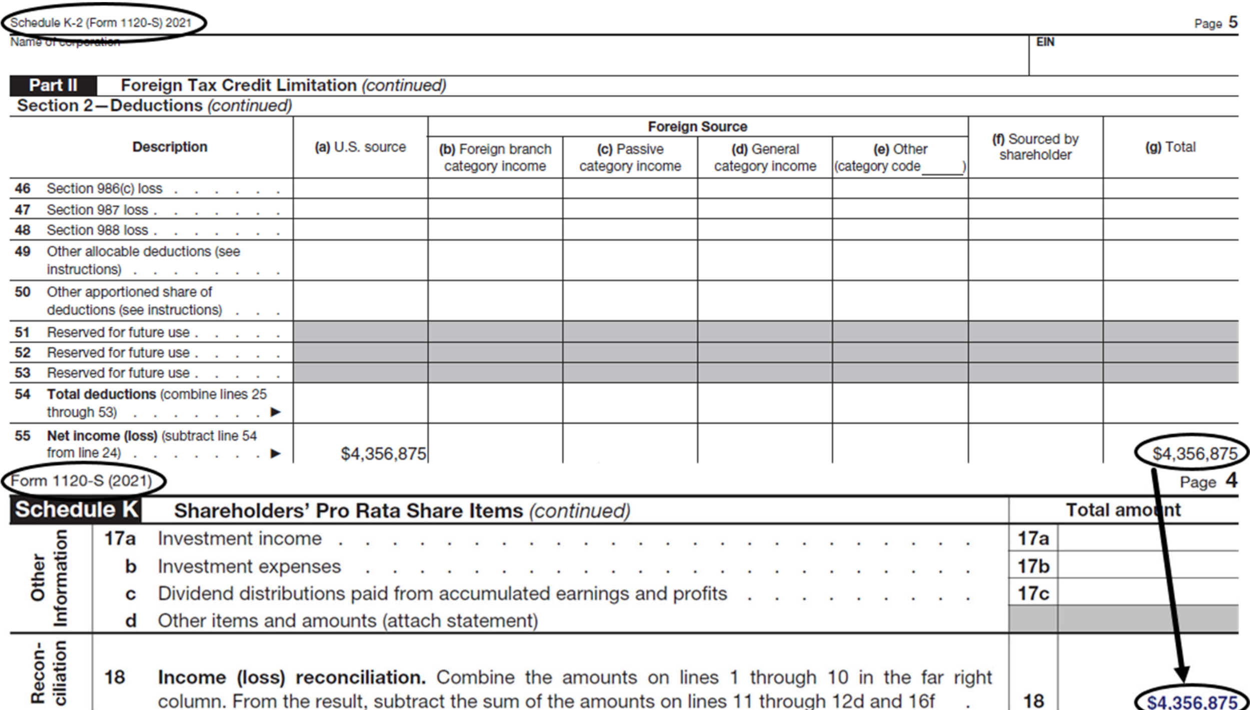
Description	(a) U.S. source	Foreign Source: (b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ____)	(f) Sourced by partner	(g) Total
46 Section 986(c) loss							
47 Section 987 loss							
48 Section 988 loss							
49 Other allocable deductions (see instructions)							
50 Other apportioned share of deductions (see instructions)							
51 Reserved for future use							
52 Reserved for future use							
53 Reserved for future use							
54 **Total deductions** (combine lines 25 through 53) ▶							
55 **Net income (loss)** (subtract line 54 from line 24) ▶	$5,597,012						$5,597,012

Form 1065 (2021) Page 5

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 21	1	$5,597,012

©2022



Schedule K-2 (Form 1120-S) 2021 Page 5

Name of corporation | EIN

Part II Foreign Tax Credit Limitation *(continued)*

Section 2—Deductions *(continued)*

	Description	(a) U.S. source	Foreign Source (b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ____)	(f) Sourced by shareholder	(g) Total
46	Section 986(c) loss							
47	Section 987 loss							
48	Section 988 loss							
49	Other allocable deductions (see instructions)							
50	Other apportioned share of deductions (see instructions)							
51	Reserved for future use							
52	Reserved for future use							
53	Reserved for future use							
54	**Total deductions** (combine lines 25 through 53) ▶							
55	**Net income (loss)** (subtract line 54 from line 24) ▶	$4,356,875						$4,356,875

Form 1120-S (2021) Page 4

Schedule K		Shareholders' Pro Rata Share Items *(continued)*		Total amount
Other Information	17a	Investment income	17a	
	b	Investment expenses	17b	
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (attach statement)		
Reconciliation	18	**Income (loss) reconciliation.** Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 16f	18	$4,356,875

Reporting interest expense on Schedules K-2 and K-3

Partnerships and S corporations report interest expense on Schedule K-2, Part II, lines 39 through 43.

39	Interest expense specifically allocable under Regulations section 1.861-10(e)
40	Other interest expense specifically allocable under Regulations section 1.861-10T
41	Other interest expense—business
42	Other interest expense—investment
43	Other interest expense—passive activity

Line 39 – Interest expense specifically allocable under Treas. Regs. §1.861-10(e): This is certain related group indebtedness described as excess borrowing by a United States affiliated group from unrelated parties.

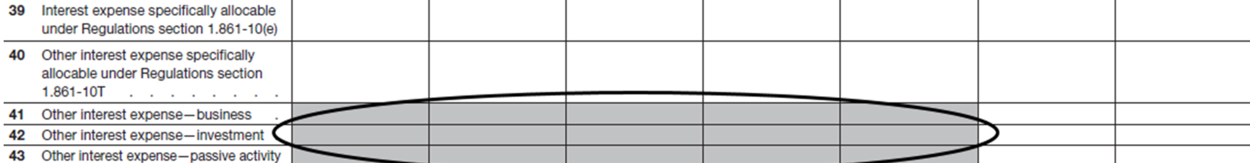
Line 40 – Interest expense specifically allocable under Treas. Regs. § 1.861-10T: This is generally "qualified nonrecourse debt"; for example, mortgage debt on real property (and secured by the property).

Line 41 – Other interest expense–business: This is general business interest expense that is neither investment interest nor related to a passive activity; for example, interest paid on business credit cards or a bank line of credit for an operating business. If a partnership's only partners are corporations, then don't use lines 42 or 43 (just use lines 39, 40, and 41). (IRS Partnership Instructions for Schedules K-2 and K-3)

Line 42 – Other interest expense–investment: This is investment interest expense. For example, if a partnership receives a margin loan to purchase investments, the interest on the loan is reported on line 42.

Line 43 – Other interest expense–passive activity: This is interest expense incurred to fund passive activities, such as rental activities. However, this wouldn't include interest on qualified nonrecourse debt, which is reported on line 40.

Lines 41-43 – the gray lines: Business, investment, and passive activity interest reported on lines 41-43 should not be directly allocated to income from a specific property, so columns (a) through (e) are not required. This is why those lines are grayed-out on Schedule K-2.



Line	Description							
39	Interest expense specifically allocable under Regulations section 1.861-10(e)							
40	Other interest expense specifically allocable under Regulations section 1.861-10T							
41	Other interest expense—business .							
42	Other interest expense—investment							
43	Other interest expense—passive activity							

Moving interest expense from Schedule K-3 to Form 1116

Interest expense reported on Schedule K-3, lines 39 through 43 will flow to Form 1116, Part I, line 4b with two exceptions:

- Interest allocable to U.S.-source income; and
- Where foreign-source income is less than $5,000.

Interest not reported on Form 1116, line 4b: Interest reported on Schedule K-3 that is U.S.-source interest doesn't flow to Form 1116, line 4b because Part I of Form 1116 is only used to report foreign-source income and expenses. U.S.-source income and deductions don't appear on Form 1116 at all.

If a taxpayer's total foreign-source income is less than $5,000, then all interest expense can be allocated to U.S.-source income at the taxpayer's choosing and therefore doesn't flow to line 4b (because once again, it's not treated as foreign-source income and therefore doesn't belong anywhere on Form 1116). (IRS Instructions to Form 1116)

Digging deeper into interest that must be reported on Form 1116, line 4b: Generally, each type of interest expense reported on Schedule K-3 must be apportioned by the partner or S corporation shareholder separately and reported on Form 1116, line 4b using an "asset method."

As an exception to using an asset method, taxpayers may (at the taxpayer's option) allocate interest reported on Schedule K-3 based solely on their share of foreign- and U.S.-source income if the partner or S corporation shareholder:

- Owns less than 10% of the business that issued the Schedule K-3; and
- Does not actively participate in management of the partnership or S corporation. (Treas. Regs. §1.904-4(n); IRS Instructions to Form 1116)

Example of asset method

Joe has investment interest expense of $2,000 reported on Schedule K-3. His share of partnership assets (Schedule K-3, Part III, Section 2) is $100,000:

- $40,000 of which generates U.S.-source income; and
- $60,000 of which generates foreign-source income.

Joe must apportion his investment interest expense as follows:

	U.S.-source	**Foreign-source**
Asset allocation	$ 40,000	$ 60,000
Total assets	÷ 100,000	÷ 100,000
Interest expense	× 2,000	× 2,000
Interest allocation	$ 800	$ 1,200

Joe will enter $1,200 of foreign-source interest expense on Form 1116, Part I, line 4b. His $800 of U.S.-source interest expense is not entered on Form 1116 at all.

Penalties

Failure to timely comply with these new requirements may subject the partnership or S corporation to severe penalties. The primary penalties include:

- Failure to file or show information on a partnership or S corporation return — in an amount equal to $195 per month per partner or shareholder for up to 12 months; and
- Failure to file correct information returns — penalties of up to $280 per return up to $3,426,000.
  (IRC §§6698, 6699, 6721, 6722)

PRACTITIONER ISSUES

E-SIGNATURES EXTENDED THROUGH OCTOBER 31, 2023

The IRS has extended its deadline for when it will accept a digital signature on certain forms that previously had required a handwritten signature, but tax professionals had expressed concern over obtaining handwritten signatures in the midst of the COVID-19 pandemic. The e-signature availability has been extended through October 31, 2023.

Comment

None of the common forms such as 1040, 1065, 1120 series forms may be paper-filed without original signatures. E-file authorizations for these forms can be signed digitally, but only through the use of knowledge-based authentication. (www.irs.gov/e-file-providers/frequently-asked-questions-for-irs-efile-signature-authorization)

Available forms

The full list of forms available for e-signature is available at:

Website
www.irs.gov/pub/foia/ig/spder/nhq-01-1121-0004.pdf
www.irs.gov/pub/foia/ig/spder/nhq-10-1121-0005.pdf

Types of e-signatures allowed

The acceptable forms of e-signature are:

- Typed names on a signature block;
- Scanned or digital images of handwritten signatures;
- Handwritten signatures on a signature pad; and
- Signatures created by third-party software.

ENTITY CHANGES REQUIRING NEW EIN

Generally, a business needs a new Employer Identification Number (EIN) when the ownership or structure has changed. In contrast, changing the name or location of the business does not require a new EIN. However, there are many other scenarios specific to each entity type that may or may not require a new EIN. (www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein)

 ©2022

Entity Changes Requiring New EIN		
Entity type	**New EIN required when …**	**New EIN *not* required when …**
Sole proprietor	• Sole proprietor is subject to a bankruptcy proceeding • Sole proprietor incorporates • Sole proprietor takes in partners and operates as a partnership • Taxpayer purchases another person's sole proprietorship business and runs it as their own	• Sole proprietor changes the name of the business • Sole proprietor changes the business location and/or adds other locations • Sole proprietor operates multiple businesses (other than opening different locations of the same business)
Corporation	• The corporation receives a new charter from the Secretary of State • The corporation is a subsidiary of a corporation, using the parent corporation's EIN, or the corporation becomes a subsidiary of a corporation • The corporation changes to a partnership or a sole proprietorship • A new corporation is created after a statutory merger	• The corporation is a division of a corporation • The surviving corporation uses the existing EIN after a corporate merger • The corporation declares bankruptcy • The corporate name or location changes • The corporation chooses to be taxed as an S corporation • Reorganization of a corporation changes only the identity or place of business • Conversion occurs at the state level with the business structure remaining unchanged
		(continued)

Entity Changes Requiring New EIN (continued)		
Entity type	**New EIN required when …**	**New EIN not required when …**
Partnerships	• The partnership incorporates • The partnership is taken over by one of the partners and is operated as a sole proprietorship • An old partnership is ended and a new one begins	• The partnership declares bankruptcy • The partnership name changes • The location of the partnership changes or other locations are added • A new partnership is formed as a result of the termination of a partnership under IRC §708(b)(1)(B) • 50% or more of the ownership of the partnership (measured by interests in capital and profits) changes hands within a 12-month period (terminated partnerships under Treas. Regs. §301.6109-1)
LLCs	• A new LLC with more than one owner (multimember LLC) is formed under state law	• The LLC reports income tax as a branch or division of a corporation or other entity, and the LLC has no employees or excise tax liability • An existing partnership converts to an LLC classified as a partnership • The LLC name or location changes • An LLC that already has an EIN chooses to be taxed as a corporation or as an S corporation • A new LLC with one owner (SMLLC) is formed under state law, does not choose to be taxed as a corporation or S corporation, and has no employees or excise tax liability. **Note:** The LLC may request an EIN for banking or state tax purposes, but an EIN is not required for federal tax purposes
		(continued)

Entity Changes Requiring New EIN (continued)		
Entity type	**New EIN required when …**	**New EIN not required when …**
Single member LLCs	• A new LLC with one owner (SMLLC) is formed under state law, and has an excise tax or employment tax filing requirement • A SMLLC adds a member and becomes an entity taxed as either a partnership or corporation • A partnership loses a partner and becomes a SMLLC	N/A
Estates	• A trust is created with funds from the estate (not simply a continuation of the estate) • The estate operates a business after the owner's death	• The administrator, personal representative, or executor changes his/her name or address
Trusts	• One grantor establishes multiple trusts that require EINs, each trust must have its own EIN • A trust changes to an estate • A living or *inter vivos* trust changes to a testamentary trust • A living trust terminates by distributing its property to a residual trust	• The trustee changes • The grantor or beneficiary changes his/her name or address

The IRS has a webpage dedicated to answering whether a taxpayer needs a new EIN, which we have summarized in the chart above. The IRS webpage can be found at:

Website
www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein

E-FILE REJECTS DUE TO NAME CONTROL MATCHING

Name control matching is an e-file process that verifies the EIN and name control of the filer against the IRS's National Account Profile database.

Most tax professionals have experienced the e-file reject that reads, "This reject is common the first time a filing and/or extension is electronically filed for a corporate or S corporate entity."

Comment

Many tax professionals received e-filing rejects during the 2022 filing season for name control issues. Apparently, the IRS previously had the name control requirement turned off in their e-file system and then switched it back on. This resulted in e-file rejects for clients who didn't have problems e-filing their returns in years past.

Generally, but not always, the name control is the first four letters of the taxpayer's last name (in the case of individual taxpayers) and the first four letters of a business. To know which four letters to use, the tax professional needs to know whether the EIN was applied for on paper or on the IRS website. If the EIN was applied for online, use the first four letters; if applied for on paper, use the last four (this applies to trust returns):

- Internet application EINs will start with: 20, 26, 27, 45, 46, 47, 81, 82, 83, 84, 85, 86, 87, or 88; or
- If the EIN starts with any other number, it was paper-filed.

For issues with name control matching, call the IRS specialty help desk at:

☎ **Telephone**
(800) 829-4933

For more information on name controls, see IRS Publication 4163, Modernized e-File Information for Authorized IRS e-File Providers for Business Returns — Tax Returns Processed in Year 2022.

Name control for 1040s

The individual name controls for all of the following must equal the first four significant characters of the primary taxpayer's last name:

- The primary taxpayer and spouse in the Form 1040 return header;
- Form 1040 dependent and spouse exemption;
- Schedule EIC Qualifying Child;
- Form 2441 Qualifying Person; and
- All Form 8863, Education Credits, students.
  (IRS Publication 4164, Modernized e-File (MeF) Guide for Software Developers and Transmitters Processing Year 2022)

The IRS has established the following special name control rules:

- The name control consists of no more than four alpha and/or numeric characters;
- The hyphen or a blank space are the only special characters allowed in the name control. These characters cannot be in the first position of the name control;
- If an individual has a hyphenated last name, the name control is the first four characters from the first of the two last names; and
- For joint returns, regardless of whether the payees use the same or different last names, the name control is the first four characters of the primary taxpayer's last name.

The IRS has provided the following name control examples in Table 13-5 of Publication 4164.

Name Control Examples		
Individual name	**Name control**	**General rule**
John Brown	BROW	a. The name control generally consists of the first four characters of the individual's last name.
Mary Smith & John Jones	SMIT	
Ralph Teak	TEAK	
Dorothy Willow	WILL	
Joe McCedar	MCCE	
Joe McCarty	MCCA	
Torn MacDouglas	MACD	
Joseph MacTitus	MACT	
John Hardy, Minor	HARD	
April May Jordan	JORD	
John Lea-Smith	LEA-	b. The hyphen (-) is the only special character allowed in the PersonNameControlType. **Note:** When a taxpayer's last name contains an apostrophe ('), ignore/disregard the apostrophe when establishing the name control.
Thomas A. El-Oak	EL-O	
Rana Al-Smadi	AL-S	
John O'Neil	ONEI	
Ann O'Spruce	OSPR	
Mark D'Magnolia	DMAG	c. The name control may be less than four characters (if applicable). **Note:** The first character must be an alpha character. Blanks are not needed as a filler.
John O'Willow	OWIL	
Danette B	B	
James P. Ai	AI	
John A. Fir	FIR	
John Ao, Sr.	AO	
John En, Sr.	EN	
Daniel P. Di Almond	DIAL	d. Taxpayer names such as "Van," "Von," "Vander," Al," El," Abu" and Di" are considered part of the individual name control. **Note:** See Table 13-7 (in Publication 4164) "Asian Pacific" for exceptions to this rule related to names of Asian Pacific origin.
Mary J. Van Elm	VANE	
Susan L. Von Birch	VONB	
Aya Abu Sham	ABUS	
Donald Vander Oak	VAND	
Otto Von Hickory	VONH	
Nabil Al Feyez	ALFE	
Amr El Bayoumi	ELBA	

(continued)

Name Control Examples (continued)		
Individual name	**Name control**	**General rule**
Janet C. Redbud Laurel	LAUR	e. When two last names are shown for an individual, derive the name control from the second last name of the individual. **Note:** See exceptions to this rule for Hispanic names (Table 13-6) Asian-Pacific names (Table 13-7), Native American names (Table 13-8) and Islamic and Arab Names (separate table not provided). (Tables are in Publication 4164.)
Dee (Plum) Birch	BIRC	
Mary Johnson Garcia	GARC	
Joan Hickory-Hawthorn	HICK	f. When two last names are connected by a hyphen, derive the name control from the first last name.
Dale Redwood-Cesar	REDW	
John Lea-Wren	LEA-	
Dell Ash & Linda Birch	ASH	g. On a joint return, whether the taxpayers use the same or different last names, derive the name control from the primary taxpayer's last name.
Trey & Joan Eucalyptus	EUCA	
Linda Birch & Dell Ash	BIRC	
Mary Smith & Mike Best	SMIT	

The full IRS Publication 4164 can be found at the following website. The name control charts for the various types of taxpayers can be found in the exhibits at Section 13 of Publication 4164:

Website
www.irs.gov/pub/irs-pdf/p4164.pdf

IRS AUDITS

National Research Program audits

The IRS National Research Program (NRP) conducts a variety of studies (e.g., audits of a random sample of tax returns) to gather data on voluntary compliance. According to the IRS, these NRP audits provide the reliable compliance estimates they need to determine which key areas of noncompliance to address to maximize their limited resources. (I.R.M. 4.22.6.1.1)

New examinations under the IRS's National Research Program are initiated using Letter 6316, NRP Field Exam Correspondence Contact. The types of returns applicable to these cases include:

- Form 1040, Individual Income Tax;
- Form 1120S, Sub-Chapter S Tax;
- Form 1120, Corporate Income Tax;
- Form 941, Employment Tax; and
- Form 720, Fuel Excise Tax.
  (I.R.M. 4.22.3.1)

 ©2022

Not a regular audit

The IRS explains these audits to taxpayers as being part of the process that helps them fairly administer the tax system. However, unlike a regular audit which stems from a particular issue that flagged the return, the random NRP audits are much more involved because they examine the entire return, line-by-line, including items that match information provided by third parties (such as W-2s and 1099s, among others). This means taxpayers must provide substantiation for every single item reported on the return.

Some of the items examined that the IRS specifically provides guidelines for in the Internal Revenue Manual include:

- The Earned Income Credit;
- Schedules B, C, D, E, and F income and losses;
- Tip income;
- Head of household status;
- Net operating loss deductions;
- The Foreign Tax Credit;
- Schedule A deductions;
- Employee business expenses; and
- "Large, unusual, or questionable" items, based on comparative size of the item, the absolute size of the item, inherent character of the item, evidence of intent to mislead, beneficial effect of manner in which the item was reported, relationship to other items, possible whipsaw effect on other taxpayers, automatic adjustments, and missing items. (I.R.M. 4.10.2.3.1) (I.R.M. 4.22.3.3.4)

If an NRP audit results in tax owed, the taxpayer can request the regular collection alternatives such as an installment agreement or offer in compromise.

Because an NRP audit, like a regular audit, can result in tax owed plus interest and penalties, it is important to respond to Letter 6316 in a timely fashion and prepare for the audit process.

Reasonable compensation audits

The IRS has also increased its reasonable compensation audits of corporations. The issue, as the IRS sees it, is more prevalent with S corporations. A Taxpayer Inspector General for Tax Administration (TIGTA) report from August 11, 2021, analyzed all S corporation returns received for the taxable years 2016 through 2018 and identified 266,095 returns with profits greater than $100,000, a single shareholder, and no officer compensation claimed that were not selected for a field examination. (www.treasury.gov/tigta/auditreports/2021reports/202130042fr.pdf)

The TIGTA report concluded that on those 266,095 returns, the single-shareholder owners had profits of $108 billion and took $69 billion in the form a distribution, without reporting they received officer's compensation for which they would have to pay Social Security and Medicare tax. As a result, an estimated $3.3 billion of FICA went uncollected.

The definition of an employee for FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act) and federal income tax withholding under the Internal Revenue Code include corporate officers. (IRC §162(a)(1); Treas. Regs. §1.162-7) When corporate officers perform a service for the corporation and receive or are entitled to payments, those payments are considered wages.

The fact that an officer is also a shareholder does not change this requirement. Such payments to the corporate officer are treated as wages. Courts have consistently held S corporation

officers/shareholders who provide more than minor services to their corporation and receive, or are entitled to receive, compensation are subject to federal employment taxes.

If an officer does not perform any services or only performs minor services and is not entitled to compensation, the officer would not be considered an employee.

What is reasonable compensation?

The Internal Revenue Code allows a business deduction for a "reasonable allowance for salaries or other compensation for personal services actually rendered." (IRC §162(a)(1)) The IRS and taxpayers have fought in the court system for decades over the definition of reasonable compensation. The outcome of each case is ultimately decided based on the particular facts and circumstances at issue.

The regulations provide that reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises under like circumstances. (Treas. Regs. §1.162-7(b)(3))

The courts have developed the following list of factors to consider when determining reasonable compensation:

- The employee's qualifications and role in the company, including factors such as hours worked, the employee's position, duties performed, and overall contributions to the company (see ***Levenson & Klein, Inc. v. Comm.*** (1977) 67 T.C. 694);
- The character and condition of the company, including factors such as the size of the company, the complexity of the business, and the general economic conditions (see ***Vans Chevrolet v. Comm.***, TCM 1967-172);
- A comparison of the employee's compensation with the compensation paid by similar companies for comparable services (see ***William Yuenger Manufacturing Co., Inc. v . U.S.***, TCM 1969-229);
- The salary policy of the company for all its employees and the particular employee's salary history with the company (see ***Herold Marketing Associates, Inc. v. Comm.***, TCM 1999-26);
- The likelihood that a hypothetical, independent investor would be willing to compensate the employee at the levels paid by the company taking into account dividends paid and capital growth (see ***Automotive Investment Development Inc. v. Comm.***, TCM 1993-298); and
- Whether there is any conflict of interest which might permit the company to disguise nondeductible corporate distributions as salary. This is especially an issue where the employee in question is the corporation's sole shareholder (see ***Elliott's, Inc. v. Comm.***, TCM 1980-282).

✐ **Practice Pointer**

The statute of limitations for a payroll tax audit is three years from the due date of the return if it is timely filed, but the statute of limitations does not begin to run until a return is filed. For corporations (C or S) that do not pay any salaries or wages to anyone, including their employee-shareholders, consider filing Form 945, Annual Return of Withheld Federal Income Tax.

Filing this annual payroll tax form will begin the running of the three-year statute of limitations for the IRS to assess payroll taxes.

SUPERSEDING RETURNS CAN NOW BE E-FILED

The IRS has announced that it has added a superseding return electronic checkbox to the 1040 so that superseding 1040 forms can now be filed electronically. (IR-2022-130) Previously, only superseding business tax returns (Forms 1120, 1120-S, 1120-F, 1065, and 1041) could be filed electronically. Until now, superseding individual returns had to be paper-filed.

What is a superseding return?

A superseding tax return replaces a previously filed original return and is treated as the original return. It incorporates new or corrected information. The superseding return is filed after the original return but must be filed within the filing period, including extensions.

Why file a superseding return?

Common reasons for filing a superseding return include:

- Avoiding penalties, such as the accuracy-related penalty;
- Taking advantage of retroactive laws, such as what happened in 2020 with the passage of the CARES Act;
- Changing filing status from MFJ to MFS (but see the "Timing is everything" section below);
- Allowing taxpayers to change how an overpayment should be applied — for example, changing an overpayment from being applied to the following tax year to requesting a refund (but see the "Timing is everything" section below); and
- For partnerships, avoiding having to file an administrative adjustment request (AAR). Remember that under the centralized partnership audit regime (CPAR), most partnerships may no longer file an amended partnership return. By automatically filing an extension request, partnerships may avoid having to file an AAR if they file a superseding return when they uncover errors or oversights within the extension period.

Timing is everything

The IRS does not allow an irrevocable election to be made on a return filed after the original due date but on or before the extended due date. (IRM 21.67.4.10) In these situations, the IRS does not treat the return filed after the original due date as a superseding return. Only a superseding return filed before the original due date can change an irrevocable election.

Examples of common irrevocable elections include the IRC §179 election, filing MFS, or electing to apply overpayments to estimated tax payments in the following year. (Id.; IRS Taxpayer Advocate Blog Post "The Value of 'Superseding' Returns and Processing the Additional $500 Stimulus Benefit for Certain Non-Filers" (April 29, 2020, updated April 15, 2022))

Example of irrevocable election on superseding return

Marcia and Floyd file a 2022 MFJ return on February 15, 2023. They decide that they would rather file MFS. Generally, taxpayers may not file an amended return to convert from MFJ to MFS (however, they can amend to do the opposite).

If they file a second return by April 18, 2023, and check the superseding return checkbox, the IRS will treat the second return as a superseding return and will allow them to change their filing status to MFS.

If they file their second return after April 18, 2023, the IRS will not treat the return as a superseding return and will not allow them to change their filing status from MFJ to MFS.

No impact on statute of limitations

The date a taxpayer files an original return, not the later date of any superseding return, starts the running of the statute of limitation periods. (CCA 202026002; also see www.taxpayeradvocate.irs.gov/news/nta-blog-did-you-file-a-superseding-return-if-so-read-on/)

The IRS must assess additional tax for a given tax year within three years after "the return" for that year was filed. (IRC §6501(a)) Or, if a taxpayer is filing a claim for a refund of any overpayment of tax, the taxpayer must file the claim within three years from the time "the return" was filed or two years from the time the tax was paid, whichever period expires later. (IRC §6511(a))

If both the original and superseding returns are filed before the original due date, this has no effect on when the statute of limitations begins because a return filed before the last day prescribed for filing is deemed filed on the last day of the filing period, and the statute will begin on the original due date for the return.

However, a return filed on extension is treated as filed on the day it is received. So where the first return is filed before the last date prescribed for filing (original or extended), and a superseding return is subsequently filed during the extension period, the statute begins to run on the date the first original return was filed. (Referencing ***Zellerbach Paper Co. v. Helvering*** (1934) 293 U.S. 172 and ***National Paper Products Co. v. Helvering*** (1934) 293 U.S. 183)

IRS ISSUES

INCREASED IRS FUNDING

The 2022 Inflation Reduction Act provides an additional $80 billion to the IRS to improve customer services and expand its enforcement and compliance efforts. The Congressional Budget Office estimates that these investments will raise an additional $124 billion from increased collections over a 10-year period. (IRA '22 §10301)

The IRA '22 allocates the following amounts to be available through September 2031 (unless otherwise noted):

- $3.18 billion to provide additional/improved taxpayers services such as prefiling assistance and education, filing and account services, and taxpayer advocate services;
- $45.64 billion to beef up enforcement efforts including increased digital asset monitoring and compliance activities and criminal investigations;
- $25.33 billion in operations support, including information technology development, enhancement, operations, maintenance, and security;
- $4.75 billion for business systems modernization, including development of call-back technology and other technology to provide a more personalized customer service but not including the operation and maintenance of legacy systems;
- $15 million to prepare a report for Congress by May 16, 2023 (nine months from August 16, 2022, the IRA '22's enactment date), regarding the feasibility of developing a free direct e-file tax return system and the projected cost of such a system depending on the taxpayer's AGI and return complexity;
- $403 million to fund Taxpayer Inspector General for Tax Administration (TIGTA) functions;
- $104 million for the Treasury Department's Office of Tax Policy to promulgate regulations;
- $153 million for the Tax Court; and
- $50 million to implement the IRA '22.
  (IRA '22 §10301)

 ©2022

Comment

The IRA '22 states that none of the funds are intended to increase taxes on any taxpayer with a taxable income below $400,000. (IRA '22 §10301(b))

Start having early discussions with clients to ensure they are audit ready

Currently, the IRS only has 6,500 front-line revenue agents conducting audits, and audit rates for taxpayers making under $1 million per year remain under 1%. (www.irs.gov/pub/irs-utl/statement-for-updated-audit-rates-ty-19.pdf)

It will take the IRS time to ramp up its audit enforcement with its new IRA '22 funding, so we aren't likely to see an immediate increase in audit rates. However, the IRA '22 should serve as an early warning to clients that increased audit rates will be coming in the near future.

Consider having early discussions with clients regarding best practices for document retention and recordkeeping. It also wouldn't hurt tax professionals to remind clients that it is their responsibility to retain records for possible future use, including possible examination by the taxing authorities. Your engagement letter should contain language to this effect.

UNDERSTANDING IRS TRANSCRIPT CODES

When reading an IRS account transcript, the transaction codes listed in the left column of the Tax Account portion of the transcript provide information about the taxpayer's account activity. There is also a brief description of the code, which isn't always helpful, but the IRS provides more detailed description of these codes in Section 8A of their Document 6209, ADP and IDRS Information Reference Guide.

There are hundreds of transaction codes, but it's important to know a few of the more common ones. For example, by looking at the transaction codes on a transcript, you can see if a client's return has been flagged for examination even before the client ever receives an IRS notice.

What transaction codes mean

As a taxpayer's account is updated in the IRS's Master File, transaction codes are added to it to indicate changes. These transaction codes are three digits long, and they identify the transaction being processed and maintain a history of actions posted to a taxpayer's account on the Master File. For example, transaction code 014 indicates an address change for the taxpayer from previous years.

The codes are data processing instructions to the IRS's system, so some of them may be administrative in nature and not necessarily tied to a dollar amount.

There are codes to note one action and a different code to reverse that same action. For example, transaction code 420 indicates that the return has been referred to the examination or appeals division. Transaction code 421 means that code 420 was reversed. Also, an "R" following the transaction code can indicate the transaction has been reversed.

The following chart contains some common transaction codes.

IRS Transaction Codes	
Code	**Explanation**
014	Address change: replaces street address, city, state, and zip code
094	S election denied
095	S election revocation/termination received but not processed
096	S election terminated
129	Child support enforcement agency information request
166	Delinquency penalty
176	Estimated tax penalty
196/336	Interest assessed
276	Failure to pay penalty
290	Additional tax assessment
291	Abatement of prior tax assessment (in whole or part)
300	Additional tax assessment as a result of examination
420	Return referred to Examination or Appeals Division
421	Reverse examination indicator
424	Examination request: return referred to Examination or Appeals Division
460	Form 2350 and Form 4868 extension of time to file
530	Account currently not collectible
540	Deceased taxpayer
582	Federal tax lien has been filed
610	Payment received with return
694	Credit for payment of fees and collection costs
806	Credit for tax withheld

Practice Pointer

The pamphlet is a summarized list of transaction codes, taken from Section 8A of the Document 6209. When reviewing an IRS transcript, it might be helpful to have both documents, since Document 6209 contains a bit more description for the transaction codes. Access Section 8A at:

Website
www.irs.gov/pub/irs-pia/6209-section8a-2020-sealed.pdf

 ©2022

TAX PRO ACCOUNT

Do you have a Tax Pro Account? If not, it is time to get on board. Tax Pro Account lets you submit an authorization request to an individual taxpayer's IRS online account, which they can sign electronically, and then the authorization is processed in real time (generally within two business days).

If you even occasionally need a POA or TIA to access client information — and do not want to wait the five weeks it's currently taking the IRS's CAF unit to process POAs — requesting authorization through Tax Pro Account will save time. If your client already has their own IRS account, the request process will take about five minutes, and then you will have access to their IRS account.

Tax professionals can log in to their Tax Pro Account, or create a new account if they don't already have one, at the following IRS website:

Website
sa.www4.irs.gov/secureaccess/ui/

To register, log in to your Tax Pro Account and complete the POA form, which takes no longer than completing a POA or TIA in your favorite software. The IRS will send it to your client, and they will receive an e-mail to log in and approve it. Both you and your client will think it is "super simple."

Practice Pointer

Practitioners who simply want to obtain information should utilize Form 8821, Tax Information Authorization, instead of Form 2848, Power of Attorney and Declaration of Representative.

Form 8821 only authorizes the tax professional to obtain information and is not an affirmative declaration of representation. For tax professionals taking on a new client with potentially troublesome tax situations, the Form 8821 is a good way to get a "lay of the land" before committing to represent a client.

IRS REFUND TOOL NOW INCLUDES PRIOR TWO YEARS

The IRS has updated its Where's My Refund? tool to allow taxpayers to check the status of their current and two prior-years' refunds. (IR-2022-109)) Refund information for those calling the refund hotline will be limited to the current year (2021) tax return. Where's My Refund? is updated once a day, usually overnight, so a taxpayer should only check it once a day. Taxpayers should not contact the IRS about their refund unless the Where's My Refund? system:

- Doesn't show the return was received or the refund approved, and it's been more than 21 days since the return was filed electronically;
- Shows a refund was sent, but the taxpayer hasn't received it after 15 days; or
- Indicates the IRS can provide more information about the refund's status.

FOREIGN TAX ISSUES

FOREIGN-EARNED INCOME EXCLUSION

Current limits

In 2022, a U.S. individual living abroad can exclude up to $112,000 of foreign-earned income if the taxpayer's tax home is in a foreign country and the taxpayer satisfies either the *bona fide* residence test or the physical presence test. (IRC §911; Rev. Proc. 2021-45) The exclusion applies separately to spouses; as such, if both spouses are qualified individuals, they may exclude up to $224,000 on a jointly filed return.

The 2023 foreign earned-income exclusion amount is $120,000. (Rev. Proc. 2022-38)

Foreign-earned income relief

The IRS has provided a waiver of the time requirements for taxpayers claiming the foreign-earned income exclusion if the taxpayer was forced to return to the United States due to war, civil unrest, or similar adverse conditions that precluded the normal conduct of business in the following countries beginning on the dates specified:

- **Iraq:** January 19, 2021;
- **Myanmar:** March 30, 2021;
- **Chad:** April 17, 2021;
- **Afghanistan:** April 27, 2021; and
- **Ethiopia:** November 5, 2021.
  (Rev. Proc. 2022-18)

To qualify for this relief, an individual must have established residency or have been physically present in the foreign country on or before the date that the Secretary of the Treasury determines that individuals were required to leave the foreign country. For example, individuals who were first physically present or established residency in Iraq after January 19, 2021, are not eligible to qualify for the exception provided for 2021. (IRC §911(d)(4))

California nonconformity

California does not conform to the foreign-earned income exclusion. (R&TC §17024.5) California taxes California residents on their worldwide income. Each year, the IRS provides the FTB with a list of taxpayers who took the foreign-earned income exclusion on the federal return.

WITHHOLDING REQUIREMENTS

IRC §§864(c)(8) and 1446(f) were added to the Tax Code by the TCJA and generally provide that:

- Gain or loss derived by a foreign person on the sale or exchange of an interest in a partnership engaged in a U.S. trade or business is effectively connected gain or loss subject to U.S. tax (IRC §864(c)(8)); and
- A transferee of an interest in a partnership is required to withhold 10% of the amount realized if any portion of the gain on the disposition would be treated as effectively connected with the conduct of a trade or business within the U.S. It also requires the partnership to withhold on distributions to the transferee if the transferee fails to withhold. (IRC §1446(f))

 ©2022

In 2021, the IRS announced a deferral until January 1, 2023, regulations implementing the following foreign partnership withholding requirements imposed pursuant to IRC §1446:

- Withholding on transfers of interest in publicly traded partnerships (PTP interests);
- Withholding on distributions made with respect to PTP interests; and
- Withholding by partnerships on distributions to transferees.
  (Notice 2021-51)

FOREIGN REPORTING

U.S. persons with interests in foreign bank accounts (FBAR) or foreign assets (FATCA) must file annual reports with the U.S. government (see page 11-9 for a chart outlining these requirements and page 11-10 for a comparison of the FBAR and FATCA requirements).

California conformity

California conforms to the FATCA, but not FBAR, reporting requirements, including the $10,000 penalty for failure to file Form 8938, Statement of Specified Foreign Financial Assets, without reasonable cause. (R&TC §19141.5(d)) For California filers, this means a total penalty of $20,000 for failure to file Form 8938 ($10,000 federal + $10,000 California).

FBAR due dates

The FBAR (FinCEN Form 114, Report of Foreign Bank and Financial Accounts) due date is April 15, with an automatic six-month extension to October 15. No extension form is necessary to receive the automatic extension. Prior to 2017, the FBAR was due June 30, and no extensions were available. (Surface Transportation and Veterans Health Care Choice Improvement Act of 2015)

In addition to the FBAR, taxpayers may also need to file Form 8938, Statement of Specified Foreign Financial Assets, with regard to their foreign bank accounts. Form 8938 is filed along with the taxpayer's personal income tax return.

FBAR virtual currency reporting

FinCEN announced that it intends to change the FBAR regulations to make foreign accounts holding virtual currency reportable. (FinCEN Notice 2020-2; 31 Code of Fed. Regs. §1010.350) The current FBAR regulations don't recognize a foreign account holding virtual currency as a type of reportable account; therefore, a taxpayer is not required to file an FBAR reporting that account (unless the account holds assets besides virtual currency).

FBAR PENALTIES

Under IRC §5321 the maximum penalty for an FBAR nonwillful violation is $13,481 (inflation-adjusted for penalties assessed on or after February 19, 2020). Willful violations are subject to a maximum penalty equal to the greater of $134,806 (inflation-adjusted for penalties assessed on or after February 19, 2020) or 50% of the balance in the account. (31 U.S.C. §5321; 31 Code of Fed. Regs. §1010.821)

Comment

FBAR penalties are inflation-adjusted, but they are not adjusted annually. The last time they were adjusted for inflation was February 2020.

U.S. Supreme Court will decide split in appellate courts

In late June 2022, the U.S. Supreme Court agreed to hear ***Bittner v. U.S.***, a Fifth Circuit decision that held that each foreign bank account not reported on the taxpayer's FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), constituted a separate violation for the purposes of applying the FBAR penalty. (***Bittner v. U.S.*** (U.S. June 21, 2022) No. 21-1195 petition for cert. granted; ***U.S. v. Bittner*** (CA 5 2021) 19 F.4th 734; ***U.S. v. Bittner*** (E.D. Tex. 2020) 469 F.Supp.3d 709)

However, a split existed with the Ninth Circuit, which held that the penalty should be applied per form rather than per account. (***U.S. v. Boyd*** (CA 9 2021) 991 F.3d 1077) The Supreme Court will hear and decide the ***Bittner*** case during its current term, which runs from October 2022 through June 2023.

FOREIGN TAX CREDIT

The IRS has issued final Foreign Tax Credit regulations that apply to taxable years beginning on or after December 28, 2021. (TD-9959) The changes include:

- Adding a jurisdictional nexus requirement (referred to as an "attribution requirement") for purposes of determining whether a credit can be claimed for a foreign income tax, or tax in lieu of an income tax, paid by a nonresident taxpayer; and
- Revising the tests used to determine whether the Foreign Tax Credit net gain requirement is met for purposes of making the foreign tax paid creditable.
  (Treas. Regs. §1.901-2(b))

☑ Planning Pointer

In a nutshell, and very broadly speaking, these final regulations will prevent U.S. taxpayers from claiming Foreign Tax Credits for some of the newer extraterritorial taxes being imposed by some foreign countries (e.g., digital services taxes) and those foreign taxes that utilize destination-source or market-based sourcing rules. It will also make foreign taxes based on taxing schemes that do not sufficiently mirror U.S. income tax law noncreditable.

These changes will not impact most of our clients who are only paying Foreign Tax Credits on income received from mutual funds or who are working abroad and paying foreign taxes on their wages. These changes may have a significant impact on taxpayers providing services over the internet, charging royalties, foreign taxpayers who are subject to nonresident withholding, and taxpayers selling interests in foreign entities, and/or involved in multitier entity structures.

Jurisdictional nexus

Whether a foreign tax is an "income tax" or a "tax in lieu of an income tax" eligible for the Foreign Tax Credit is based on U.S. revenue laws, which, according to the IRS, include a jurisdictional nexus limitation (referred to as a new "attribution requirement"). (Treas. Regs. §1.901-2(b)(5))

 ©2022

To meet the new attribution rules, the foreign tax imposed on nonresidents must establish a sufficient nexus between the foreign country and the nonresident's activities or investments by meeting one of the following tests:

- **Activities-based attribution:** The gross receipts and costs included in the foreign tax base must be limited to those attributable, under reasonable principles, to the nonresident's activities within the foreign country, or the nonresident's agent or passthrough entity. This is similar to the U.S. effectively connected income test under IRC §864(c);
- **Source-based attribution:** The income (other than sales from dispositions of property) must be based on sourcing rules similar to those applied in the Internal Revenue Code (see below for more details); or
- **Property situs attribution:** The income must be from sales of real property located in the foreign jurisdiction or an interest in a resident corporation or other entity that owns real property in the foreign country (similar to the IRC §867 Foreign Investment in Real Property Act (FIRTPA) provisions), or property that is part of the business property creating a taxable presence in the foreign country (utilizing effectively connected income-type analysis).

Comment

In the preamble to the final regulations, it was noted that one commentator on the proposed regulation imposing the jurisdictional nexus requirement asked the IRS to develop a list of "per se" credible and noncredible taxes to provide taxpayers certainty and reduce compliance burdens. The IRS responded, "A per se list of creditable and non-creditable taxes would require significant government resources to analyze foreign taxes and maintain such a list, would need to be updated every time foreign tax laws change. Therefore, the final regulations do not adopt this comment."

What are the sourcing rules?

How income is characterized (e.g., service income, royalties, etc.) is based on how such income is characterized under foreign law. However, whether the income is properly sourced by the foreign country is determined by comparing the foreign country's sourcing laws to determine whether the foreign treatment is similar to U.S. sourcing laws.

The final regulations do provide the following guidelines for purposes of determining whether there is jurisdictional nexus, however:

- **Royalties:** The foreign tax law must impose tax on royalties based on the place of use of, or the right to use, the intangible property. However, the foreign jurisdiction does not have to necessarily reach the same conclusion as to where the property is used as the IRS in a particular revenue ruling or a U.S. court in a particular case;
- **Service income:** The income from services must be sourced based on where the services are performed, not on the location of the service recipient; and
- **Property sales (including sales of copyrighted articles sold through electronic media):** The income must be sourced under the activities-based attribution rules or property situs attribution rules discussed above. Copyrighted articles must be treated as a sale of tangible property and not as a license of intangible property.

Example of sourcing rules

Michelle is a U.S. resident but is living and working in Country A in her consulting business. Her customers are located in countries A and B, and she performs all of her work in Country A. Country B taxes her income based on the location of her customers, and she pays Country B on income from her Country B customers. Under the rules outlined above, Michelle cannot claim the Foreign Tax Credit for the taxes paid to Country B because Country B is taxing Michelle based on the location of Michelle's customers and not based on the location where the services were performed (which was in Country A).

Treatment of royalties under new proposed regulations

The IRS has proposed changes to the final Foreign Tax Credit regulations that were adopted on January 4, 2022, and applicable to taxable years beginning on or after December 28, 2021. (REG-112096-22)

The proposed regulations provide an exception to the Foreign Tax Credit sourcing rule if the taxpayer licenses intangible property solely for use in the country in which the licensee is a resident (referred to as the "single-country exception") and can substantiate this through a written license agreement. (Prop. Treas. Regs. §1.903-1(c)(2)) The written agreement must be executed prior to the payment of the royalties for the exception to apply. However, a special transition documentation rule is provided for royalties paid on or before May 17, 2023, if an agreement is executed by May 17, 2023.

Impact of foreign treaties

A foreign tax paid by a U.S. citizen or U.S. resident that is treated as an income tax under the relief from double taxation article of an income tax treaty that the U.S. has entered into with the country imposing the tax is treated as a creditable foreign income tax. (Treas. Regs. §1.901-2(a)(1)(iii)) This automatic eligibility does not extend to foreign taxes paid by controlled foreign corporations (CFCs), which must analyze whether the foreign jurisdiction's tax meets the jurisdictional nexus requirements (unless the treaty specifically addresses this issue).

If, in the example above, the U.S. and Country B had a treaty that allowed Michelle to claim the Foreign Tax Credit for the income taxed by Country B, then the treaty would trump the FTC rules discussed above.

Net gain requirement

The final regulations still apply the following three-component analysis to determine whether the foreign tax meets the net gain requirement:

- **The realization requirement:** Generally speaking, the income can only be taxed when it is realized;
- **The gross receipts requirement:** Generally speaking, the tax must be based on gross receipts; and
- **The net income requirements (renamed the cost recovery requirement):** See the following discussion.
  (Treas. Regs. §1.901-2(b))

 ©2022

The final regulations limit the role of the previously required predominant character and the empirical analysis for purposes of determining whether a tax is an "income tax" in the U.S. sense, which looked at how the tax was normally applied. Now, the determination of whether a tax satisfies each of the requirements is based on the terms of the foreign tax law governing the computation of the tax base. This will be undertaken by evaluating the law's statutes, regulations, case law, rulings, and pronouncements.

Gross receipts test

The previously applied alternative gross receipts test is eliminated. However, the final regulations still allow certain deemed gross receipts resulting from deemed realization events (e.g., mark-to-market regimes) or insignificant nonrealization events to be included in gross receipts. (Treas. Regs. §1.901-2(b)(3))

Cost recovery requirement

The final regulations revise the cost recovery requirement (formerly known as the net income requirement) to ensure that a foreign tax is a creditable tax only if the determination of the foreign tax base conforms in essential respect to the determination of taxable income under the Tax Code. (Treas. Regs. §1.901-2(b)(4)) To accomplish this, the final regulations:

- Require that the foreign tax law must by its terms allow recovery of significant costs and expenses to be creditable and provides a list of "per se" expenses that must be deductible under the foreign tax law including recovery of costs and expenses related to capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation. Foreign tax laws that disallow various expenses need not mirror U.S. expense rules but should be consistent with its principles (e.g., disallowing interest expenses in excess of 10% of taxable income would not make the foreign tax noncreditable);
- Limit the use of the alternative allowance rule, which treats a foreign tax as creditable, even if it doesn't permit recovery of one or more significant costs or expenses, if it provides allowances to compensate for the nonrecovery of such items. Under the final regulations, use of the alternative allowance rule will only be allowed if, by the terms of the foreign tax law, it permits recovery of an amount that equals or exceeds the actual amounts of such significant costs and expenses. However, the final regulations treat a foreign tax law as creditable if the law gives the taxpayer the choice between deducting actual expenses or an optional allowance in lieu of actual expenses, or if the alternative allowance is adopted to minimize administrative or compliance burdens with respect to small taxpayers (e.g., a small business safe harbor);
- Remove the nonconfiscatory gross basis tax rule that treated a gross receipts tax as a creditable income tax so long as it reaches net income. Foreign taxes that do not permit recovery of significant costs and expenses will not be treated as creditable income taxes unless there are, in fact, no significant costs and expenses attributable to the gross receipts included in the taxable base; and
- Clarify that a foreign tax that does not permit recovery of costs and expenses attributable to wages and investment income not derived from a trade or business or that do not permit the recovery of personal expenses will still meet the cost recovery requirement.

Proposed regulations

Recognizing that it may not always be possible to decipher whether this "principles-based exception" is satisfied, the IRS issued new proposed regulations that will treat a foreign tax as creditable if the foreign tax law, by its terms, permits recovery of substantially all of each item of significant cost or expense. (Prop. Treas. Regs. §1.901-2(b)(4)) The term "substantially all" is not defined, but a safe harbor is proposed that will treat a foreign tax as meeting the cost recovery requirement if it meets any of the following requirements:

- The portion of the item(s) that is disallowed does not exceed 25% of the cost or expense; or
- The limitation on the deduction does not exceed 15% of gross receipts, gross income, or similar measure; or
- The limitation on the deduction does not exceed 30% of taxable income or similar measure.

Tax in lieu of income tax

Under the final regulations, a foreign tax paid in lieu of a tax on income will only be treated as a creditable tax under IRC §903 if it meets the substitution test and must, based on the terms of the foreign tax law, meet the following four-part test:

- The generally imposed net income tax requirement, which requires that the country imposing the in lieu tax (aka the "tested tax") must also impose a net income tax as defined above;
- The nonduplication requirement, which prohibits the same tax base from being used for both the foreign net income tax and the tested tax;
- The close connection requirement, which requires that, but for the existence of the tested tax, the generally imposed net income tax would otherwise have been imposed on the excluded income; and
- The jurisdiction-to-tax requirement (the same as the jurisdiction-to-tax requirement discussed above).
  (Treas. Regs. §1.903-1)

Treatment of refundable credits

The final regulations clarify that a tax credit allowed under federal law is considered to reduce the amount of foreign income tax paid, regardless of whether the amount of the tax credit is refundable in cash to the extent it exceeds the taxpayer's liability for foreign income tax. (Treas. Regs. §1.901-2(e)) However, an exception applies for overpayments of a different tax liability that are refundable in cash, but at the taxpayer's option, are applied to satisfy the taxpayer's foreign income tax liability.

 ©2022

Other changes

Other final regulations make numerous other changes, including:

- Clarify the relationship between the Foreign Tax Credit and the dividends received deduction (Treas. Regs. §1.245A(d)-1(a));
- Provide additional guidance on the allocation and apportionment of foreign income tax (Treas. Regs. §1.861-20(d)(3));
- Address timing issues related to claiming the credit in instances involving accrual taxpayers, instances involving midyear events or contested tax liabilities, etc. (Treas. Regs. §1.905-1(f)); and
- Clarify which services qualify as foreign-derived deduction-eligible service income for purposes of the Internal Revenue Code. (Treas. Regs. §1.250(b)-5)

DISASTER RELIEF

LOCAL DISASTER RELIEF PROVISIONS

The IRS provides local disaster relief for specified areas of the country. A link to the IRS's latest relief, which is updated in real time, can be found here:

Website
www.irs.gov/newsroom/tax-relief-in-disaster-situations

PLANNING CHECKLISTS

The checklists on the following pages are quick reference guides to many of the planning pointers and techniques scattered throughout the federal chapters of this manual, along with some other tried-and-true favorites.

<table>
<tr><th colspan="2">Planning Checklist: Individuals</th></tr>
<tr><th colspan="2">Planning with dependents</th></tr>
<tr><td>☐</td><td>If preparing tax returns for young adult children, be sure to have them sign their own engagement letter, and direct questions directly to them. This will help you identify additional income, deductions, and planning opportunities more accurately than talking only with their parents.</td></tr>
<tr><td>☐</td><td>Consider making annual Roth IRA contributions on behalf of working teenagers. Doing so won't yield any immediate tax benefits, but the funds will benefit from decades of tax-free growth before they retire. Contributions must be made by the due date of the teenager's income tax return, not including extensions (generally April 15).</td></tr>
<tr><th colspan="2">Estimated tax planning</th></tr>
<tr><td>☐</td><td>Check withholding and estimated tax payments to reduce estimated tax penalties. The client must qualify under one of the existing exceptions:
• Lesser of 90% of current tax or 100/110% of prior-year tax;
• Annualization method;
• No tax liability in the prior year, and the return was (or would have been, had the taxpayer been required to file) for a full 12 months;
• Retired after reaching age 62 or became disabled, and the underpayment was due to reasonable cause; and
• Casualty, disaster, other unusual circumstance, or if it would be inequitable to impose the penalty. (IRC §6654(e)(3)(A)) Other rules apply to short-period returns, nonresident aliens, and farmers and fishermen.</td></tr>
<tr><td>☐</td><td>Be sure to review one-time or unique transactions when preparing estimates for the following year. Don't just base the next year's estimates on current-year income if current-year income is out of the ordinary, for example, if the client had large taxable gains in the current year from the sale of a rental property.</td></tr>
<tr><td>☐</td><td>Taxpayers who miss estimated tax payments can modify their withholding from other sources such as W-2 wages or retirement distributions to make up the difference before the end of the year. Taxes withheld at the source are deemed paid evenly throughout the year, even if all the withholding is at the end of the year. Increasing withholding near the end of the year can help reduce estimated tax penalties.</td></tr>
<tr><th colspan="2">Gross income planning</th></tr>
<tr><td>☐</td><td>For clients with COD income, be sure to discuss whether the client was insolvent at the time the debt was discharged. Prepare a personal balance sheet for the client (aka a statement of net worth), and include the cancelled debt as a liability. If the taxpayer's net worth is negative, then they qualify to exclude the COD income.</td></tr>
<tr><td>☐</td><td>For clients who are still carrying student loan debt, be sure to provide them with the information necessary to apply for loan forgiveness if they haven't already.</td></tr>
<tr><td>☐</td><td>Review alimony agreements to determine whether they were executed prior to January 1, 2019. If they were, then the alimony is deductible by the payor and must be included in the recipient's gross income.</td></tr>
<tr><td>☐</td><td>Income generated from hobby activities are taxable, but expenses are not deductible because they are classified as 2% miscellaneous itemized deductions, which are suspended through 2025. However, taxpayers are permitted to deduct the cost of goods sold from their gross revenue when arriving at the taxable portion of their hobby income.
An activity is generally presumed to be a business (not a hobby) if the taxpayer generates a profit in three out of the five years ending with the tax year at issue. Advise clients who have difficulty making a profit for at least three out of five years about the nine factors the IRS and courts will use to determine whether their activity is a business or a hobby. The nine factors are discussed on page 1-11.</td></tr>
<tr><td colspan="2" align="right">(continued)</td></tr>
</table>

<table>
<tr><th colspan="2">Planning Checklist: Individuals (continued)</th></tr>
<tr><th colspan="2">Investments and capital gain (loss) planning</th></tr>
<tr><td>☐</td><td>For clients who value the security of Series I Treasury bonds, remind them that they can only purchase up to $10,000 per tax ID number through the Treasury Direct website. However, they can purchase up to $5,000 of additional paper Series I bonds per tax return by redirecting income tax refunds. Taxpayers who want to use their refund to purchase bonds should make additional estimated tax payments or extension payments to ensure their refund is large enough. Series I bonds are discussed on page 1-62.</td></tr>
<tr><td>☐</td><td>Advise clients that cryptocurrency 1099-B reporting begins for the 2023 taxable year (forms that will be issued in early 2024). Clients who are invested in cryptocurrencies should be ready for the additional reporting forms.</td></tr>
<tr><td>☐</td><td>When discussing potential capital gain transactions for clients, don't forget to factor in the net investment income tax. Often when clients ask about their tax burden when selling a capital asset, tax professionals have a tendency to just use a 15% or 20% federal capital gain rate as an estimate and fail to account for the 3.8% net investment income tax. See page 1-26 for a discussion of the net investment income tax.</td></tr>
<tr><td>☐</td><td>For lower-income clients with investment income, be sure to review their estimated taxable income for the coming year. They may be able to harvest long-term capital gains at the 0% tax bracket. See page 1-9 for the taxable income breakpoints for the 0%, 15%, and 20% long-term capital gain rates.</td></tr>
<tr><td>☐</td><td>For taxpayers who are elderly or in poor health, consider harvesting:
Capital loss carryovers before death by selling assets that will produce large gains; and
Net operating loss carryovers before death by taking additional retirement distributions or selling assets with large gains.
When preparing an analysis, don't forget that assets will receive a basis step-up on death, which may or may not be more beneficial than the lost capital loss or net operating loss carryovers.</td></tr>
<tr><td>☐</td><td>If available, consider spreading large capital gains out over two or more years using an installment sale if doing so will keep the taxpayer's income below the net investment income tax threshold.</td></tr>
<tr><td>☐</td><td>If the taxpayer has a large capital loss, sell assets subject to a capital gain to take advantage of the loss. Stocks, bonds, or mutual funds can be repurchased immediately, and basis will be reset. Wash sale rules do not apply when stock is sold at a gain.</td></tr>
<tr><td>☐</td><td>Harvest losses from cryptocurrencies. Cryptocurrencies are not subject to the wash sale rules (at least not yet), so cryptocurrencies can be sold for large losses and purchased again right away. The losses can either be used to offset other gains or carried over indefinitely until the taxpayer does have large gains.</td></tr>
<tr><th colspan="2">Deduction planning</th></tr>
<tr><td>☐</td><td>Taxpayers with HSA-eligible health insurance and who do not make the maximum contributions through payroll deductions have until the original due date of their return, not including extensions (generally April 15), to make a contribution for the prior taxable year and claim an extra above-the-line deduction.</td></tr>
<tr><td>☐</td><td>Taxpayers who itemized deductions and are close to, but not over, the standard deduction can benefit from bunching deductions. Consider the timing of payments for medical expenses, charitable contributions, and even an extra mortgage payment to push the taxpayer's deductions over the standard deduction threshold.</td></tr>
<tr><td>☐</td><td>Consider donating appreciated assets, such as stock, to charity. If the asset would produce long-term capital gains if sold, instead of being donated, then the taxpayer can claim a charitable contribution deduction equal to the FMV of the asset on the date it is donated and does not recognize any income. Remember, however, that if you donate an asset other than publicly traded stock, an appraisal may be required.</td></tr>
<tr><td colspan="2" align="right">(continued)</td></tr>
</table>

Planning checklist: Individuals (continued)	
Deduction planning (continued)	
☐	Donor advised funds are a great way to generate a large charitable contribution deduction today, while maintaining annual gifting. Contributions to a donor advised fund are deductible in the year contributed even though the funds aren't transferred from the fund to qualified charities until later — usually a little each year. Donor advised funds are a great charitable contribution strategy to offset tax in high income years.
☐	For taxpayers whose taxable income is below the IRC §199A phaseout threshold, their deduction is 20% of the lesser of their taxable income or their qualified business income (QBI). Taxpayers whose only source of income is qualified business income will see their §199A deduction limited by the taxable income limitation after accounting for the standard deduction or itemized deductions. These taxpayers should consider ways to generate other sources of income (other than capital gains). The additional income will raise the taxpayer's taxable income closer to their qualified business income and can effectively create a 20% deduction even against non-QBI sources of income.
☐	A taxpayer's qualified business income (QBI) is reduced by, among other things, retirement contributions related to the source of QBI. However, traditional IRA contributions don't reduce QBI. Consider contributing up to the traditional IRA limits first and then contribute to a SEP IRA or other retirement plan to limit the taxpayer's QBI reduction.
☐	Entrance fees to life plan retirement communities contain a long-term care contract component. The community will provide an actuary-prepared present value of the long-term care contract. The value of the long-term care contract is deductible as a medical expense deduction and can easily reach $100,000 or more. This very large medical expense deduction is lost if not used in the year the taxpayer pays their move-in fee for the community. Taxpayers often sell their principal residence to fund their life plan community entrance fees. If the home sale produces more gain than can be excluded from the home sale exclusion rules, then timing the home sale to occur in the same year as the move into the life plan community is a great way to shelter taxable gain from the home sale. Alternatively, consider a Roth conversion to generate taxable income to ensure that the large medical expense deduction is not wasted.
Planning for tax credits	
☐	The Clean Vehicle Credit (formerly known as the New Qualified Plug-in Electric Drive Motor Vehicle Credit) is subject to more limitations due to changes made by the Inflation Reduction Act of 2022. The limitations are based on the date the car is placed in service, manufacturer limitations, MSRP limitations, and AGI limitations of the taxpayer, among others. Be sure to review the rules at page 1-35 and the IRS's list of eligible vehicles (website link on page 1-37) with a client before advising them that they are eligible for the credit.
☐	Starting in 2023, used cars can qualify for the Previously Owned Clean Vehicle Tax Credit. The credit is only eligible if the car is at least two model years old, has not already been sold as a used car before, is purchased from a licensed dealer, is purchased for $25,000 or less, and the taxpayer's AGI is under certain thresholds, among other requirements. Be sure to review the rules at page 1-41 with a client before advising them that they are eligible for the credit.
☐	The Residential Clean Energy Credit (formerly known as the Residential Energy Efficient Property (REEP) Credit) is generally claimed for solar energy property, but other types of clean energy qualify for the credit. The credit is reinstated at 30%, retroactive to the beginning of 2022. The credit is claimed in the year the property is placed in service, not the year the cost are incurred. Advise clients who are seeking to install qualifying property near the end of the year that they need to finish the project by December 31; otherwise, they must wait another year to claim the credit. For projects that aren't completed by year-end, consider adjusting wage withholding or estimates to provide the client with some immediate tax relief based on their expected credit eligibility.
	(continued)

Planning Checklist: Individuals (continued)	
Planning for tax credits (continued)	
☐	Starting in 2023, the determination of whether health coverage for an employee is affordable is made separately from the employee's family (spouse and dependents). An eligible employer-sponsored plan is affordable for the employee's family only if the portion of the annual premiums the employee must pay for family coverage does not exceed 9.61% of household income (in 2022). If the employee's required contribution rate for the family coverage exceeds 9.61%, then the family members are eligible to claim the Premium Tax Credit for health insurance purchased through an exchange.

Planning Checklist: Retirement, Estates and Trusts	
Estate and gift planning	
☐	Widowed clients who expect their estate to climb over $5 million should consider filing estate tax returns for their deceased spouse to claim the deceased spouse's unused exclusion (DSUE). Taxpayers who are not required to file an estate tax return but choose to file one solely to claim portability now have five years from the date of the first spouse's death to file.
☐	Consider annual gifting strategies to reduce the value of the client's estate. The annual gift exclusion is $16,000 in 2022 and $17,000 in 2023. Remember, gifts of tuition and medical expenses paid directly to the school or medical care provider do not count toward the annual gift limit.
☐	Consider the following rules when maximizing gifting strategies: • Cash gifts may be better if the recipient is in a high tax bracket; • Give appreciated assets to individuals who are in lower tax brackets; • Do not gift assets that have a FMV lower than the donor's basis; • Consider medical or education expense gifts to avoid gift tax — payments directly to the medical provider or educational institution are not counted toward the annual gift tax exclusion, discussed on page 1-80; and • Taxpayers can give up to five years of annual gifts at once into a §529 plan (referred to as superfunding, discussed at page 1-79). Contributions to §529 accounts are most beneficial when the funds will have time to grow tax-free before they are used. If the student will be using the funds soon, consider the education gifting strategy discussed in the prior bullet instead.
☐	For taxpayers expected to have large taxable estates, consider lifetime gifts in excess of the $5 million the unified exclusion is scheduled to revert back to after December 31, 2025. The anti-clawback rules in the regulations prevent the inclusion of the value of lifetime gifts into the taxpayer's estate in excess of the unified exclusion amount at the time of death. The anti-clawback rule is discussed on page 1-74 along with exceptions to the anti-clawback rule issued in proposed regulations by the IRS in 2022 (page 1-77).
☐	Taxpayers who are not required to file an estate tax return upon the death of a spouse but choose to file one to claim their deceased spouse's unused exclusion (aka the portability election) have five years from the date of the decedent's death to file the estate tax return and make the election. Consider filing an estate tax return and making the portability election for any client whose taxable estate is expected to exceed $5 million (the amount the unified exclusion is scheduled to revert back to after December 31, 2025).
Retirement contribution planning	
☐	Taxpayers have until the original due date of their return, not including extensions (generally, April 15), to make deductible IRA contributions. The lower AGI may help taxpayers claim numerous other tax benefits tied to AGI.
	(continued)

Planning Checklist: Retirement, Estates and Trusts (continued)	
Retirement contribution planning (continued)	
☐	Taxpayers who won't benefit from deductible traditional IRA contributions but whose income is low enough also have until the due date of their return, not including extensions, to make Roth IRA contributions.
☐	Consider making IRA contributions even if the taxpayers won't receive a deduction. Nondeductible IRA contributions provide basis for the client, and the IRA investment will still grow tax-deferred. Taxpayers who don't have other IRA funds can make nondeductible traditional IRA contributions and immediately convert them to a Roth IRA (the backdoor Roth strategy). Be sure to review the IRA aggregation rules before applying this strategy discussed on page 2-29.
☐	Clients who have access to an employer-sponsored retirement plan such as a 401(k) should contribute to their employer's plan first, at least up to the point of maximizing employer matching contributions, before contributing to a traditional IRA. Employer matching contributions are free money, so don't pass them up.
☐	Consider Roth conversions during stock market declines. Taxpayers can convert some of their IRA funds to a Roth IRA when values are low, then when the stock market rebounds, the funds in the Roth IRA grow tax-free and won't be taxed when the taxpayer retires.
Retirement distribution planning	
☐	Review inherited IRA accounts and help clients develop a distribution strategy. Taxpayers who are eligible designated beneficiaries can spread their distributions out over their own life expectancy, but others must fully distribute the funds by the end of the year containing the 10th anniversary of the account owner's date of death, subject to annual RMD rules. Timing annual distributions around life events, such as moving from a high tax state to a low tax state, can help save significant tax dollars.
☐	Discuss qualified longevity annuity contracts (QLACs), discussed on page 2-8, for clients who: • Are afraid of outliving their IRA funds; or • Want to reduce their RMDs (and therefore, their AGI), which can help reduce the amount of Social Security benefits that are taxable and any other tax attribute tied to AGI.
☐	Discuss qualified charitable distributions (QCDs, aka IRA-to-charity), discussed on page 2-10, with clients who: • Are over the age of 70½ (the age for QCDs remains at 70½ even though the RMD age is now 72); • Draw from an IRA; and • Regularly give to charity. Doing so will provide a charitable contribution deduction for clients who use the standard deduction and will lower the client's AGI.
☐	Give special review to a client's income in the year they turn age 72 and their anticipated income the following year. Taxpayers can delay their RMD in the year they turn age 72, but they must take the missed RMD by April 1 of the following year, plus that second year's RMD by December 31 (two RMDs in the same year). Taxpayers with unusually high income in the year they turn age 72 may benefit by delaying their first RMD, especially if their income in the following year will be much smaller.
☐	Taxpayers can generally begin taking distributions from their retirement accounts once they turn age 59½ without penalties. Clients who retire early and who have both Roth and traditional retirement accounts should consider prioritizing distribution funds from their traditional accounts before they turn age 72 when they have an RMD requirement. Doing so will reduce the balance of their traditional IRAs and will reduce their RMDs later. This will help keep AGI low and may reduce the amount of taxable Social Security later in retirement.
Social Security and Medicare planning	
☐	Clients who are (or will soon be) on Medicare and who experience life changing events that will result in lost income going forward should consider filing Form SSA-44 to help avoid or reduce a Medicare premium surcharge.

Planning Checklist: Business	
☐	Review client payroll tax returns to determine whether they claimed any COVID-19–related credits that will require amended income tax returns (such as the Employee Retention Credit), discussed on page 3-1.
☐	Discuss the change in the R&D deduction and plan estimates ahead due to the reduced deduction caused by mandatory capitalization of R&D expenses, discussed on page 3-23.
☐	Discuss future asset purchases, and plan for reduced bonus depreciation starting in 2023 when 100% bonus depreciation is reduced to 80% and is reduced by an additional 20% each year thereafter until bonus depreciation is 0%.
☐	Review financial statements, W-2s, and K-1s thoroughly to determine if the client is reporting accountable and nonaccountable plans appropriately. For example, many small business clients will deduct medical insurance paid on behalf of partners and 2% S corporation shareholders instead of treating the health insurance as taxable wages (for S corporations) or guaranteed payments (for partners), which should be deducted on Schedule 1 of the owner's Form 1040.
☐	Be sure to review the business interest expense limitation rules, particularly for small businesses generating a loss. Such businesses can find themselves inadvertently classified as a tax shelter and will have their business interest expense limited. If eligible, electing to be treated as a real property or a farming trade or business will avoid the business interest limitation rules.
☐	Elect out of the CPAR rules if eligible, thus preserving the right to file amended partnership income tax returns if changes are necessary.
☐	File extensions for all partnership clients, thereby giving you until the extended due date of the return to file a superseding return instead of having to file an administrative adjustment request if the partnership is subject to the CPAR rules.
☐	Check corporate tax returns for reasonable compensation, and discuss the requirement with clients who are not paying themselves or are paying themselves very little.
☐	Review the salaries and wages of any C corporation owners who zero-out profits each year. Make sure that any bonuses or other payments are justified and aren't just paid to the owners based on their ownership percentages.
☐	Use an accountable plan to ensure employee business expenses are reimbursed. See page 3-39 for a discussion of accountable versus nonaccountable plans.
☐	File an extension for business clients (including individuals with Schedule C businesses) if the client needs more time to make their profit sharing or employer 401(k) contributions. The contributions are due by the due date of the return including extensions. **Note**: An extension can be filed even after the return has been filed (as long as the extension is filed by the original due date of the return), and the return can be filed before retirement contributions are made, as long as the client makes the contribution equivalent to the amount deducted on the return.
☐	For new businesses with aggressive growth strategies, consider the benefits of the 21% C corporation tax rate and the income exclusion on gain from the sale of qualified small business stock (QSBS) under IRC §1202. The lower tax rate will benefit the business that wants to keep most profits in the business to fund growth, and the QSBS exclusion can provide tax-free income to shareholders who qualify when they sell the stock.
☐	Consider the new Qualified Commercial Clean Vehicle Credit for business vehicle purchases after December 31, 2022. Qualifying vehicles are eligible for a tax credit up to $40,000 ($7,500 for vehicles with a GVWR less than 14,000 lbs.). The basis of the vehicle is reduced by the amount of the credit claimed, and the remaining basis is eligible for 80% bonus depreciation in 2023 (and drops by 20% per year each year thereafter).
☐	Improvements made to commercial buildings by owners or lessees are eligible for the enhanced Energy Efficient Commercial Building Deduction starting in 2023. Consider this special deduction for property that otherwise must be capitalized when making commercial building improvements, such as HVAC and interior lighting improvements, among others. The full details of the deduction can be found at page 3-8.
☐	Consider installing electric vehicle charging stations or other alternative fuel vehicle refueling property at your place of business. The Alternative Fuel Vehicle Refueling Property Credit provides a credit of up to 30% of the cost of such property. This is a great option for businesses with their own alternative fuel vehicle fleet.

Planning Checklist: Real Estate	
☐	Cost segregation studies can create accelerated depreciation deductions. When a taxpayer purchases real property such as a rental property, the purchase price is separated into a nondepreciable land component and a building component depreciated over 27.5 year for residential real estate or 39 years for nonresidential real estate. The land-to-building allocation is usually calculated to align with the land-to-building allocation on the property tax statements. A cost segregation study breaks up the building into its shorter useful life components, such as 5-year, 7-year, 10-year, and 15-year components. Bonus depreciation can be claimed where eligible. If the cost segregation study is performed years after the real property is placed in service, then taxpayers can file Form 3115, Application for Change in Accounting Method, and claim past years' depreciation all in the current year.
☐	Taxpayers are permitted to capitalize annual taxes and carrying charges for real property that is **both** unimproved and unproductive (generally, raw land) under IRC §266. The $10,000 limit on state and local income tax (SALT) deductions and the elimination of 2% miscellaneous itemized deductions through 2025 combine to create a situation where taxpayers may receive no current deduction for the property taxes and carrying charges on eligible property. By capitalizing taxes and carrying charges, taxpayers can add these expenditures to the property's basis and reduce the taxable gain on the property when it is eventually sold.
☐	For taxpayers who convert their residence into a rental, discuss whether losing the home sale exclusion (up to $250,000 for single filers and $500,000 for joint filers) is worth giving up over the life of the rental property. Consider whether selling the property, claiming the large income exclusion, and then purchasing a separate property as a rental is more beneficial.
☐	Instead of selling appreciated rental properties outright, consider a like-kind exchange and leverage the sale proceeds to purchase a larger, more lucrative property. For taxpayers who don't want the burden of a rental property or the management responsibilities, consider using the like-kind exchange to get into real property held by a Delaware statutory trust (DST) that is professionally managed. See page 4-16 for a discussion of DSTs.

Planning Checklist: Practice Management	
☐	Sign up for Spidell's Flash E-mail alerts so that you always stay informed of the biggest news as it breaks. You can sign up here: www.caltax.com/get-more-from-spidell/
☐	Ask clients to send their documents at least a week before their in-person appointment. The benefit of receiving documents ahead of the client's appointment include: • It allows you to identify missing information and request that it be brought to the appointment; • It will result in a more efficient (and faster) appointment; • It will allow you to dedicate more appointment time to tax planning instead of pouring over documents and organizer questions; and • If the client is able to transmit their documents electronically (such as through a secure portal), you will save expensive administrative time that would otherwise be spent scanning documents.
☐	Deliver bad news fast, and do it personally. Few things will lose a client faster than informing them of a large balance due to the taxing agencies close to the filing deadline. It's especially bad when the client first learns of the balance due when their finished tax return arrives in the mail. Call or e-mail the client, and notify them of the balance due and the reason for it. This is where a two-year comparison worksheet from your tax software is worth its weight in gold.
	(continued)

<table>
<tr><th colspan="2">Planning Checklist: Practice Management (continued)</th></tr>
<tr><td>☐</td><td>Fire the following clients every year:
• Those on the bottom of your fee scale;
• Those who push deadlines and cause stress; and
• Those whose issues are beyond your area of expertise or that of your staff. For example, if you aren't competent handling foreign reporting issues, send those clients elsewhere.</td></tr>
<tr><td>☐</td><td>Raise your fees every year.</td></tr>
<tr><td>☐</td><td>Make sure you have a data security plan in place and that it is reviewed annually. A sample data security plan can be downloaded from the link on page 11-5.</td></tr>
<tr><td>☐</td><td>For clients who work closely with a financial advisor, consider asking them ahead of time if they would like you to send a copy of their finished income tax return to their financial advisor. Your client will appreciate the effort, and it will help you establish a relationship with a valuable referral source for new clients.
Caution: Only send the tax returns with your client's express written consent, and only send them securely, never by e-mail unless the e-mail is encrypted. Passwords are not the same as encryption.</td></tr>
</table>

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

27. For CTA reporting, which choice best reflects what must be reported and the timing of such reporting?

    a) Applicants and beneficial owners must provide their full legal name, birthdate, residential or business address, and identification documents for confirmation upon request
    b) Companies have six months after the effective date of the final regulations to give their initial reports to FinCEN
    c) Penalties will apply against the beneficial owner, not the person who completes the report, if they willfully provide false information on the report
    d) Companies and individuals can register for a FinCEN identifier to use instead of their identifying information

28. There are new reporting requirements for S corporations and partnerships involving Schedules K-2 and K-3. What are among the details of these requirements?

    a) A partnership or S corporation with no foreign-source income does not need to file Schedule K-2 or K-3
    b) If a domestic partnership has foreign activity, the partnership may still meet the exception for filing the schedules if the foreign activity is limited to passive category foreign income upon which no more than $300 of foreign income taxes that are allowed as a credit are treated as paid or accrued by the partnership, and such income and taxes are shown on a payee statement that is furnished to the partnership
    c) There is a new domestic filing exception for the schedules, which states that, among other requirements, partnerships don't have to complete the schedules if no partners specifically request a Schedule K-3 from the partnership by January 15
    d) A partnership may have a direct partner that is another partnership, corporation, or LLC and qualify for the domestic filing exception for the schedules

29. Which choice correctly identifies a circumstance in which a new Employer Identification Number would not be required?

    a) An existing partnership converts to an LLC classified as a partnership
    b) 40% of the ownership of a partnership, based on interests in capital and assets, changes hands within a 12-month period
    c) A partnership adds locations
    d) A partnership incorporates

 ©2022

30. Which of the following statements is true regarding various foreign tax issues?

    a) For taxable years beginning after December 28, 2021, there is a new jurisdictional nexus requirement when determining if a credit can be claimed for a foreign income tax paid by a nonresident taxpayer
    b) Taxpayers are required to file an FBAR for a foreign account that holds only virtual currency
    c) A U.S. person living abroad can exclude up to $115,000 of foreign-earned income if the taxpayer's home is in a foreign country and they satisfy the physical presence test
    d) FBAR penalties are adjusted annually

SOLUTIONS TO REVIEW QUESTIONS

27. For CTA reporting, which choice best reflects what must be reported and the timing of such reporting? **(Page 5-9)**

    a) Incorrect. Applicants and beneficial owners must provide identifying documents, like an active passport of driver's license.
    b) Incorrect. Companies that are in existence as of January 1, 2024, have until January 1, 2025, to file their first report.
    c) Incorrect. Both the beneficial owner and the person completing the report are subject to penalties.
    d) Correct. The FinCEN ID is designed to help ease reporting company compliance obligations.

28. There are new reporting requirements for S corporations and partnerships involving Schedules K-2 and K-3. What are among the details of these requirements? **(Page 5-12)**

    a) Incorrect. The entity may still need to report information on the schedules, although there is transitional relief for 2021 only.
    b) Correct. This is part of the new domestic filing exception in the updated draft Schedule K-2/K-3 instructions for the 2022 tax year.
    c) Incorrect. The request must be made by February 15.
    d) Incorrect. The list of eligible direct partners does not include any entities other than domestic trusts or estates.

29. Which choice correctly identifies a circumstance in which a new Employer Identification Number would not be required? **(Page 5-24)**

    a) Incorrect. This event would not require the entity to obtain a new EIN.
    b) Incorrect. The threshold requiring a new EIN is 50% change in ownership.
    c) Incorrect. This will not trigger the need for a new EIN, nor will a new EIN be required if the partnership itself changes locations.
    d) Correct. The formation of a new corporation requires a new EIN.

30. Which of the following statements is true regarding various foreign tax issues? **(Page 5-38)**

    a) Correct. The is called an "attribution requirement."
    b) Incorrect. Reporting of virtual currency will be required in the future, but currently a taxpayer doesn't need to file an FBAR unless the account holds assets other than virtual currency.
    c) Incorrect. The exclusion is for up to $112,000 of foreign-earned income, and the taxpayer must satisfy either the physical presence test or the *bona fide* residence test.
    d) Incorrect. FBAR penalties are not adjusted annually but are inflation-adjusted.

 ©2022

This page intentionally left blank.

Chapter 6

California Legislation and Filing Issues

CALIFORNIA LEGISLATION AND FILING ISSUES

LEGISLATION

NEW LEGISLATION OF INTEREST

Tax Bills Enacted in 2022		
Bill No.	**Chapter No.**	**Description**
AB 152	Ch. 22-736	Extends the COVID-19 paid supplemental sick leave mandate for employers with more than 25 employees and establishes grant program for employers with 26 to 49 employees to help cover costs (see page 6-14).
AB 156	Ch. 22-569	Establishes HOPE trust accounts for children in foster care or for certain children whose parent died from COVID-19. Amounts deposited in, earnings from, and any accrued interest in these accounts are excluded from gross income.
AB 158	Ch. 22-737	Enacts a new personal income tax credit for union dues paid (see page 6-16) and makes additional PPP conformity enacted by AB 194 (Ch. 22-55) retroactive to post-2018 tax years (see page 7-2).
AB 192	Ch. 22-51	Authorizes Middle Class Tax "Refunds" (see page 8-1).
AB 194	Ch. 22-55	Omnibus tax bill that: • Partially conforms to Paycheck Protection Program for PPP loans approved after March 31, 2021 (see page 7-2); • Enacts first-time penalty abatement program for individual taxpayers (see page 8-4); • Allows Main Street Hiring Credits to be claimed on amended returns (see page 6-14); • Enacts temporary partial sales and use tax exemption for diesel fuel purchases; • Extends California Competes Tax Credit (see page 6-15); • Makes technical corrections to Homeless Hiring Credit; and • Prohibits offset of California tax refunds for individuals who received Earned Income Tax Credit or Young Child Tax Credit.
AB 195	Ch. 22-56	Provides cannabis tax relief (see page 9-24).
AB 205	Ch. 22-61	Excludes utility company electric and gas COVID-19 arrearage credits from an individual's gross income.
AB 209	Ch. 22-251	Finances sales and use tax "green energy" exclusions for projects that manufacture, refine, extract, process, or recover lithium.
		(continued)

Tax Bills Enacted in 2022 (continued)		
Bill No.	**Chapter No.**	**Description**
AB 1041	Ch. 22-748	Expands the list of individuals for whom an individual can claim unpaid family leave of up to 12 weeks or state-mandated paid sick leave to include individuals designated by the worker.
AB 1249	Ch. 22-749	Excludes PG&E settlements paid to wildfire victims of the 2015 Butte Fire, the 2017 North Bay Fire, and the 2018 Camp Fire (see page 6-11).
AB 1601	Ch. 22-752	Prohibits call center employers of 75 or more employees from claiming any state tax credits for five taxable years if they relocate outside the U.S., effective January 1, 2023.
AB 1654	Ch. 22-638	Requires specified amounts of low-income housing credits to be set aside for farmworker housing projects.
AB 1715	Ch. 22-379	Includes the Space Force in the definition of Armed Forces for various code sections (e.g., Disabled Veterans' Property Tax Exemption).
AB 1854	Ch. 22-112	Extends indefinitely the provision authorizing online applications (and electronic signatures) for the EDD's work sharing program (see page 10-15).
AB 1933	Ch. 22-643	Expands the property tax welfare exemption to eligible nonprofit corporations that build and rehabilitate affordable housing units for sale to low-income families.
AB 2142	Ch. 22-674	Enacts a gross income exclusion for turf replacement rebates and other incentives (see page 6-12).
AB 2216	Ch. 22-896	Conforms to the increased ABLE account contribution levels enacted by the TCJA and makes other ABLE-related technical corrections (see page 6-12).
AB 2431	Ch. 22-331	Clarifies that an LLC Statement of Information must contain a disclosure regarding labor law violations by members of a member-managed LLC.
AB 2453	Ch. 22-286	Authorizes imposition of Ventura County transactions and use tax in excess of the 2% of combined transactions and use tax rate limit.
AB 2622	Ch. 22-353	Extends until January 1, 2026, the sales and use tax exemption for public agency purchases of zero-emission transit buses.
AB 2651	Ch. 22-656	Extends for an additional two years, until January 1, 2027, the community land trust property tax welfare exemption.
AB 2880	Ch. 22-976	Extends the College Access Tax Credit for five years, through the 2027 taxable year (see page 6-13).
		(continued)

Tax Bills Enacted in 2022 (continued)		
Bill No.	**Chapter No.**	**Description**
AB 2887	Ch. 22-248	Increases the amount of the annual sales and use tax exclusions that can be approved by the California Alternative Energy and Advanced Transportation Financing Authority from $100 million to $150 million annually.
AB 2955	Ch. 22-443	Extends the ABC test worker classification exemption for commercial fishers until January 1, 2026, (see page 10-14).
SB 49	Ch. 22-237	Establishes a procedure that allows California corporations to convert in a single step to a business entity organized under the laws of another state (see page 10-21).
SB 113	Ch. 22-3	Tax relief bill that: • Expands eligibility for the passthrough entity elective tax (see page 9-2); • Conforms California law to federal treatment of Restaurant Revitalization Fund grants (full conformity) and Shuttered Venue Operators Grants (partial conformity) (see page 7-6); • Repeals the $5 million business credit limitation and NOL suspension for the 2022 tax year (see page 9-23); and • Provides gross income exclusion for various utility bill credits (see page 6-12).
SB 114	Ch. 22-4	Requires employers with more than 25 employees to provide up to 80 hours of COVID-19 supplemental paid sick leave from January 1, 2022, through September 30, 2022.
SB 154	Ch. 22-43	Suspends SOS new business organization, incorporation, and registration processing fees for the 2022–23 fiscal year (see page 10-21), sets collection and filing enforcement cost recovery fees (see page 10-7), and retains the EITC 85% adjustment factor.
SB 201	Ch. 22-72	Allows qualified taxpayers without earned income to claim the Young Child Tax Credit, enacts a new Foster Youth Tax Credit, and revises the phaseout percentages for the Earned Income Tax Credit (see page 8-15).
SB 440	Ch. 22-299	Authorizes the State Board of Equalization to automatically extend alcoholic beverage filing and payment deadlines for taxpayers located in Governor-declared state of emergency areas.
SB 518	Ch. 22-702	Requires electronic filing of wine and beer tax returns filed with the Board of Equalization and allows public disclosure of return information unless the taxpayer elects to prohibit the disclosure.
SB 851	Ch. 22-705	Revises the Other State Tax Credit (OSTC) calculation for taxpayers claiming both the OSTC and the Passthrough Entity Elective Tax Credit (see page 9-20).
		(continued)

Tax Bills Enacted in 2022 (continued)		
Bill No.	**Chapter No.**	**Description**
SB 951	Ch. 22-878	Extends the increased wage replacement rates for State Disability Insurance and Paid Family Leave and provides for further increases beginning January 1, 2025. Subjects all wages to SDI taxes effective January 1, 2024 (see page 6-18).
SB 967	Ch. 22-170	Adds a new check box to the California personal income tax return asking taxpayers if they are interested in no-cost or low-cost health insurance and allows the FTB to share information with Covered California.
SB 989	Ch. 22-712	Allows until January 1, 2026, deferment of property taxes for taxpayers claiming Proposition 19 base-year value transfers under specified circumstances (see page 10-9).
SB 1041	Ch. 22-225	Extends indefinitely the sales and use tax exemption for certain thrift stores on military bases.
SB 1126	Ch. 22-192	Expands the CalSavers program to include businesses with one or more employees, effective December 31, 2025 (see page 9-42).
SB 1202	Ch. 22-617	Makes various technical corrections to the Corporation Code provision regarding business entities' Secretary of State filing requirements.
SB 1246	Ch. 22-841	Excludes Southern California Edison settlements paid to the wildfire victims of the 2017 Thomas Fire and 2018 Woolsey Fire (see page 6-11).
SB 1312	Ch. 22-228	Amends California's Marketplace Facilitator Act to exempt vehicle rental brokers from the definition of marketplace facilitator.
SB 1340	Ch. 22-425	Extends for two years the new construction property tax reassessment exclusion for solar energy systems (see page 10-7).
SB 1382	Ch. 22-375	Enacts a temporary sales and use tax exemption for low-income taxpayers who purchase a clean energy vehicle through the Clean Cars for All program.
SB 1443	Ch. 22-625	Extends the authority for the California Board of Accountancy through 2024.
		(continued)

Tax Bills Enacted in 2022 (continued)		
Bill No.	**Chapter No.**	**Description**
SB 1496	Ch. 22-474	CDTFA omnibus bill that makes numerous changes, including but not limited to: • Providing automatic filing and payment extension relief for taxpayers living in areas located in Governor-declared states of emergency (see page 10-17); • Postponing until January 1, 2026, the requirement that certain used car dealers begin remitting sales and use taxes to the DMV (see page 10-18); and • Extending for an additional five years the CDTFA's authority to enter into an Offer-in-Compromise (OIC) agreement and clarifies that either the CDTFA or BOE may enter into an OIC related to alcoholic beverage taxes.

Tax Bills Vetoed in 2022	
Bill No.	**Description**
AB 1288	The bill would have revised how low-income housing tax credits were allocated and allowed investors to claim the credits when the construction was completed.
AB 1951	The bill would have replaced the current partial manufacturing sales tax exemption with a full exemption.
AB 2548	The bill would have increased the initial new board recipient seed deposit amount for a CalKids account from $25 to $100.
AB 2847	The bill would have created the Excluded Workers Pilot Program to provide unemployment benefits to those ineligible due to their immigration status.
SB 457	The bill would have enacted a refundable $1,000 tax credit for households with no registered vehicles.
SB 834	The bill would have authorized the FTB to revoke tax-exempt status for organizations involved in treason, insurrection, etc.
SB 944	The bill would have provided additional state subsidies for qualified individuals receiving health care through Covered California.
SB 1374	The bill would have provided a tax deduction for contributions made to the ScholarShare qualified tuition program.

Other Bills of Interest Enacted in 2022		
Bill No.	**Chapter No.**	**Description**
AB 156	Ch. 22-569	Provides wage and hour law equity between sheepherders and goat herders.
AB 1655	Ch. 22-753	Designates Juneteenth (June 19) as a state holiday.
AB 1949	Ch. 22-767	Requires employers with five or more employees to provide up to five days of unpaid bereavement leave, effective January 1, 2023.
AB 2109	Ch. 22-437	Makes it illegal to use any shark bait, lure, or chum to attract any white shark to the shoreline.
AB 2949	Ch. 22-871	Exempts vehicles registered to veterans displaying specialized license plates from paying tolls or related fines.
SB 60	Ch. 22-307	Increases the dollar amount of fines that may be imposed related to residential short-term rental local ordinance violations to $1,500 (first-time violation) up to $5,000 for repeat violations.
SB 379	Ch. 22-356	Mandates most local governments to establish an online, automated residential solar permitting system.
SB 786	Ch. 22-704	Authorizes a county recorder to issue a certified copy of a birth, death, or marriage record by means of blockchain technology.

NOVEMBER 2022 TAX-RELATED BALLOT INITIATIVES

November 2022 Tax-related Ballot Initiatives		
Proposition No.	**Description**	**Result**
26	If approved, this initiative would authorize in-person sports betting at approved privately operated racetracks and tribal casinos on any professional, college, or amateur sport or athletic event (excluding high school sports or events, college events where any California college team participates, and certain horse races). A 10% sports wagering tax on all sports wagers, less the daily total of winnings paid, would be imposed. Fifteen percent of the tax revenues raised would be targeted to address gambling addiction and mental health programs, an additional 15% would be allocated to the state's Bureau of Gambling Control, and the remaining 70% would be deposited in the state's general fund.	Did not pass
27	If approved, Proposition 27 would authorize federally recognized Indian tribes and eligible gaming businesses that contract with the tribes to offer online and mobile sports wagering on sporting events, other than youth sports events. A 10% online sports betting operator surcharge would be imposed on the operators' adjusted gross online sports betting receipts, which are the operator's gross receipts less winnings paid out, voided bets, and federal excise taxes. Revenues raised would first cover regulatory costs. Of the remaining funds, 85% would be targeted to address homelessness and gambling addiction programs, and 15% would be allocated to tribes not involved in online sports betting.	Did not pass
30	If approved, Proposition 30 would, beginning with the 2023 taxable year, impose an additional 1.75% personal income tax on the portion of a taxpayer's taxable income that exceeds $2 million, similar to the current 1% additional tax imposed on taxpayers with taxable income over $1 million. Approval of Proposition 30 would bring the California personal income tax rate to over 15% for individuals with taxable incomes that exceed $2 million. The 1.75% tax would be in effect until 2043 but may be repealed earlier if California's greenhouse gas emissions fall below targeted levels prior to that date. Eighty percent of the funds raised from the new tax would be dedicated to support zero-emission vehicle programs (e.g., electric vehicle rebate programs for low-income individuals and financing of electric vehicle charging stations). The remainder would be dedicated to wildfire response and prevention activities.	Did not pass

TAX BASIS CAPITAL ACCOUNT REPORTING

For 2022 Forms 565 and 568, tax professionals must provide the partners' and members' capital account using California tax basis. This was originally "required" for 2021 returns, but the FTB granted a one-year reprieve and allowed entities to provide their partners' and members' capital accounts using their federal tax basis for the 2021 taxable year. (FTB Notice 2022-01)

Practice Pointer

Partnerships and LLCs must adjust federal tax basis capital account figures to account for California basis differences on their 2022 tax returns (and going forward). This means these entities, and their tax professionals, should start putting these figures together now so when the 2023 filing season kicks in, they are ready and will not be frantically trying to piece these figures together at filing time.

HOW TO RECREATE CALIFORNIA TAX BASIS

The instructions to the Schedule K-1 (565/568) direct the taxpayer to look to the information provided on the partner's tax basis capital account in the instructions for the federal Schedule K-1 (Form 1065). This means taxpayers will make California adjustments to the tax basis capital account numbers reported on the Schedule K-1 (Form 1065).

We know the thought of recreating a partner's California tax basis appears quite daunting, but assuming California is following the federal methods for computing tax basis capital account reporting as the starting point for determining the California tax basis capital account, keep in mind:

- Under the federal rules (which we believe are followed by California), small partnerships are exempt from the requirement. To qualify, the partnership must:
    - Have less than $250,000 gross revenue for the tax year;
    - Have less than $1 million in total assets at the end of the year;
    - Timely file the K-1s (including extensions) with the IRS/FTB and furnish copies to the partners; and
    - Not be required to file a Schedule M-3, Net Income (Loss) Reconciliation for Certain Partnerships;
- Taxpayers may use the federal tax basis figure reported on their federal return as the starting point. This means California recognizes the safe harbors the IRS allowed partnerships to use to recreate tax basis on the federal returns (e.g., the modified outside basis method and the modified previously taxed capital method). Additional information regarding these safe harbors is contained in the Form 565/568 booklets; and
- If the only differences between the federal and California tax basis involve depreciation amounts (e.g., IRC §179 deductions, bonus depreciation, depreciable life differences, etc.), taxpayers may easily convert federal tax basis capital accounts to California tax basis capital accounts by using the federal and California accumulated depreciation balances as of January 1, 2022, and run these figures through the increase (decrease) on Schedule M-2.

 ©2022

Other key differences that may impact California tax basis that will need to be accounted for include:

- Income exempt under California law but not federal law (e.g., California COVID-19 Small Business Relief Grants);
- PPP loan forgiveness for AB 80-ineligible entities and for loans approved after March 31, 2021;
- Charitable contribution amounts;
- Interest income on government bonds;
- Treatment of foreign income;
- Investments in Qualified Opportunity Zones;
- Wage expense deductions related to taking federal and/or state tax credits;
- Different treatment of research expenses on federal and state tax returns;
- Different treatment of independent contractors (if treated as an employee for California tax purposes); and
- Business interest expense (limited on the federal but not the California return for post-2017 tax years).

Comment

The only way to truly and accurately get the basis right is to go back and recalculate basis for each partner starting from the first tax return. That was the point of the IRS's safe harbor methods: They recognized that for older entities, this may be an impossible task. We hope that the FTB will adopt a similar approach for 2022.

REPORTING UNCLAIMED PROPERTY ON CALIFORNIA TAX RETURNS

As a result of AB 466 (Ch. 21-92), enacted in 2021, the FTB added new questions on California business tax returns (Forms 100, 100S, 565, and 568) related to a business's unclaimed property reporting history. For decades, businesses have been required to annually file unclaimed property reports with the California State Controller's Office, and failure to do so can result in significant interest and fines being imposed.

NEW TAX RETURN QUESTIONS

Businesses must now respond to the following questions on their California tax returns:

1. Has this business entity previously filed an unclaimed property Holder Remit Report with the State Controller's office?
2. If "Yes," when was the last report filed (mm/dd/yyyy)?
3. What is the amount last remitted?

✐ **Practice Pointer**

Tax professionals may want to consider adding these questions to their client organizer list.

WHO MUST FILE UNCLAIMED PROPERTY REPORTS?

In general, California businesses, banking and financial institutions, life insurance corporations, and other business entities holding unclaimed financial assets belonging to another person are

required to file a report with the California State Controller's Office if the item has been held by the entity for longer than the dormancy period for that item, which is usually three years. Examples include:

- Any dividend, profit, distribution, interest, or payment on principal owed to a shareholder that has not been claimed within three years;
- Vendor payments;
- Wages, salaries, commissions, and similar items that remain unclaimed by the owner for more than one year; and
- Intangible property like rebates that are unclaimed for more than three years.

A business has to file two different reports with the Controller's Office: a Holder Notice report on November 1 and a Holder Remit Report and Remittance of Property the following year between June 1 and June 15. Different dates apply to insurance companies.

UNCLAIMED PROPERTY VOLUNTARY DISCLOSURE PROGRAM

Businesses should expect to see an increase in unclaimed property audits due to the addition of these questions on business tax returns. AB 2280, which was enacted in 2022, establishes a new Unclaimed Property Voluntary Disclosure Program that will waive interest for taxpayers who voluntarily come into compliance. (AB 2280 (Ch. 22-282)) The program is effective January 1, 2023, but is dependent on the Legislature appropriating money for the program. However, funding for the program was not included in this year's budget agreement, so it will likely not be implemented until later in 2023. According to AB 2280's author, it is estimated that 1.3 million businesses that file tax returns with the FTB have failed to report unclaimed property in their possession.

Get audit-ready now

It's important to let your business clients know about the increased likelihood of unclaimed property audits in the future and that now is a good time to review whether they are compliant with their reporting/remitting requirements.

FTB DISCLOSURES

AB 466 also grants the FTB the authority to share the information from the new form questions with the State Controller's Office as part of a statewide effort to boost compliance with the business's unclaimed property reporting. The FTB is also authorized to share with the State Controller the taxpayer's:

- Entity status and the date the FTB last updated the taxpayer's entity status; and
- Revenue range, which is the entity's net income (for corporations), ordinary income (for partnerships), total income (for LLCs), or total gross receipts (for nonprofits). (R&TC §19554)

COST OF NONCOMPLIANCE

Businesses that, without reasonable cause, fail to comply with the reporting requirements outlined in the box are subject to interest at the rate of 12% on the value of the property that should have been reported, paid, or delivered. (Cal. Code Civ. Proc. §1577) The interest is capped at $10,000 if the holder timely pays or delivers the property but fails to "substantially comply" with the reporting requirements.

 ©2022

A business that willfully fails to comply is subject to additional fines of $100 per day for each day the report is withheld, or the duty not performed, up to a $10,000 cap. Businesses that refuse to pay or deliver escheated property to the SCO are subject to fines of $5,000 to $50,000. (Cal. Code Civ. Proc. §1576)

VOLUNTARY COMPLIANCE PROGRAM

Once the program becomes operational, a business holding unreported unclaimed property may apply to the State Controller's Office to participate in the Unclaimed Property Voluntary Disclosure Program if it:

- Is not currently involved in or been notified of an unclaimed property audit;
- Is not the subject of a civil or criminal prosecution related to the unclaimed property law;
- Has an unpaid interest assessment from a notice issued within the last five years (businesses can apply for the program after paying the interest assessment); and
- Has had an interest assessment waived within the last five years.

The Controller's Office has full discretion as to whether to accept an applicant. If accepted into the program, the business must comply with the following to have the interest assessment waived:

- Complete the Controller's Office's unclaimed property educational training program within three months of enrollment in the Unclaimed Property Voluntary Disclosure Program;
- Review their books and records for unclaimed property for at least the previous 10 years;
- Make reasonable efforts to notify owners of reportable property by mail or electronically, no less than 30 days prior to submitting the report described immediately below;
- File a report with the Controller's Office regarding any unclaimed property discovered during the review within six months of enrolling in the program (up to 18 months if an extension is granted); and
- File an updated report within 7½ months of enrolling in the program and remitting all identified escheated property to the Controller's Office.

WILDFIRE SETTLEMENT EXCLUSION

AB 1249 (Ch. 22-749) and SB 1246 (Ch. 22-841) excludes from gross income, for both personal income and corporation franchise tax and income tax purposes, settlements paid by PG&E and Southern California Edison to qualified taxpayers who were victims of the following wildfires:

- 2015 Butte Fire;
- 2017 North Bay fires and Thomas Fire; and
- 2018 Woolsey and Camp fires.
  (R&TC §§17138.5, 17138.6, 24309.1, 24309.3)

The exclusions apply to all taxpayers who owned real property or resided in the impacted counties and paid or incurred expenses and received amounts from the settlements. For purposes of the Thomas and Woolsey fires only, it also includes wildfire victims that had a place of business in Los Angeles, Santa Barbara, and Ventura counties that paid or incurred expenses and received amounts from the settlements.

PG&E and Southern California Edison are directed to provide to the FTB, upon request, documentation of the settlement payments.

The exclusion is applicable to pre-2028 tax years (for pre-2026 tax years for Thomas and Woolsey Fire settlement payees). Taxpayers who already filed returns reporting these settlements may file a claim for refund or credit.

If the statute of limitations for filing a claim for a credit or refund of any overpayment of tax that would result from the application of this bill's provisions has expired, a qualified taxpayer is permitted to file a claim before the close of the one-year period from September 30, 2022 (the effective date of the bills).

TURF REPLACEMENT REBATE EXCLUSION

AB 2142 (Ch. 22-674) excludes from gross income for both personal income and corporation franchise and income taxes any amount received from a turf replacement water conservation program in the form of a rebate, voucher, or other financial incentive that is issued by a public water system, local government, or state agency. (R&TC §§17138.2, 24308.9) The exclusion applies for taxable years beginning on or after January 1, 2022, and before January 1, 2027.

WATER AND UTILITY PAYMENT EXCLUSION

For the 2021 through 2025 tax years, SB 113 (Ch. 22-3) also excludes from gross income bill credits or credits received by a customer for water, wastewater, gas, and electric utility payments related to the COVID-19 pandemic under:

- The California Arrearage Payment Program; and
- The California Water and Wastewater Arrearage Payment Program.
  (R&TC §§17131.16, 17131.17, 24308.4, 24308.5)

A similar personal income tax exclusion was enacted by AB 205 (Ch. 22-61) for credits or credits received by a customer for electric and gas bill arrearages during the 2022 through 2026 taxable years. (R&TC §17131.20)

Comment

AB 205 refers to these payments as payments made related to the COVID-19 "disaster" pursuant to IRC §139. Consequently, we believe these payments are excluded from federal gross income as well.

ABLE ACCOUNT CONTRIBUTION LIMITS

AB 2216 (Ch. 22-896) conforms to the TCJA provision that allows aggregate annual contributions to a single ABLE account to exceed the annual gift tax exclusion amount ($16,000 for 2022). Effective January 1, 2023, a designated beneficiary may make additional contributions to their own ABLE account up to the lesser of:

- Their compensation includible in gross income for the tax year; or
- The federal poverty line for a one-person household for the year ($13,590 for 2022).
  (Welf. & Inst. Code §4879(b)(2))

©2022

For federal purposes, the TCJA applies these additional contribution allowances for tax years beginning after December 22, 2017, and before January 1, 2026. California's increased contribution provisions apply indefinitely.

Prior to AB 2216, California did not conform to the increased contribution provisions. While CalABLE accounts limited contributions to the annual gift tax exclusion amounts, other states allowed excess contributions in conformity with the TCJA. Taxpayers were required to include income from those accounts on their beneficiary's California return. With the enactment of AB 2216, the beneficiary will no longer be required to include income from these excess contributions to other state's ABLE accounts on their California returns.

AB 2216 also:

- Clarifies that the beneficiary of a CalABLE account may make a change in the successor beneficiary of their account to take effect upon the death of the original beneficiary; and
- Modifies the state's cost recovery protections for Medicaid plans to disallow collection activities only for CalABLE accounts and not for those formed outside of California, for accounts established on or after January 1, 2023.
  (Welf. & Inst. Code §4885)

ABLE accounts

An ABLE account provides a tax-advantaged savings plan for disabled individuals. (IRC §529A) They are closely modeled on IRC §529 Qualified Tuition Plans (QTPs).

Like QTPs, contributions to §529A plans are not deductible, but earnings are tax-free (as are qualified distributions).

Under the ABLE program, a §529A plan may be set up for an eligible individual who will generally be the only individual allowed to take distributions from the account. An eligible individual is one who, during the tax year, has certain specified disabilities.

COLLEGE ACCESS TAX CREDIT EXTENDED

AB 2880 (Ch. 22-976) extends the College Access Tax Credit against personal income tax and corporation franchise and income taxes for an additional five years, through the 2027 taxable year. (R&TC §§12207, 17053.87, 23687)

The College Access Tax Credit enables taxpayers to claim up to 50% of cash contributions made to the College Access Tax Credit Fund. The fund provides support for the CalGrants program to provide educational financial aid to low and middle-income students.

A charitable contribution deduction may not be claimed on the California return for the amount of the credit claimed.

Caution

Under Treas. Regs. §1.170A-1(h)(3), no federal charitable contribution deductions may be claimed for payments made to charitable or governmental entities if the taxpayer claims a state or local tax credit in excess of 15% for the payments.

APPLYING FOR THE CREDIT

Taxpayers must first apply for the credit and make a donation through the California Education Facilities Authority (CEFA). CEFA is taking applications for the 2022 tax credit up until 5 p.m. on January 2, 2023. Applications can be made at:

Website
www.treasurer.ca.gov/cefa/catc/

Once the credit is approved, CEFA will send the taxpayer a College Access Tax Credit certification.

CLAIMING THE CREDIT

Taxpayers claim the credit by attaching FTB Form 3592, College Access Tax Credit, to their tax return.

The credit can reduce tax below the tentative minimum tax. Unused credit may be carried forward for up to six years.

COVID-19 PAID SUPPLEMENTAL SICK LEAVE

AB 152 (Ch. 22-736) extends the mandate for employers with more than 25 employees (both full and part-time) to provide up to 80 hours of COVID-19 supplemental paid sick leave through December 31, 2022, with modifications allowing the employer to require additional testing under certain circumstances. (Labor Code §§248.6, 248.7) The mandate was previously scheduled to expire on September 30, 2022. (Labor Code §248.6 et seq.)

The bill also authorizes California Small Business and Nonprofit COVID-19 Supplemental Paid Sick Leave Grants of up to $50,000 to qualified businesses and certain nonprofits that have between 26 to 49 employees to compensate them for their costs of providing the COVID-19 supplemental paid sick leave to their employees during 2022. (Gov't. Code §12100.96 et seq.) Like the earlier COVID-19 Relief Grants of up to $25,000 provided by the state, these grants are excludable from California gross income. (R&TC §§17158, 24312)

However, the legislation does not allow for expenses paid with these grants to be deducted. Under California law, deductions are not allowed for expenses paid with tax-exempt income. (R&TC §§17280, 24425)

MAIN STREET SMALL BUSINESS TAX CREDIT REQUIREMENTS EASED

AB 194 (Ch. 22-55) allows taxpayers to claim the 2020 and 2021 Main Street Small Business Tax Credit on an amended personal or corporate tax return. (R&TC §§17053.71, 17053.72.1, 23267.1, 23628)

These credits were designed to provide hiring incentives (up to $1,000 for each net increase in qualified full-time equivalent employees) to small- and medium-sized businesses that suffered significant economic losses during the COVID-19 pandemic. Unfortunately, many taxpayers inadvertently lost out on receiving the credits.

 ©2022

Many taxpayers received the required tentative credit reservation from the CDTFA but failed to claim the credit on a timely filed, original personal income or corporation franchise or income tax return, as was originally required by statute.

AB 194 allows these taxpayers to file amended 2020 or 2021 tax returns to receive these credits.

Practice Pointer

According to the FTB, Form 100X and Schedule X can accommodate amended returns for the AB 194 retroactive changes to the Main Street Small Business Tax Credits. The FTB is in the process of revising the 2020 and 2021 Form FTB 3866, Main Street Small Business Tax Credit. The changes will be instructional only. There will be no changes to the physical form or field calculations.

CALIFORNIA COMPETES TAX CREDIT EXTENDED

AB 194 (Ch. 22-55) also extends the California Competes Tax Credit by five years, through the 2027–28 fiscal year, and expands certain factors GO-Biz may consider when awarding the credit. The aggregate amount of credit available is $180 million per each fiscal year. (R&TC §§17059.2, 23689)

The California Competes Tax Credit (CCTC) is a nonrefundable credit against corporate franchise and personal income taxes that is available to new and growing California businesses or businesses that are considering terminating or leaving California. (R&TC §§17059.2, 23689) The credit may reduce the regular tax below the tentative minimum tax. (R&TC §§17039(c), 23036(d))

The credit is awarded on a competitive basis. Taxpayers apply in advance for the credits and the actual credit terms are negotiated in a credit agreement with the Governor's Office of Business and Economic Development (GO-Biz). The agreement is then approved or rejected by the California Competes Tax Credit Committee, which is comprised of the State Treasurer, the Director of Finance, and the GO-Biz Director (or their designated representatives), and one appointee each from the California Assembly and the Senate. (R&TC §§17059.2, 23689)

Taxpayers are not required to be located in any specific geographic zone to qualify for the credit.

Details concerning the credit and the application process are available at:

Website
https://business.ca.gov/california-competes-tax-credit/

HOMELESS HIRING TAX CREDIT

For the 2022 through 2026 tax years, employers may claim a credit of up to $10,000 per qualified employee for hiring individuals who are currently or were recently homeless or who recently received supportive services from a homeless services provider. (R&TC §§17053.80, 23629) The credit is capped at $30,000 per taxpayer.

To qualify, the employer must pay California wages equal to at least 120% of the state minimum wage and must obtain and provide to the FTB, upon request, a certification from a designated homeless services provider. Certification is provided on Form 5020, Homeless Hiring Tax Credit

Certificate, which is available on the FTB's website. The employer must also reserve the credit with the FTB within 30 days of hiring the individual or within 60 days of receiving a new certification from the homeless services provider.

The credit is claimed on Form 3831, Homeless Hiring Tax Credit.

Details concerning the credit are available at:

Website
www.ftb.ca.gov/file/business/credits/homeless-hiring-tax-credit/index.html

CALIFORNIA HISTORIC REHABILITATION TAX CREDIT HAS BEEN FUNDED

Beginning with the 2022 tax year, taxpayers may claim a credit of between 20% to 25% of the qualified costs incurred in the rehabilitation of certified historic structures. (R&TC §§17053.91, 23691) The credit was enacted earlier, but funding for the credit was not provided until 2022.

The program is administered by the Office of Historic Preservation and the California Tax Credit Allocation Committee, which are currently developing regulations, guidelines, and application forms for the credit. This process was targeted for completion by the third quarter of 2022. Taxpayers will have to apply for a credit allocation. Applications are expected to be accepted in late 2022 or early 2023.

The credit is capped at $50 million annually, $10 million of which will be set aside for rehabilitation projects for qualified residences and for rehabilitation projects with qualified expenditures of less than $1 million.

Taxpayers allocated a credit will claim the credit on Form FTB 3835, State Historic Rehabilitation Tax Credit, and use credit code 243.

WORKERS' TAX CREDIT

Beginning with the 2024 taxable year, qualified taxpayers may claim a refundable personal income tax credit equal to the greater of:

- Dues or dues equivalents paid to a *bona fide* labor organization multiplied by the Workers' Tax Credit adjustment factor; or
- The dollar amount of dues paid during the year, up to $100 (adjusted annually). (AB 158 (Ch. 22-737); R&TC §17053.75)

QUALIFIED TAXPAYER

A qualified taxpayer is an individual who is represented for purposes of collective bargaining by, and who pays dues or dues equivalents to, a *bona fide* labor organization and:

- Has wages subject to California personal income tax withholding;
- Is an in-home supportive services (IHSS) provider; or
- Is a provider of waiver personal care services.

WORKERS' TAX CREDIT ADJUSTMENT FACTOR

The Workers' Tax Credit adjustment factor is zero unless otherwise specified in the annual state budget.

TOP REASONS FOR FTB E-FILE REJECTIONS

At a recent FTB presentation on e-file and substitute forms, the FTB reported on the top reasons why e-filed returns are rejected.

BUSINESS ENTITIES

The 2021 filing season saw 36,000 rejections, which, compared to last year's 19,000, is an increase of 90%. The most common issues for business entity returns were:

1. The state return version that was filed does not match the FTB's version of the form. Contact the software provider to resolve this error as they likely do not have the most current version of the form. This type of error was up 123% from the previous filing season.
2. Form 565, Partnership Return of Income, rejections due to returns being submitted with all zeroes, all nines, or some variation of this in the California entity ID field. This field is optional. If the entity does not have an SOS number, they only need to provide their FEIN. This type of error was up to 3,960 rejections from the 23 rejections of the previous filing season.
3. The federal return version that was filed does not match the IRS version of the form. Contact the software provider to resolve this error.
4. The Electronic Funds Withdrawal requested date for a stand-alone EFW payment request cannot be more than five days prior to the received date of when the request was processed by the FTB.
5. On Form 568, Limited Liability Company Return of Income, if the "Disregarded Entity" box on question U1 is checked "No," then Schedule K must be attached.

INDIVIDUALS AND FIDUCIARIES

The 2021 filing season saw 495,000 rejections, which is down 40% from the 823,000 rejections the prior year. The most common issues for these returns were:

1. The state return version that was filed does not match the FTB's version of the form. Contact the software provider to resolve this error as they may not have the most current version of the form.
2. The primary taxpayer's submitted prior-year AGI does not match the FTB's records. This type of error was up 76% from the previous filing season. The taxpayer can log in to their MyFTB account to verify their prior-year AGI or e-file by signing Form 8453-OL, California Online e-file Return Authorization for Individuals.
3. Duplicate return rejections stemming from the taxpayer's SSN matching a previously accepted return, without the "superseded return" or "amended return" box being checked.
4. The spouse's submitted prior-year AGI does not match the FTB's records. The taxpayer can log in to their MyFTB account to verify their prior-year AGI or e-file by signing Form 8453-OL.
5. The e-file system has identified a return as being a duplicate of a previously accepted return. If the only change is to the Social Security number, do not resubmit. Instead, to resolve this error contact the FTB's e-Programs Customer Service at (916) 845-0353.

NEW PERSONAL INCOME TAX RETURN CHECKBOXES

Beginning with the 2022 tax return, the FTB has added a new voter registration information checkbox on the tax return that directs taxpayers to check the box if they would like voter registration information.

SB 967 (Ch. 22-170) directs the FTB to add a new checkbox to the 2023 California personal income tax return filed in 2024 that asks taxpayers if they are interested in no-cost or low-cost health insurance and allows the FTB to share the following taxpayer information with the California Health Benefit Exchange for taxpayers that indicate an interest:

- Name;
- Mailing address;
- Number and age of dependents; and
- Gross income.
  (R&TC §§18543, 19548.9)

The Exchange is the state agency that administers Covered California.

SDI BENEFIT AMOUNTS AND TAX BASE EXPANDED

SB 951 (Ch. 22-878):

- Repeals the wage ceiling for contributions into the SDI fund. This means all wages paid will be subject to the SDI tax, effective January 1, 2024 (UIC §985). The SDI rate for 2023 is 0.9% with a maximum wage base of $153,164 and maximum amount to withhold of $1,378.48. Starting in 2024, wages in excess of the current wage base ($153,164 for 2023) will be subject to the SDI tax;
- Extends the existing wage replacement rates for the State Disability (SDI) and Paid Family Leave programs, which provide a 60-70% wage replacement rate through 2024 (previously scheduled to sunset January 1, 2023) (UIC §2655); and
- Revises the formula for determining the SDI and Paid Family Leave benefits for claims commencing after 2024 to provide an increased wage replacement rate, ranging from 70-90% based on the individual's wages earned. (UIC §§2655, 3301)

State Disability Insurance (SDI) Withholding Rate			
Year	**Rate**	**Maximum wage base**	**Maximum payment**
2022	1.1%	$145,600	$1,601.60
2023	0.9%	$153,164	$1,378.48

 ©2022

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Which choice is true regarding reporting unclaimed property in California?

    a) A business is required to file two reports to the California State Controller's office: a Holder Notice report on November 1 and a Holder Remit Report and Remittance of Property the next year between June 1-15
    b) The FTB has added new questions to California returns, including Forms 540, 100, 565, and 568, related to unclaimed property
    c) Effective January 1, 2024, there is a new Unclaimed Property Voluntary Disclosure Program, which waives interest in cases where taxpayers voluntarily comply with reporting requirements
    d) Business that fail to comply with the reporting requirements are subject to 10% interest on the value of the property that should have been reported, capped at $10,000

2. Which of these statements is true as it pertains to various state credits?

    a) The College Access Tax Credit cannot reduce tax below the tentative minimum tax
    b) For the California Competes Tax Credit, taxpayers must be located in low-income zones to qualify
    c) Beginning in 2024, qualified taxpayer may claim a refundable personal income tax credit up to the dollar amount of dues paid for the year
    d) For the Homeless Hiring Tax Credit, the employer must pay California wages of at least 120% of the state minimum wage

 ©2022

SOLUTIONS TO REVIEW QUESTIONS

1. Which choice is true regarding reporting unclaimed property in California? **(Page 6-10)**

   a) Correct. This is true for business entities holding unclaimed financial assets that belong to another person, although the dates may be different for insurance companies.
   b) Incorrect. The forms are 100, 100S, 565, and 568 specifically pertaining to a business's unclaimed property.
   c) Incorrect. The effective date is January 1, 2023. There was no funding for the program in the budget agreement, so the program probably won't be implemented until later in 2023.
   d) Incorrect. The interest rate is 12% of the value of the property.

2. Which of these statements is true as it pertains to various state credits? **(Page 6-15)**

   a) Incorrect. This credit can reduce tax below the tentative minimum tax.
   b) Incorrect. There is no requirement that a taxpayer be located in a specific zone.
   c) Incorrect. The credit equals the greater of dues paid to a *bona fide* labor organization multiplied by the worker's tax credit adjustment factor or the dollar amount of dues paid for the year, up to a maximum of $100.
   d) Correct. The employer also must provide the FTB, if requested, a certification from a designated homeless services provider.

 ©2022

Chapter 7

California Conformity

CALIFORNIA CONFORMITY

STUDENT LOAN FORGIVENESS

As discussed on page 1-12, under the President's Student Loan Debt Relief Plan announced on August 24, 2022, the Department of Education will forgive up to $20,000 of federal student loan debt for qualified borrowers who received Pell Grants, and $10,000 for all others.

The American Rescue Plan Act expanded the COD exclusion to apply to all student loans forgiven during the 2021–2025 tax years, so this latest round of forgiveness will not be taxed as COD income for federal purposes. Unfortunately, California does not conform to this provision of the American Rescue Plan Act.

CALIFORNIA'S EXCLUSION

Unless legislation is enacted to conform California law to the expanded exclusion enacted by the ARPA, for California purposes, the COD exclusion is limited to specified discharges of student debt. (R&TC §§17131, 17132.11, 17134, 17144.8) If the taxpayer doesn't meet one of these specified student loan exemptions, then the COD income is taxable on the California return unless the taxpayer qualifies for the general IRC §108 insolvency or bankruptcy COD exclusions.

California allows an exclusion from gross income for student loan debt excluded under federal law prior to its amendment by the ARPA, including:

- Loans forgiven due to the student working for a certain period of time in certain professions for any of a broad class of employers (for example, as a doctor in certain underserved areas);
- Loans refinanced by education institutions or tax-exempt organizations if the refinancing organization requires the student to perform public service work; and
- Loan payments made by the National Health Service Corps Loan Repayment Program and certain State Loan Repayment Programs.

California law also excludes student loans discharged due to the student's death or disability or cancelled or repaid under the income-based repayment programs administered by the U.S. Department of Education. (R&TC §§17132.11(a), 17144.8)

In addition, for loans discharged prior to 2024, California excludes loans discharged:

- Because the individual successfully asserts that the school did something wrong or failed to do something that it should have done or because the individual could not complete a program of study due to the school closing;
- For students of Brightwood College who attended on or before December 5, 2018, if the discharge is made in connection with attending that school; and
- For students of The Art Institute of California, if the discharge is made in connection with attending that school.

Previously, California also allowed an exclusion of loans cancelled under the Income Contingent Repayment Plan, the Pay As You Earn Repayment Plan, and the Revised Pay As You Earn Repayment Plan, which are administered by the U.S. Department of Education. But this exclusion only applied to loans discharged after 2016 and before 2022. (20 U.S.C. §1087e(e); R&TC §17132.11(b))

PPP LOAN FORGIVENESS PARTIAL CONFORMITY

California excludes PPP loan forgiveness amounts from taxable income and will allow deductions for amounts paid with forgiven PPP debt. (AB 1577 (Ch. 20-39); AB 80 (Ch. 21-17)) However, under AB 80 to qualify to take the deductions for expenses paid with the forgiven loan amounts, a business must demonstrate at least a 25% reduction in gross receipts during specified periods.

POST-MARCH 2021 LOANS

AB 80 did not conform to the federal exclusion of forgiven amounts for PPP loans approved after March 31, 2021, because at the time AB 80 was enacted, "covered loans" eligible for PPP loan forgiveness did not include these loans. The federal Paycheck Protection Program Extension Act of 2021 (PPPEA) expanded the definition of "covered loans" to include loans approved after March 31, 2021, and in June 2022 AB 194 (Ch. 22-52) was enacted, which retroactively conformed California law to incorporate the PPPEA's expanded definition of a covered loan to post-2021 taxable years. AB 158 (Ch. 22-737) makes the conformity to the PPPEA loan forgiveness retroactive to tax years beginning on or after January 1, 2019.

Practice Pointer

Taxpayers that filed 2020 or 2021 tax returns prior to AB 194's enactment and included the PPP loan forgiveness of loans approved after March 31, 2021, as taxable cancelation of debt (COD) income should consider filing amended returns to exclude this income.

Just like PPP loans approved prior to April 1, 2021, to qualify to deduct expenses paid with forgiven PPP loan amounts for loans approved after March 2021, a business must demonstrate at least a 25% reduction in gross receipts.

25% gross receipts threshold

The 25% gross receipts reduction requirement is a cliff test. If a taxpayer has less than a 25% gross receipts reduction (discussed in more detail below), then they are ineligible to take any deductions for expenses paid with the forgiven PPP loan amount.

The 25% gross receipt reduction requirement contained in AB 80 piggybacks on the PPP second draw loan provision contained in the Consolidated Appropriations Act of 2021. However, the bill does not include any of the other restrictions from that provision, such as an employee limit.

The FTB has stated that they will follow the SBA's guidance on interpreting who qualifies for the 25% gross receipts reduction. The SBA guidance can be found at:

Website
https://home.treasury.gov/system/files/136/Second-Draw-PPP-Loans--How-Calculate-Revenue-Reduction-Maximum-Loan-Amounts-Including-Documentation-Provide1192021.pdf

Website
www.sba.gov/sites/default/files/2021-07/FINAL%20IFR%20Forgiveness%207.23.21-508.pdf

 ©2022

WHEN DO WE MEASURE GROSS RECEIPTS?

The FTB follows the SBA's guidance regarding gross receipts calculations and which periods taxpayers must use to measure the reduction in gross receipts:

- Taxpayers may compare any quarter in 2020 to the comparable quarter in 2019. Alternatively, they can compare the gross receipts from calendar-year 2020 to the gross receipts from calendar-year 2019;
- For entities not in business during the first and second quarters of 2019 but in operation during the third and fourth quarters of 2019, taxpayers must demonstrate that gross receipts in any quarter of 2020 were at least 25% lower than during either the third or fourth quarters of 2019;
- For entities not in business during the first, second, and third quarters of 2019 but in operation during the fourth quarter of 2019, taxpayers must demonstrate that gross receipts in any quarter of 2020 were at least 25% lower than the fourth quarter of 2019; and
- For entities not in business during 2019 but in operation on February 15, 2020, taxpayers must demonstrate that gross receipts in the second, third, or fourth quarter of 2020 were at least 25% lower than the first quarter of 2020.

All taxpayers will measure these amounts using calendar-year quarters, even if they are fiscal-year taxpayers.

Comment

The comparison period is still 2020 versus 2019 even if the loan was approved, received, and/or forgiven in 2021 or 2022.

Change of entity classification

The FTB is following SBA guidance for businesses that have changed entity classification. Those entities will use 2019 gross receipts under the prior entity classification for purposes of these calculations.

WHAT DOCUMENTATION IS REQUIRED?

The FTB has confirmed that there will not be any additional forms or certifications to demonstrate the drop in gross receipts. And nothing will be filed with the California return to verify the 25% gross receipts reduction. However, taxpayers should maintain the necessary documents to substantiate their certification of a 25% gross receipts reduction in case of an audit.

The drop in gross receipts can be supported using any of the following:

- Quarterly financial statements;
- Quarterly or monthly bank statements; or
- Annual IRS income tax filings of the entity (required if using an annual reference period).

Cash versus accrual

Many practitioners have asked if they are required to use cash or accrual basis documentation. The SBA guidance does not specifically address this but does state that taxpayers may use financial statements, bank statements, or their tax returns to document the reduction.

WHEN ARE DEDUCTIONS REDUCED?

The FTB has confirmed that although Revenue Ruling 2020-27 has been made obsolete for federal purposes, California still conforms to the underlying principles of the guidance for those taxpayers that are ineligible to deduct expenses paid with the forgiven PPP loan amounts. That means borrowers that had a reasonable expectation of PPP loan forgiveness in the future were required to reduce deductions in the year the expenses were paid, even if the forgiveness happened in a later year.

This means 2021 expenses paid with loans issued in 2021 are not deductible on the 2021 return. This is true even if the taxpayer did not file their forgiveness applications or have them approved until 2022.

Example of "reasonable expectation"

Dandy Lions, Inc., an animal training company, received a $30,000 loan in early May 2021. They used a 12-week covered period and used all $30,000 for payroll expenses in May, June, and July of 2021.

Dandy did not apply for loan forgiveness until late 2021, and the loan forgiveness was approved in March 2022.

Dandy did not meet the 25% gross receipts reduction threshold, so it is required to reduce its 2021 wage deduction by the $30,000 paid with the forgiven PPP debt.

When Dandy filed its 2021 return, it did not reduce its wage expenses. Dandy must file an amended return and reduce its wage expense deduction because at the time it filed its 2021 return, it had a reasonable expectation that its loan forgiveness application would be approved because it had used all of the PPP loan on expenses that qualified for loan forgiveness.

WHERE ARE THE ADJUSTMENTS MADE?

Taxpayers that do not meet the 25% gross receipts threshold must make an adjustment on their California return. The adjustments are made by reporting the disallowed deductions as follows:

- **For sole proprietorships:** On the Schedule CA (540), Part I, Sec. B, line 3, column C;
- **For partnerships and LLCs taxed as partnerships:** Reduce the deductions (e.g., wages, guaranteed payments, rent, utilities, etc.) as appropriate on the Form 565/568 and in column C of the corresponding line of the K-1 (we know this sounds strange, but this is what the FTB guidance says);
- **For C corporations:** Include the reduced deduction amounts on line 8, "other additions," and attach a schedule; and
- **For S corporations:** Include the reduced deduction amounts on line 7, "other additions," and attach a schedule. As with partnerships/LLCs, the adjustment to the deductions flow through to the shareholder as a column C adjustment on the applicable K-1 line.

 ©2022

WHAT IF WE ALREADY FILED?

Taxpayers that already filed their 2021 returns but now face changes to those returns due to AB 194's inclusion of post-March 31, 2021, loans must file amended returns. This is true for taxpayers that:

- Included the COD income in their taxable income and now qualify to exclude it; or
- Did not meet the 25% gross receipts threshold reduction and deducted expenses paid with the forgiven PPP loan amounts.

ARE SCHEDULE C BORROWERS REQUIRED TO REDUCE DEDUCTIONS?

Schedule C borrowers with no employees are not required to reduce their expense deductions to the extent the borrower applied all funds to payroll. This is true even if these taxpayers do not have a 25% drop in gross receipts. Because the loans were issued to replace net Schedule C income from 2019, these taxpayers were not required to issue payroll checks to themselves for their loans to be forgiven and for loan amounts to be allocated to payroll.

Schedule C borrowers with no employees who use borrowed funds to pay interest, rent, or utilities must reduce these deductions in an amount equal to the expenses paid with such funds.

Comment

We believe the same reasoning would apply to guaranteed payments to partners who are subject to self-employment tax.

WHAT ABOUT MULTISTATE TAXPAYERS?

Multistate taxpayers must apply any deduction reductions to total preapportioned income and must reduce the deductions by all expenses paid with forgiven PPP debt, even if they were not California expenses. They then apply their apportionment formula to the adjusted income amount.

Example of multistate taxpayer

Multistate Corp. operates across the United States. They have preapportioned taxable income of $1 million, and 30% of their sales were in California. Multistate received a $400,000 PPP loan, which was fully forgiven. They do not meet the 25% drop in gross receipts test, and they estimate that only 10% of those funds were used for California expenses.

Preapportioned taxable income	$1,000,000
Expenses paid with forgiven PPP debt	400,000
Adjusted preapportioned income	1,400,000
Percentage of sales in California	30%
California taxable income	$ 420,000

CONFORMITY TO PPP LOAN FORGIVENESS BASIS ADJUSTMENTS

The FTB has stated that because California follows the federal treatment, they will follow Rev. Proc. 2021-48 for these loans and Rev. Proc. 2021-49, which are retroactive to taxable years ending after March 27, 2020 (the date the CARES Act was enacted).

Rev. Proc. 2021-48 gives taxpayers the option to treat the tax-exempt income from the forgiveness of PPP loans as received or accrued:

- When eligible expenses are paid or incurred;
- When an application for PPP loan forgiveness is filed; or
- When PPP loan forgiveness is granted.

Providing taxpayers the option to choose when to declare the tax-exempt income gives taxpayers the flexibility to increase their basis in the year(s) when losses are highest, enabling the passthrough entity owners to maximize their ability to claim losses on their returns. Taxpayers may make different choices on their federal and California returns.

Rev. Proc. 2021-49 clarifies how these basis adjustments are allocated to partners, shareholders, and parent corporations of consolidated groups.

CONTINUING NONCONFORMITY

California still does not conform to the American Rescue Plan Act's expansion of PPP loan eligibility to include certain nonprofit entities and certain internet publishing companies. Consequently, loans made to such entities that qualify for loan forgiveness do not qualify for the California exclusion. Loans made to these entities that are forgiven will be treated as COD income, and expenses paid with these forgiven loans are deductible.

ADDITIONAL PANDEMIC RELIEF CONFORMITY

RESTAURANT REVITALIZATION FUND GRANTS

SB 113 (Ch. 22-3) fully conforms to the federal treatment of Restaurant Revitalization Fund grants, retroactive to taxable years beginning on or after January 1, 2020. This means the grants are excludable from gross income, and expenses paid with the grants are fully deductible. Under both federal and California law, no deduction may be denied, no tax attribute reduced, and no basis increase denied by reason of the exclusion. (R&TC §§17158.2, 24308.2)

> ***Comment***
>
> Unlike California's partial conformity to PPP loan forgiveness and Shuttered Venue Operators Grants, there is no 25% gross reduction threshold for taxpayers to qualify to fully deduct expenses paid with Restaurant Revitalization Fund grants.

SHUTTERED VENUE OPERATOR GRANTS

Retroactive to taxable years beginning on or after January 1, 2019, California partially conforms to the federal tax treatment of Shuttered Venue Operators Grants. This means that the grants are excludable from gross income and, unless the taxpayer is an "ineligible entity," the expenses are fully deductible, no tax attribute may be reduced, and no basis increase denied due to the exclusion. (R&TC §§17158.3, 24308.3)

An ineligible entity is a publicly traded company or an entity that does not meet the 25% gross receipts reduction threshold used for purposes of determining whether PPP loan forgiveness recipients qualify to deduct expenses paid with forgiven PPP loan amounts.

> ✐ **Practice Pointer**
>
> Taxpayers that included income from these grants in their California income on previously filed returns should consider filing amended returns.

EXCESS BUSINESS LOSS LIMITATION

California conforms to the IRC §461(l) limitation on excess business losses for noncorporate taxpayers with modifications.

Although the excess business loss limitation was deferred until the 2021 taxable year for federal purposes, California imposes this limit for taxable years beginning after December 31, 2017. (IRC §461(l); R&TC §17560.5) The federal limitation applies through the 2028 taxable year, whereas the California deduction applies indefinitely.

EXCESS BUSINESS LOSS

For noncorporate taxpayers, an excess business loss for the taxable year is the excess of the aggregate of all of the taxpayer's trade or business deductions or losses over aggregate gross revenues or gain, plus a threshold amount. The threshold amount for the 2022 taxable year is $270,000 ($540,000 in the case of a joint return), increased to $ $289,000 for the 2023 taxable year ($578,000 for joint returns).

> ***Comment***
>
> The excess business loss provision has the effect of limiting the amount of business losses a taxpayer can utilize in offsetting other income in the year the loss is generated.

The excess business loss rules apply after the application of the passive activity loss rules. (IRC §461(l)(6)) Therefore, losses suspended in the current tax year under the passive loss rules do not have an effect in the current year. Any prior-year suspended losses that are released in the current year do have an effect in the current year.

LOSS CARRYOVERS

California treats any unused business loss as a "carryover excess business loss." This is different from the federal treatment, where unused losses are treated as NOL carryovers in the following year. The California carryover is required to be included in subsequent years in determining the amount of excess business loss that may be deducted for that year. (R&TC §17560.5)

Carryover losses erroneously lost

The FTB has acknowledged that their original 2018 through 2021 instructions for Form 3461, Limitation on Business Losses, were incomplete, which lead many taxpayers to falsely believe that they did not and could not benefit from excess business loss carryovers from prior years.

When we brought this issue to the FTB, they quickly worked to revise the form instructions to ensure that taxpayers do not lose out on benefiting from these excess business loss carryovers.

The current instructions are much clearer about explaining the interplay between the Form 3461 and the Schedule CA (540), California Adjustments.

✐ **Practice Pointer**

We strongly encourage you to review the revised Form 3461 form instructions to determine if your clients have excess business loss carryovers from 2019 or 2020. If your clients "lost" the benefit of the excess business loss carryover in the current- or prior-year return, you should consider filing an amended return(s) for your clients.

Make sure the carryover didn't "disappear"

Because of the lack of clarity in the earlier form instructions, an excess business loss carryover was frequently not applied even though the taxpayer had sufficient business income in the tax year to offset the prior-year's excess business loss carryover.

The revised instructions make it clear that:

- If there is only a prior-year excess business loss carryover that is below the current-year's threshold amount and no current-year loss, then the excess business carryover loss should be reported directly on Schedule CA (540), Part I, Section B, line 3, column B. However, we have seen some software carry it over to Schedule CA (540), Part I, Section B, line 8z, column B. The same result is achieved. This enables the loss to be used on the current-year return;
- If there is only a prior-year carryover that exceeds the threshold amounts, only the threshold amount is entered in line 3 or line 8z of the Schedule CA, Part I. The remaining excess business loss carryover amount is reported on Form 3461, line 16 to be applied in calculating the excess business loss deduction on the following year's return;
- If the excess business loss carryover from the prior year plus the current-year losses do not exceed the current-year's excess business loss threshold, then the prior-year's excess business loss carryover should be reported directly on Schedule CA (540), Part I, Section B, line 3 (or 8z in some software), column B. This allows both current- and prior-year losses to be used on the current-year return; and
- If the combined current-year loss and excess business loss exceeds the threshold amount, the excess business loss carryover that will be applied on the following year's return will be reflected on line 16 of Form 3461.

Example of how carryover should be applied

Joe, a single taxpayer, has $350,000 of investment income and $250,000 of business losses in 2022. He also has an excess business loss carryover of $141,000 from the 2021 tax year.

Joe's total business loss for 2022 is $391,000 ($250,000 + $141,000). Joe will claim a loss of $262,000 on his 2022 return (the excess business loss threshold for the 2022 tax year) that can be applied against his $350,000 of investment income, resulting in $88,000 ($350,000 - $262,000) of AGI.

He will carry over $129,000 ($391,000 - $262,000) of excess business loss to the following year; this amount will be used when calculating his allowable business loss for 2023.

The $129,000 is reflected on line 16 of the 2022 Form 3461 and line 14b of the 2023 Form 3461. If he has no business loss in the following year and the same amount of investment income, he will be able to claim the full carryover excess business loss of $129,000 on his 2023 return by making the adjustment on Schedule CA (540) Part I, Section B, line 3 (or 8z in some software), column B.

 ©2022

Form 541 filers

The FTB is also in the process of revising the 2022 Form 3461 instructions to include guidance regarding where the taxpayer should be reporting the adjustment for purposes of estates and trusts. For purposes of reporting the prior-year excess business loss carryover on Form 541, the taxpayer should report the amount on line 8 as a negative amount.

The updated 2022 Form 3461 will be available by December 15. Tax professionals should review their software to make sure that the excess business loss is being reported correctly and, if not, will have to make manual adjustments on Form 541, line 8.

OTHER NONCONFORMITY ISSUES

California also modifies the federal excess business loss limitation to require that the excess business loss calculation be applied after applying California's passive loss provision (which ignores real estate professional status and makes modifications for California credits) rather than the federal loss provision.

California does not conform to the CARES Act amendments that:

- Exclude NOLs, IRC §199A, and capital loss deductions from the business deductions used to calculate the excess business loss;
- Exclude wages from the excess business loss computation; and
- Limit the capital gains included in the excess business loss computation to the lesser of:
  - Capital gain net income solely attributable to gains and losses from a trade or business; or
  - The taxpayer's capital gain net income.

Wages and the excess business loss calculation

As stated above, California does not conform to the CARES Act change to the federal excess business loss provision that excludes wages from the business income calculation. (IRC §461(l)(3)(B)(ii)) Specifically, the CARES Act provision states that the excess business loss "shall be determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee."

On the California FTB Form 3461, Limitation on Business Losses, taxpayers must include wages, salaries, tips, etc., and unemployment compensation in their calculation of income attributable to a trade or business.

Because wage income is considered part of the taxpayer's trade or business income on California Form 3461, the wage income offsets the amount of nonwage business losses, which will allow a taxpayer to deduct a greater portion of their current-year losses.

Example of federal/California wage treatment difference

Jenny has $400,000 in business losses and $300,000 in W-2 income. She has no other income or losses. Wages are not classified as business income for federal purposes, so Jenny will have more of her nonwage business losses limited in the current year, leaving a larger federal carryover compared to California.

The following calculation summarizes the different federal and California wage treatment.

	Federal	**California**
Nonwage business losses	($400,000)	($400,000)
Wages (treated as business income for CA, not federal)	N/A	300,000
Overall business loss for purposes of calculation	($400,000)	($100,000)
Lesser of limitation amount or overall business loss	262,000	100,000*
Loss carryover to the following year	($138,000)	$ 0

* California's excess business loss limitation is the same as the federal amount of $262,000, but because Jenny's overall business loss is only $100,000, she does not have any excess business losses in the current year.

The difference in the California and federal losses will be reflected on Schedule CA (540), Part I, Section B, line 3.

Applying the limit to multistate entities

While many tax professionals were concerned that California's conformity to the excess business loss limitations would dramatically limit the amount of business loss deductions that can be claimed at the state level, at least for owners of multistate passthrough entities, this anticipated outcome may not be realized. That's because only a portion of the multistate entity's total business loss will be apportioned to California, making it less likely that the distributable share of the owner's loss will exceed the excess business loss limitation threshold amount.

One significant modification at the state level is that the business losses passed through to the owner are based on the entity's losses apportioned to California.

Partners and S corporation shareholders receive the business income/loss information from the partnership and S corporation on the K-1s. These business loss amounts reported on the K-1s have already been apportioned at the entity level and the distributable amount reported to the individual owner.

 ©2022

Example of California versus multistate business loss computation

Frannie is a 50% shareholder of a California S corporation that only does business in California and has a business loss of $2 million for the 2021 tax year. She also has $300,000 of investment income.

Fred is a 50% shareholder of a multistate S corporation that also has a business loss of $2 million for the 2021 tax year (reported on line 1 of the K-1), 25% of which is apportionable to California. Fred also has $300,000 of wage income from a California job.

	Frannie	**Fred**
Distributable share of passthrough business loss	($1,000,000)[1]	($250,000)[2]
Less: Threshold amount	262,000	262,000
Excess business loss	$ 738,000	$ 0

[1] $2 million × 50%
[2] $2 million × 50% × 25%

Frannie's excess business loss will be carried forward and included in her California business loss limitation calculation for 2022.

Because Fred's excess business loss is less than the $261,359 limitation, he may claim the entire loss on his California return.

QUICK GUIDE TO CALIFORNIA NONCONFORMITY FOR TAXABLE YEAR 2022

Spidell's Quick Guide to California Nonconformity for Taxable Year 2022 appears on the following 12 pages.

Chart 21-2			
Quick Guide to California Nonconformity for Taxable Year 2022			
General notes The following potential differences are not reflected in this guide: • Qualified nonmilitary spouses of nonresident military servicemembers stationed in CA are not subject to CA tax on income they earn in CA. As CA nonresidents, qualified spouses may also exclude from CA income their interest and dividends and other intangible income, which is taxed to the state of residence. (Military Spouses Residency Relief Act (P.L. 111-97)); and • Registered domestic partners (RDPs): There will be a number of differences between federal and CA because the couple will file as single for federal purposes and as married for CA. This means that phaseouts, limitations, and computations will be different (e.g., taxable Social Security, deductible passive losses, mortgage interest, etc.)			
	IRC §	PITL R&TC §	CTL R&TC §
Filing Status and Personal Exemptions			
Taxpayers must use the same filing status on the CA return that they used on the federal return, unless: • One spouse is a nonresident with no CA source income; • One spouse is a nonresident military servicemember; or • They are in a registered domestic partnership (RDP). In the first two cases above, the spouses may elect to file MFS for CA and MFJ for federal purposes.	2	18521	N/A
Dependents: A parent who elects to forgo claiming a child as a dependent on the federal return (so that the child may claim a federal education credit) may claim the child as a dependent for CA purposes.	152	17056	N/A
Exemption credits: CA allows personal exemption credits and does not require Social Security number or ITIN for dependents.	151	17054	N/A
Phaseouts: CA phases out exemption credits and itemized deductions based on 6% of federal AGI.	N/A	17054	N/A
RDPs: RDPs must file as single taxpayers for federal purposes, and must file their CA income tax returns as married taxpayers (generally either married/RDP filing joint or married/RDP filing separate).	N/A	18521	N/A
Wages, Salaries, Tips, Etc.			
Bicycle commuting: CA allows an exclusion for qualified bicycle commuting reimbursement.	132	17149	N/A
CA qualified stock option income: Not taxable by CA if exercised by certain individuals.	N/A	17502	N/A
Clergy housing: Exclusion not limited to the fair rental value, and CA allows state-employed clergy to allocate up to 50% of their salary to either the rental value or the rental allowance. (Gov't Code §19827.5)	107	17131.6	N/A
Combat pay: Combat pay for military members serving in the Sinai Peninsula is taxable for CA.	11026(b), P.L. 115-97	17142.5, 18571	N/A
Dependent care assistance programs: CA limits the exclusion to $5,000 ($2,500 MFS).	129	17131	N/A
Educational assistance programs: CA does not exclude from income employer payments of student loans.	127	17024.5, 17151	N/A
Employer-paid HSA contributions: Included in CA wages.	106	17131.4, 17131.5	N/A
Employer-provided transportation benefits: CA exclusions are different from federal.	132	17090, 17149	24343.5
Gig workers/independent contractors: With the exception of app-based drivers, CA treats payments to gig workers/independent contractors who are treated as employees for CA but not federal purposes as wages rather than Schedule C income.	IRC §7701(a)(20)	17020.12, 18406	18406, 21003.5, 23045.6

 ©2022

Wages, Salaries, Tips, Etc. — continued	IRC §	PITL R&TC §	CTL R&TC §
Health FSA and health reimbursement arrangements: Amounts withdrawn to cover over-the-counter medicines, drugs, and feminine hygiene products are taxable distributions.	106(f); CARES Act §3702(c)	17024.5, 17131	N/A
Military pay: Military wages earned by nonresident military domiciled in a state other than CA are not included in federal AGI when computing CA tax.	N/A	P.L. 108–189, 17140.5	N/A
Moving expense reimbursements: For moves after December 31, 2017, nonmilitary moving expense reimbursements are excludable for CA but not federal.	132(g)	172	N/A
Native Americans: Earned income is excludable if earned by a Native American on any CA Indian country and taxpayer residing in any CA Indian country.	N/A	17131.7	N/A
Nonmilitary spouse income: Excluded if the spouse has same domicile as his or her servicemember spouse. (Military Spouses Residency Relief Act (P.L. 111-97))	N/A	P.L. 111-97	N/A
Nonresident wages: Not taxable by CA when a taxpayer earned wages while a resident, but receives the wages after becoming a nonresident and services were not performed in CA.	N/A	17951	N/A
Qualified equity grant: Income included when grant exercised for CA.	83(i)	17024.5	N/A
RDP medical and expense reimbursements and accident and health insurance paid by an employer is not taxable by CA.	105, 106	17021.7, 17141–17141.3	N/A
Sick pay under the Federal Insurance Contributions Act and Railroad Retirement Act is excludable from CA wages.	86	17087	N/A
Tip income: Report the actual amount for CA if the federal amount is estimated.	N/A	N/A	N/A
U.S. treaties exempt income: Taxable by CA unless the treaty specifically excludes the income for state purposes.	N/A	FTB Pub. 1001	N/A
Volunteer firefighter and emergency medical responder: CA does not conform to the exclusion for state and local tax benefits and qualified payments.	139B	17024.5	N/A
Work Colleges Program income: CA does not conform to the expansion of the scholarship exclusion to include this income.	117	17024.5, 17131	N/A
Interest			
Interest from the following bonds is not taxable by California			
Municipal bonds issued by a county, city, town, or other local government unit in a state other than CA. For bonds held by mutual funds, exclusion only applies if at least 50% of assets held are from tax-free obligations.	N/A	17143	24272
Qualified tax credit bonds (for example, Build America Bonds).	54	17143	24272
U.S. savings bonds, U.S. Treasury bills, notes, or any other bonds or obligations (excluding Fannie Mae, Ginnie Mae, and FHLMC bonds or securities) of the U.S. and its territories, including CA.	103 141–150	17133	24272
Interest from the following is taxable by California			
Canadian RRSPs: Interest on Canadian RRSPs included currently in CA income.	N/A	17501	N/A
District of Columbia obligations issued after December 27, 1973.		17143	24272
HOPE trust accounts established for children in foster care or for certain children whose parent died from COVID-19.			
HSAs: Interest on HSAs included in CA income.	223	17215.4	N/A
Seized property interest: Interest paid by IRS in conjunction with returning seized property as a result of a court action taxable for CA, excludable for federal.	139H	17024.5	23051.1

Dividends			
Controlled foreign corporation dividends: Taxable by CA in the year distributed rather than the year earned.	N/A	FTB Pub. 1001	FTB Pub. 1001
Exempt-interest dividends: Dividends that relate to exempt interest from tax exempt assets are excludable if the mutual fund has at least 50% of its assets invested in tax-exempt government obligations. Fully taxable if less than 50%.	N/A	17145	24272
HSAs: Dividends from HSAs invested in stocks or mutual funds are taxable by CA.	223	17215.4	N/A
Non-cash patronage dividends from farmers' cooperative or mutual associations: CA amounts may be different if an election is made.	1385	17086	24273.5
RIC undistributed capital gains: Taxable by CA in the year distributed rather than earned.	N/A	17088	N/A
S corporation distributions of pre-1987 earnings: Taxable by CA.	N/A	FTB Pub. 1001	FTB Pub. 1001
State Tax Refund			
State income tax refunds, including refunds from other states: Not taxable to CA.	N/A	17131 17220	24345
Alimony			
In general: CA continues the IRC §71 alimony rules prior to its amendment by the TCJA.	71	17081, 17201	N/A
Nonresident aliens with alimony income: Taxable by CA.	71	FTB Pub. 1001	N/A
Business Income and Loss			
Income differences			
Business conducted partially in CA: Worldwide income included in nonresident's AGI from all sources; CA-source business income determined using an apportionment formula.	N/A	17951	N/A
CA Relief Grants and COVID-19 supplemental paid sick leave grants: CA excludes from gross income California COVID-19 relief grants for small businesses, California Venues Grants, and California Microbusiness COVID-19 relief grants and COVID-19 supplemental paid sick leave paid to qualified businesses. Expenses paid with these grants are not deductible.	N/A	17158, 17158.1	24311, 24312
Forgiven PPP loans: California does not conform to the ARPA's expanded exclusion of PPP loan forgiveness granted to certain nonprofit entities and internet publishers.	P.L. 117-2	17024.5	23051.5
Gambling income: CA does not limit losses for professional gamblers to gambling winnings.	165(d)	17024.5, 17201	N/A
Prevention of certain losses from tax-indifferent parties: CA does not conform.	267	17024.5, 17201	23051.5, 24427
Shuttered Venue Operator Grants: Expenses paid with these tax-exempt funds are not deductible if the taxpayer does not meet the 25% gross receipts reduction threshold or if is a publicly traded company.	CRTRA §278; ARPA §§5003, 9673	17158.3	24308.3
Credits that may create basis differences			
Income may be different due to different basis adjustments for federal and/or CA credits.	Var	Var	Var
Loss differences			
Excess business losses: CA has not suspended the excess business loss deduction. CA generally conforms to excess business loss deduction other than: • CA's loss carryover is treated as a carryover loss for CA and an NOL for federal; • CA's loss limitation applies indefinitely; • CA does not exclude wages, NOLs, IRC §199A and capital loss deductions from computation; and • CA does not limit the capital gains included in the computation.	461(j); CARES Act §2302(b)	17560.5	N/A

Business Income and Loss — continued	IRC §	PITL R&TC §	CTL R&TC §
NOLs: CA conforms to federal except: • CA suspends the deduction for NOLs incurred during the 2020–21 taxable years for businesses with net business income and modified AGI of $1 million or more for individual taxpayers and with CA taxable business income of $1 million or more for corporate taxpayers; • CA does not allow NOL carrybacks after the 2018 taxable year; • There is no post-2020 80% taxable income when claiming NOL carryovers on the CA return; • CA limits the carryover to 20 years; and • CA does not allow a 2 year carryback for farming NOLs.	172	17276, 17276.21, 17276.22, 17276.23, 19131.5	24416, 24416.21, 24416.22, 24416.23
Business Expensing and Depreciation			
Expensing			
Economic development area business property (EZ, LAMBRA, TTA): CA allowed expensing up to $40,000 for the cost of qualified property for taxable years beginning before January 1, 2014. May create basis difference.	N/A	17276.2, 17276.6, 17268	24356.6, 24356.7, 24356.8
Energy-efficient commercial building expensed: CA does not conform. May create basis difference.	179D	17257.2	24349
Environment (remediation) clean-up costs expensed if paid or incurred before January 1, 2012. CA did not conform after 2003. May result in basis differences.	198	17279.4	24369.4
Federal film and television cost expensing for pre-2026 productions: CA does not conform. May result in basis difference.	181	17201.5	24356
Mine safety equipment expensing for property placed in service prior to 2018: CA did not conform. May result in basis difference.	179E	17250, 17257.4	24349, 24356
Reforestation cost expensing: CA limits to CA timber.	194	17278.5	24372.5
Depreciation that will create a basis difference			
Auto depreciation: CA does not conform to increased auto depreciation. Increase the CA basis for any hybrid electric credit claimed on the federal return.	280F	17024.5, 17250, 17255	24349
Auto lease inclusion: CA has its own lease inclusion tables.			
Bonus depreciation (50%/100%/80%), including $8,000 bonus depreciation for luxury auto: Not allowed for CA.	168	17250, 17255	24349, 24356
Business property moved into CA: If depreciation method or useful life is unacceptable to CA before the move, you must use the straight-line method. Applies also to former nonresidents who become CA residents.	N/A	17250	24349
Commercial revitalization for buildings placed in service prior to 2010: Difference in depreciation if taxpayer claimed or took the 120-month amortization.	1400I	17250	24349
Grapevines: Five-year recovery period if replaced in a CA vineyard for phylloxera infestation and for Pierce's Disease.	168	17250	24349
Income forecast method: CA conforms to the federal income forecast method, except for the treatment of participations and residuals and the treatment of distribution costs for property placed in service after October 22, 2004.	167	17250, 17250.5	24349, 24356
Indian reservations: Recovery period for property placed in service after 1993 and before 2022 is shorter depending on the property class. CA does not conform.	168	17250	24349
Insolvency creates a basis difference when elected for CA but not federal and depreciable basis (tax attribute) is reduced.	108	17144	24307

Business Expensing and Depreciation — continued	IRC §	PITL R&TC §	CTL R&TC §
IRC §179 expensing: CA modifies IRC §179 as follows: • CA's IRC §179 deduction is limited to $25,000 and $200,000 in assets. • IRC §179 for qualified property (e.g., leasehold improvement, restaurant, and retail improvement property) placed in service on or after January 1, 2010: Not allowed for CA. • Prior to 1999 and after 2002, CA's IRC §179 expense is less than federal. This could cause a depreciation and basis adjustment. • IRC §179 off-the-shelf computer software expensing: CA does not conform. • Revocation of IRC §179 election without IRS consent: CA does not conform.	179	17250, 17255	24349, 24356
Listed property: Computers and peripheral equipment are listed property for CA.	280F	17024.5, 17201	23051.5, 24349.1
Motorsports entertainment complexes: Seven-year recovery period if placed in service prior to January 1, 2026. CA does not conform.	168	17250	24349
Nonresidential real property: Recovery period for property placed in service on or after May 13, 1993, but before January 1, 1997. CA's recovery period is 31.5 years; the federal recovery period is 39 years.	168	17250	24349
Qualified improvement property: CA's recovery period has always been 39 years.	168(e)(3)(E)	17250	24349
Racehorses: Three-year recovery period if placed in service in 2015–2021. CA does not conform.	168	17250	24349
Second generation biofuel plan property placed in service before January 1, 2021: CA did not conform to additional first-year depreciation. May create basis differences.	168	17250	24349
Small aircraft recovery method: CA does not conform.	168	17250	24349
Smart electric meters and grids: Federal 10-year depreciation. CA does not conform for corporations.	168	17201, 17250	24349
Water utility property: CA does not conform to special MACRS.	168		24354.1
Amortization			
The following will create a basis difference			
Geological and geophysical costs: Starting in 2010, CA does not conform.	167(h)	17250.5	24349
Pollution control facilities: CA conforms to the federal accelerated write-offs, but only for facilities located in CA.	169	17250	24372.3, 24449
Start-up costs: CA limited the maximum first year expense to $5,000 with a limit of $50,000 rather than $10,000/$60,000 in 2010, with the remainder amortized over 180 months.	195	17201	24414
Other Business Expense Differences			
Taxpayers may need to adjust federal amounts for these California differences			
Abandonment or tax-recoupment fees for open space easements and timberland preserves not deductible for CA purposes.	N/A	17275	24441
Business interest expense: CA does not limit.	163(j)	17024.5, 17201	23051.5, 24344
Club dues: CA does not allow a deduction for payments made to clubs that discriminate.	274	17269	24333
Credits: Increase CA deduction for any federal credits taken when expense must be reduced by credit amount (e.g., Employee Retention Credit). Decrease deduction for any CA credits taken when expense must be reduced by credit amount.	Var	Var	Var
Employee achievement awards: CA does not conform to TCJA definitional changes.	274(j)(3)(A)(ii)(I)	17024.5, 17201	23051.5, 24443
Employee Retention Credit: CA wages are not reduced for the amount of the ERC claimed on the federal return. (Employee Retention Credit refunds are not included in California taxable income.)	3134, CARES Act §2301, TCDTRA §207	17024.5	23051.5

 ©2022

Other Business Expense Differences — continued	IRC §	PITL R&TC §	CTL R&TC §
Employee meals: CA does not limit the employer's deduction for meals provided for the convenience of the employer to 50% of expenses.	274	17024.5, 17201	23051.5, 24443
Entertainment: CA allows deductions for business-related entertainment expenses. (See meals below).	274	17024.5, 17201	23051.5, 24443
Illegal activities: For PIT, conformity to IRC §280E, except for licensed cannabis businesses which may deduct all expenses. For CTL, all deductions are allowed. No COGS or deductions if the taxpayer is subject to state statutory court actions for profiteering.	280E	17024.5, 17209, 17282	24436.1
Insolvency election: Reduction in tax attributes may change depreciable basis if CA election is different from federal.	108	17144	24307
Local lobbying expenses: CA continues to allow these expenses.	162(e)	17024.5, 17201	23051.5, 24343
Meals: CA limits the deductions for meal and beverage expenses incurred in a restaurant to 50%.	274(n)	17024.5, 17201	23051.5, 24443
Nondeductible penalties and fines: CA does not conform to the TCJA's expanded definition of nondeductible fines and penalties.	162(f)	17024.5, 17201	23051.5, 24343
PPP-related deductions: Expenses paid with forgiven PPP loans excludable under AB 80 and SB 113 are deductible on CA return only if borrower's gross receipts from 2019 were reduced by at least 25% in 2020 calendar quarter (compared to 2019 calendar quarter).	CRTRA §276	17131.8	24308.6
Percentage depletion for oil and gas wells and geothermal deposits: CA did not conform to temporary suspensions of taxable income limit.	611–638	17681.6	24831.6
Professional sports league penalties: CA does not allow a business expense deduction.	N/A	17228	24343.8
Qualified business income (IRC §199A): CA does not conform.	199A	17024.5, 17201	N/A
Research credit/deduction: Differences in what may be claimed for the research credit will result in different research expenses that may be deducted. California does not conform to TCJA amendments that require expenses to be capitalized/amortized over a five-year period beginning with 2022 taxable year.	41, 174, 280C	17052.12, 17201	24365, 24440, 23609
Sexual harassment settlements: CA does not conform to disallowed deductions subject to nondisclosure agreements.	162(q)	17024.5, 17201	23051.5, 24343
Tertiary injectants expenses incurred in the crude oil industry: CA allows depreciation; federal allows expensing.	193	17260	24341, 24401
Transportation fringe benefits: Employers may deduct CA transportation fringe benefits.	274	17024.5, 17090	23051.5, 24990
Worker classification: If taxpayer is a schedule C for federal and W-2 employee for CA, make adjustments on Schedule CA.			
1099 or Form W-2 not filed for personal services: CA does not allow a deduction.	N/A	17299.8	24447
Rents, Royalties, Partnerships, Estates and Trusts, etc.			
Deduction, depreciation, and basis differences			
Accumulation distribution differences to beneficiaries.			
Depreciation differences will make the CA numbers different from federal numbers.			
K-1 income differences due to net income and other differences.			
Partnership carried interest: CA does not conform to the increased holding period for capital gain treatment.	1061(a)	17024.5, 18031	N/A
Real estate professionals: CA does not conform to the federal law that treats certain passive income as nonpassive.	469	17561	N/A
Substandard housing: CA does not allow a deduction for interest, taxes, depreciation, or amortization.		17274	24436.5

Capital Gains and Losses			
Basis differences can create differences in amount of gains/losses — in addition to items listed below			
CA does not apply a lower rate for capital gains.	1	17041	N/A
Decedent dying in 2010 if no estate tax was elected: Beneficiary has carryover basis — CA basis is equal to FMV rather than adjusted carryover basis.	1022	18035.6	N/A
Gain or loss on stock and bond transactions.		17024.5	
Prior-year differences between CA and federal law.			
Self-created property: CA does not conform to the exclusion of certain property as a capital asset.	1221	17024.5, 18151	23051.5, 24990
IRC §1031: CA conforms except personal income taxpayers with federal AGI of $250,000 ($500,000 MFJ, HOH, or surviving spouse) or more must still defer gain or loss for exchanges of property other than real property.	1031	17024.5, 18031, 18031.5	23051.5, 24941, 24941.5
Other differences			
CA qualified stock option: Gain may be different.	N/A	17502	N/A
Capital loss carryover adjustment for part-year resident year.	N/A	17041	N/A
Installment sale: Different election or basis.	453	17551	24667, 24668.1
Inherited property: Gain or loss on the sale of property inherited before January 1, 1987.	N/A	18035.6, FTB Pub. 1001	N/A
Opportunity zone deferral/step-up in basis: CA does not allow capital gain deferral/ basis step-up for investments in qualified opportunity zones.	1400Z-2	17024.5	23051.5
Passthrough gain or loss from a partnership, S corporation, trust, or LLC may be different.			
Principal residence gain: Differences due to differences in depreciation or exclusion amount (e.g., RDPs).	121	17152	N/A
Qualified housing project gain where project provided rental or cooperative housing for low-income families.	N/A	18041.5	24955
Qualified small business stock: CA does not allow for a rollover on the exchange of qualified small business stock or an exclusion on the gain.	1045, 1202	18038.4, 18038.5, 18044, 18152.5, FTB Notice 2012-03	N/A
S corporation stock gain may be different if the CA S election date was later (pre-2002) or due to basis differences.	1362, 1367	N/A	23801, 23804
IRA and Pension Distributions and Deductions			
Annuity starting dates: • Annuity starting date after July 1, 1986, and before January 1, 1987, if the taxpayer elected to use the three-year recovery rule for CA purposes. • Annuities with a starting date after November 18, 1996, and before January 1, 1998, may have basis recovered under a different method.	219	FTB Pub. 1001	N/A
Basis differences due to: • CA doesn't allow deductible contributions to a traditional IRA for individuals age 70½ or older. • Catch-up contributions in 2005–2009 for former employees of bankrupt companies. • Different election to treat IRA contributions as nondeductible for federal but not CA or vice versa. • Taxpayer changed residence between taking qualified COVID-19 or disaster distribution and repayment. • Lower CA AGI limitations in 2007–2009.	219	17501, 17203, 17024.5 FTB Legal Ruling 1988-3	N/A

IRA and Pension Distributions and Deductions — continued	IRC §	PITL R&TC §	CTL R&TC §
Canadian RRSP earnings: Taxable by CA in the year earned.	408	17501	N/A
Contributions: Pre-1987 IRA SEP, Keogh, and pension contributions commonly have a higher CA basis.	219	17203	N/A
COVID-19 or disaster distribution recognition: Taxpayers may make different federal/state elections as to whether to recognize income from qualified COVID-19–related or qualified disaster distribution over three years.	CARES Act §2202(a)(5)	17024.5	N/A
HSAs: IRA rolled over to an HSA is taxable to CA.	408	17215.4	N/A
Income exempt by U.S. treaties including foreign Social Security and foreign pensions: CA does not conform to most U.S. treaties. (***Appeal of de Mey Van Streefkerk*** (November 6, 1985) 85-SBE-135)			
MSA rolled into an HSA: Taxable by CA, provides basis for CA purposes.	220	FTB Pub. 1001	N/A
Railroad retirement benefits: Tier 1 and Tier 2 are not taxable to CA.	86	17087	N/A
Self-employment or farm income: Lower IRA deduction for CA purposes for 1987–1995.	219	17203, 17507	N/A
U.S. Social Security benefits: Not taxable to CA.	86	17081	N/A
Other Income/Deductions/Exclusions			
Income/Exclusions			
CA lottery winnings: Not taxable to CA. However, winnings from other state lotteries are taxable to CA.	61	Gov't. Code §8880.68	
Compensation paid for forced or involuntary sterilization: CA excludes amounts paid from the CA Forced or Involuntary Sterilization Compensation Account.	N/A	H&SC §24217	N/A
Global intangible low-tax income (GILTI): CA does not conform and does not tax such income until actually distributed.	951A	N/A	N/A
Paid family leave benefits: Not taxable to CA even if paid through an employer plan.	85	17083	N/A
Repatriation income: CA does not conform and does not tax such income until actually distributed.	965	N/A	N/A
State tax refunds: Not taxable to CA.	111	17131, 17142	24345
Turf replacement rebates: CA excludes turf replacement rebates, vouchers, or other incentives paid by specified governmental agencies for water conservation.	N/A	17138.2	24308.9
Unemployment compensation: Not taxable to CA.	85	17083	N/A
Water and utility payments: CA excludes water and utility credits paid under specified COVID-19 relief programs.	N/A	17131.16, 17131.17, 17131.20	24308.4, 24308.5
Wildfire settlement payments: CA excludes wildfire settlement payments made by PG&E and Southern California Edison to victims of specified 2015, 2017, and 2018 wildfires.	N/A	17138.5, 17138.6	24309.1, 24309.3
Other income and deductions (Line 21 1040)			
Beverage container recycling income: Not taxable to CA.	N/A	17153.5	24315
Canadian government settlement payments made by the Canadian government to redress injustices done during World War II to persons of Japanese ancestry: Not taxable to CA.	N/A	17156.5	N/A

Other Income/Deductions/Exclusions — continued	IRC §	PITL R&TC §	CTL R&TC §
Cancellation of debt: The following are differences between CA/federal treatment: • Insolvency election: Reduction in tax attributes may change depreciable basis if CA election is different than federal. • Principal residence exclusion: CA does not allow after 2013. • Student loan forgiveness: CA excludes loans forgiven under income-based repayment (IBR) program and income-contingent repayment programs and loans due to school closing/doing something wrong, or failing to do something they should have. CA does not conform to the exclusion of all student loans discharged during 2021 through 2025. • Difference in real property indebtedness due to basis.		17131, 17132.11, 17144, 17144.5, 17144.6, 17144.8	24307
Coal power grants: CA does not allow an exclusion from gross income of certain clean coal power grants to noncorporate taxpayers.	Uncodified Sec. 343 (P.L. 114-113)	N/A	N/A
Commodity Credit Corporation loans: Different elections for income exclusion.	77	17081	24273
Congressional member living expenses: CA allows a $3,000 deduction.	162(a)	17201	N/A
Cost share payments for forest landowners: Not taxable to CA.	N/A	17135.5	24308.5
Crime hotline rewards: Not taxable to CA.	N/A	17147.7	N/A
Death benefits received from the CA National Guard, State Military Guard, or Naval Militia are excludable for CA purposes.		17132.4	N/A
Disaster loss: Difference due to different elections or basis differences. Carryback allowed for governor-only declared emergencies.	165(i)	17207.14	24347, 24347.14
Foreign-earned income or housing exclusion: Not allowed by CA.	911	17024.5	N/A
HSA withdrawn for nonqualified purposes are not taxable for CA due to basis in HSA.	223	17215.4	N/A
Nonresident aliens must include worldwide income on CA return.	N/A	17954	N/A
Olympic/Paralympic game medals/prizes: CA does not exclude these items from income.	74(d)	17024.5	N/A
Ottoman Turkish Empire Settlement Payments: CA provides an exclusion.	N/A	17131.2	24272
Per capita payments: CA does not tax Native Americans living on their tribal land receiving payments from their tribe.	N/A	FTB Pub. 1001	N/A
Prescription drug subsidies: CA does not allow exclusion.	139A	17139.6	N/A
Rebates from water agencies and suppliers: Not taxable to CA.	N/A	17138, 17138.1	24323
Seismic retrofit assistance: Excluded from CA gross income.	N/A	17138.3	24308.7
§529 plan: CA does not allow tax-free distributions for K–12 tuition. Basis may be different due to previous differences.	529	17140.3	23714
Adjustments to Income			
Educator expense $250/$300 deduction: CA does not allow.	62(a)(2)(D)	17072	N/A
HSAs: Contributions not deductible.	223	17215.4	N/A
Moving expenses: CA continues to allow moving expenses for moves into or within CA.	217	17072, 17201	N/A
Nonresident aliens who did not deduct alimony payments on their federal return can deduct alimony payments on their CA return. CA continues the IRC §71 alimony rules prior to its amendment by the TCJA.	N/A	17302, 17801	N/A
Self-employed health insurance paid on behalf of a nondependent RDP: deductible for CA.	N/A	17021.7	N/A

Adjustments to Income — continued	IRC §	PITL R&TC §	CTL R&TC §
Student loan interest deduction: Subject to income limitations, CA allows deduction for student loan interest excluded from federal wages but included in CA wages. Non-CA domiciled military taxpayers exclude military wages, which may increase deduction.	221	17024.5, 17041	N/A
Student loan interest paid by employers: Payment is excludable from wages for employee and deductible by employer on federal returns. CA does not conform.	127(c)(1)(B)	17151	N/A
Whistleblower court costs: CA taxes court costs awarded in IRS, SEC, Commodities Futures Trading Commission, and State False Claims Act whistleblower cases.	62(a)(21)(A)	17072	N/A
Itemized Deductions			
When using standard deductions on the federal return but itemizing on the CA return, complete and attach a copy of the federal Schedule A (even though the taxpayer did not file one with his or her federal return).			
Itemized deduction phaseout amount is 6% of federal AGI for CA purposes.	68	17077	N/A
Any deductions subject to AGI limitations may be different for RDPs because they must file as married for CA and single for federal.			
Expenses related to income taxed under federal law but not taxed under CA law: Not deductible for CA.	265	FTB Pub. 1001	
Expenses related to income taxed under CA law but not under federal law: Deductible for CA.	265	FTB Pub. 1001	N/A
Medical expenses			
Adoption-related medical expenses: Adjust for differences between CA and federal Adoption Credit rules.	N/A	17052.25	N/A
HSA: Payments made with HSA funds are deductible.	223	17215.4	N/A
Medical insurance for taxpayer who is self-employed for federal and employee for state deductible as medical expense.	213	17020.12, 17241	21003.5
Taxes			
Foreign taxes: CA does not allow a deduction for foreign tax paid.	164	17220	N/A
Foreign real property taxes: CA allows an itemized deduction for foreign real property taxes.	164(b)(6)	17024.5, 17201	N/A
Federal estate tax: Not deductible for CA.	N/A	FTB Pub. 1001	N/A
Generation-skipping transfer tax: Not deductible for CA.	2601	17024.5	N/A
Income taxes or sales and use tax paid (including foreign income taxes, SDI, sales tax on vehicles, $800 annual tax paid by LPs and LLCs, and income or franchise taxes paid by S corporations, and passthrough entity elective tax): Not deductible for CA.	164	17220	24345
Property tax: Different capitalization elections.	266	17201	24426
State and local taxes: CA does not allow a deduction for state income tax. Other state and local taxes (property, *ad valorem*, etc.) are allowed in full.	164	17024.5, 17220	N/A
Interest and Dividends			
Capital gain and dividends: Different elections.	163	17201	N/A
Capitalizing carrying charges: Different elections.	266	17201	24426
Federal Mortgage Interest Credit: Interest deductible for CA.		FTB Pub. 1001	N/A
Investment interest differences.	163	17280	24425
Mortgage insurance premiums (pre-2022 tax years): Not deductible for CA.	163	17225	N/A
Mortgage interest: CA follows pre-TCJA rules for $1 million of acquisition debt and $100,000 of equity debt (subject to AMT).	163(h)(3)	17024.5, 17201	N/A

Interest and Dividends — continued	IRC §	PITL R&TC §	CTL R&TC §
Charitable contributions			
Agricultural research organizations: CA does not conform to federal increased individual charitable contribution limits for contributions to agricultural research organizations.	170(b)(1)	17201	N/A
Athletic seats: CA continues to allow deductions for college athletic seating rights.	170(1)(I)	17024.5, 17201	23051.5
College bribery scandal: No CA charitable contribution deduction for those taxpayers convicted in college bribery scandal.	170	17275.4	N/A
College Access Tax Credit Fund: No CA deduction for contribution if a credit for the contribution was claimed.	170	17053.86	23686
Food inventories: CA does not conform to enhanced deduction for charitable contributions of food inventories.	170(e)(3)(C)	17275.2	24357.1, 24358
Maximum limits: CA limits the maximum charitable deduction to 50% of federal AGI.	170	17024.5, 17201	N/A
Qualified conservation contributions: CA deductions are different.	170(b)(1)(B), 170(b)(2)(B)	17201	24358
Miscellaneous itemized deductions			
CA continues to allow miscellaneous itemized deductions.	67(g)	17024.5, 17076	N/A
CA phases out itemized deductions based on 6% of federal AGI.		17077	N/A
Casualty losses: CA continues to allow casualty losses; nondeductible for federal.	165	17201	N/A
Disaster loss: Different throwback elections for disaster victims under IRC §165(i), or where the CA Governor declared a disaster but the President did not.	165	17207.14	24347.14
Employee educator expense: Include $250$300 deduction due to federal education credits/deduction as miscellaneous itemized deduction.			
Interest paid to public utility for energy efficient property is deductible for CA as a miscellaneous itemized deduction not subject to 2%.		17073, 17208.1	N/A
Provisions Applicable Only to Corporations			
AMT: CA imposes AMT for corporations and does not allow an acceleration of AMT credits.	55, 56, 59	N/A	23400, 23455(a) and (d), 23456
Basis adjustment to stock of S corporations making charitable contributions of property: CA does not conform.	1367(a)(2)	N/A	23051.5, 23800
Cancellation of debt: Difference in basis due to COD for S corporations for distributions after October 11, 2001, and before January 1, 2003.	108	N/A	24307
Charitable contributions: • Charitable deduction limited to 10% of CA income. • Patents and intellectual property: Special treatment of these charitable does not apply for corporate purposes. For corporate purposes, the property is valued at basis.	170(m)	N/A	24357.1, 24358
Contributions to capital: CA does not conform to the restoration of gross income exclusion of contributions in aid of construction of regulated public water or sewage disposal utility.	118(b)	N/A	24325
Depreciation: • **ACRS and MACRS:** CA does not conform for C corporations. • **Bonus depreciation:** In lieu of electing IRC §179 expensing CA allows additional $2,000. • **Luxury automobiles and listed property:** C corporations must use CA corporate depreciation methods. First-year depreciation for C corporations, but no other general bonus depreciation.	168, 280F	N/A	24349, 24349.1, 24350, 24356

©2022

Provisions Applicable Only to Corporations — continued	IRC §	PITL R&TC §	CTL R&TC §
Dividend received deduction: With the exception of the elimination of intercompany dividends paid to a member of a unitary group and for dividends paid to a corporation by an insurance company, CA does not allow a dividends received deduction.	243	N/A	24402, 24410, 25106
Foreign derived intangible income/GILTI: CA does not conform to the 50% deduction for foreign derived intangible income or global intangible low-taxed income.	250	N/A	N/A
Health plans and insurers: CA excludes certain income.	N/A	N/A	24330
Interest on government obligations: Interest received on all government (federal, state, municipal, and tax credit bond) obligations are taxable to franchise taxpayers only.	N/A	N/A	24272
REITs: Restriction on tax-free spin-offs involving REITs.	355(a)	N/A	24451
S corporation built-in gains tax: CA uses a 10-year holding period rather than a five-year holding period.	1374	N/A	23051.5, 23809

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

3. What are among the details of California's position on forgiven PPP loans?

   a) Under AB 80, California conforms to the exclusion of forgiven PPP loans under the PPP Extension Act of 2021
   b) AB 158 makes conformity to the PPP Extension Act loan forgiveness retroactive to tax years beginning on or after January 1, 2020
   c) To qualify to deduct expenses paid with forgiven PPP loan amounts for loans approved after March 2021, businesses must show at least a 25% reduction in gross receipts
   d) Fiscal-year taxpayers must measure any reduction in gross receipts with the prior fiscal year

4. The FTB has confirmed that there have been issues with the reporting of California business losses. Which statement is accurate as it pertains to business losses and noncorporate taxpayers?

   a) The excess business loss rules apply before the application of the passive activity loss rules
   b) California treats excess business losses as a carryover excess business loss for the following taxable year
   c) Like federal law, California treats excess business losses as a net operating loss for the following year
   d) The FTB has confirmed that there is information missing from Form FTB 3461, California Limitation on Business Losses, whereby taxpayers are not able to utilize carryovers on their 2021 returns, but the FTB will make adjustments to taxpayers' returns so amended returns will not be required

 ©2022

SOLUTIONS TO REVIEW QUESTIONS

3. What are among the details of California's position on forgiven PPP loans? **(Page 7-2)**

a) Incorrect. Under AB 80, California did not conform to these loans within the extended period.
b) Incorrect. The conformity is retroactive to tax years beginning on or after January 1, 2019.
c) Correct. The 25% is a cliff test, so that if taxpayers fall below that threshold, they are not eligible to take any deductions for expenses paid with forgiven PPP loan amounts.
d) Incorrect. Both fiscal and calendar-year taxpayers measure gross receipts reduction using calendar-year quarters.

4. The FTB has confirmed that there have been issues with the reporting of California business losses. Which statement is accurate as it pertains to business losses and noncorporate taxpayers? **(Page 7-7)**

a) Incorrect. Excess business loss rules apply after passive activity loss rules.
b) Correct. This is different than federal treatment, which treats excess business losses as a net operating loss the next year.
c) Incorrect. In California, an excess business loss is treated as a carryover excess business loss the next year.
d) Incorrect. Taxpayers that have already filed returns for 2021 will have to file amended returns.

 ©2022

This page intentionally left blank.

Chapter 8

California Individuals

CALIFORNIA INDIVIDUALS

MIDDLE CLASS TAX REFUNDS

AB 192 (Ch. 22-51) authorizes approximately $9.5 billion in tax refunds, ranging from $400 to $1,050 for married filing joint taxpayers and $200 to $700 for all other taxpayers, depending on their California AGI and whether they claim any dependent credits. (Welf. & Inst. Code §8160 et seq.)

Comment

There had been a variety of proposals at the beginning of the legislative season about a "gas tax" refund, a "vehicle" refund, and an "inflation" refund. The Middle Class Tax Refund is the compromise reached between all the proponents of these various refund proposals.

Note: Although these payments are referred to as "refunds," Welfare and Institutions Code §8161(d) specifically states that these payments are not refunds of personal income tax overpayments.

As noted below, California residents who didn't file 2020 tax returns by October 15, 2021, are not eligible for these payments.

REFUND AMOUNTS

Tax Refunds Under California AB 192/SB 192			
Filing status	**California AGI range (2020)**	**Tax refund without dependent credit**	**Tax refund with dependent credit**
MFJ	Up to $150,000	$700	$1,050
	$150,001–$250,000	$500	$750
	$250,001–$500,000	$400	$600
HOH	Up to $150,000	$350	$700
	$150,001–$250,000	$250	$500
	$250,001–$500,000	$200	$400
All other filing statuses	Up to $75,000	$350	$700
	$75,001–$125,000	$250	$500
	$125,001–$250,000	$200	$400

GROSS INCOME EXCLUSION

The payments are excludable from California taxable income. (R&TC §17131.12)

Comment

The Franchise Tax Board has stated that they will be sending 1099-MISCs for payments of $600 or more, which they did not do for the Golden State Stimulus payments issued in 2020 and 2021. The FTB did not send 1099-MISC for the Golden State Stimulus Payments because they believed they qualified for the IRC §139 disaster relief exclusion. We believe those Golden State Stimulus payments qualified for a federal gross income exclusion under either IRC §139 or the general welfare exemption under federal law. Recipients of the Golden State Stimulus payments had to either be an Earned Income Tax Credit recipient or have California AGI of $75,000 or less.

The federal general welfare exemption is not codified but has evolved through case law and IRS guidance throughout the years. To qualify for the general welfare exemption test, the payment must be to an individual:

- From a government fund;
- Be for the promotion of the general welfare, based on individual or family need; and
- Not be made as payments for services.
(Rev. Rul. 2005-46)

The legislative analysis for AB 192 states that the payments are being made "to low-income and middle-income Californians in order to provide financial relief for economic disruptions resulting from the COVID-19 emergency, such as the financial burdens of inflation and increasing costs for gas, groceries, and other necessities."

Neither the courts nor the IRS has ever specified an AGI limit for purposes of determining whether a taxpayer has established the requisite need and has previously ruled that payments made to disaster victims would qualify for the general welfare exclusion, without specifying any type of income limit to qualify for the exclusion. (Rev. Rul. 2003-12) However, whether payments made to taxpayers whose AGI is up to $500,000 to assist them in meeting rising costs would qualify for the exclusion based on "need" is an open question for which we will need guidance from the IRS. In the interim, tax professionals will have to exercise their best judgement.

QUALIFICATIONS

To qualify for these payments, the taxpayer must:

- Be a California resident on the date the payment is issued, and for at least six months during the 2020 calendar year;
- Have filed their 2020 tax return by October 15, 2021 (however, taxpayers without a Social Security number had until February 15, 2022, to file their return and still qualify for the refund if they applied for an ITIN and had not received it by October 15, 2021); and
- Not be claimed as a dependent on another taxpayer's 2020 California tax return.
(Welf. & Inst. Code §8161)

In addition, taxpayers using the single filing status without claiming a dependent are ineligible for a refund if, on the date the payment is issued, the individual is deceased or incarcerated (unless only incarcerated pending the disposition of charges).

Comment

Some tax professionals have questioned what happens if a 2020 return was filed jointly and the spouse dies thereafter. We believe the surviving spouse would be entitled to the full refund available to MFJ taxpayers pursuant to Welfare and Institutions Code §8161 because there is nothing in the law that would require a reduction of the refund in this scenario.

CHECK IS NOT IN THE MAIL

According to the FTB, payments will be sent to taxpayers starting at the end of October and will conclude by the middle of January. The payments will be made by direct deposit or debit card.

Generally, direct deposit payments will be made to eligible taxpayers who e-filed their 2020 California tax return and received their California tax refund by direct deposit. Debit card payments will be mailed to the remaining eligible taxpayers, including those who:

- Received their 2020 tax refund by direct deposit but have since changed their banking institution or bank account number; or
- Received an advance payment from their tax service provider or paid their tax preparer fees with their tax refund.

Direct deposit of the Middle Class Tax Refund payments for Californians who received Golden State Stimulus I or II were to be issued by November 14, 2022, with 90% of direct deposits scheduled to be issued in October 2022.

Middle Class Tax Refund debit cards were scheduled to be mailed between October 25, 2022, and December 10, 2022, for Californians who received Golden State Stimulus I and II, with the remaining debit cards mailed by January 15, 2023.

ERRONEOUS PAYMENTS

If taxpayers have received the payments in error, they may return them to the FTB. The FTB has provided specific directions on how these payments should be returned depending on the type of payment received. See:

Website

www.ftb.ca.gov/about-ftb/newsroom/middle-class-tax-refund/help.html

FTB ASSISTANCE

The FTB has set up dedicated chat and phone lines to assist taxpayers with these payments:

- **Chat:** www.mctrpayment.com (available weekdays, 8 a.m. to 5 p.m.)
- **Customer support phone line:** (800) 542-9332 (available weekdays, 8 a.m. to 5 p.m.)
- **Card activation:** (800) 240-0223 (available 24/7)
- **Online:** www.mctrpayment.com

COLLECTION-PROOF

These refunds may not be subject to withholding or levy for outstanding state tax liabilities or other outstanding state fees, penalties, or tolls. (R&TC §19554.1)

FIRST-TIME PENALTY ABATEMENT ENACTED

After years of failed attempts to enact a first-time penalty abatement program, AB 194 (Ch. 22-55) has finally delivered, enacting a late-filing or late-payment penalty abatement program for individual taxpayers. (R&TC §19132.5)

> ***Comment***
>
> This new provision applies to requests for abatement made for taxable years beginning on or after January 1, 2022, so taxpayers will not be able to take advantage of this new relief until after the 2022 tax year payment and filing deadlines have passed. Penalties imposed for pre-2022 tax years do not qualify for California's new first-time penalty abatement program.

ELIGIBILITY

Individual taxpayers are eligible if they have not previously:

- Been required to file a California personal income tax return; or
- Received California first-time penalty abatement; and
- Filed all returns and paid or entered into an installment agreement to pay all outstanding personal income tax liabilities (other than the late filing-payment penalties).

Unlike the federal first-time penalty abatement program, California penalty abatement is only available once in a lifetime rather than once every four years.

APPLICATION

Requests may be made either orally or in writing, and abatement only applies to a timeliness penalty related to one taxable year.

The FTB has not yet announced how taxpayers will apply for the program but will be providing details over the next few months.

Taxpayers may apply for first-time penalty abatement:

- In lieu of applying for reasonable cause abatement; or
- After applying for reasonable cause abatement and being denied.

 ©2022

Differences Between Federal and California First-Time Penalty Abatement Program		
Issue	**California program**	**Federal program**
Qualified taxpayers	Only individuals	Individuals and businesses
Qualified penalties	Late-filing penalty (R&TC §19131) Late-payment penalty (R&TC §19132)	Failure to file/timely file (IRC §§6651(a)(1), 6698(a)(1), 6699(a)(1)) Failure to pay/timely pay (IRC §§6651(a)(2), 6651(a)(3)) Failure to deposit (IRC §6656)
Availability	Once in a lifetime and only for one tax year Only applies to penalties imposed for post-2021 tax years	Once every four years
Applying for abatement	Requests may be made either orally or in writing	Requests may be made orally or by filing Form 843, Claim for Refund and Request for Abatement If a taxpayer submits a reasonable cause abatement request but qualifies for first-time abatement, the IRS will apply First Time Abate

CALIFORNIA'S INDIVIDUAL HEALTH CARE MANDATE

California's health care mandate is similar to the federal program adopted under the original Affordable Care Act, ensuring that plans maintain certain baseline coverage and subjecting individuals to penalties if they fail to obtain health insurance. Even though the federal individual mandate penalty was repealed, California still imposes the penalty.

The penalty amount is based on a formula that factors in the number of months for which there is no coverage, the cost of insurance, and the taxpayer's household size. It is paid on the individual's tax return and is computed on Form 3853, Health Coverage Exemptions and Individual Shared Responsibility Penalty. A penalty calculator is available on the FTB's website at:

Website
www.ftb.ca.gov/file/personal/filing-situations/healthcare/estimator/

California also provides subsidies to keep the insurance "affordable" in those years in which increased federal subsidies are not available. However, due to the Inflation Reduction Act's extension of the increased federal ACA subsidies through 2025, California will not be providing subsidies during this period.

Comment

Because subsidies are not being provided in 2022, taxpayers will not have to complete the Form 3849, Premium Assistance Subsidy, to reconcile the amount of California premium assistance subsidy they were entitled to. They will also not be receiving the Form 3895, California Health Insurance Marketplace Statement, from Covered California. Covered California will still be sending information directly to the FTB reporting which individuals had coverage throughout 2022.

California residents must maintain monthly minimum essential health care coverage for themselves and their dependents, as defined under R&TC §17056, unless they are exempt from the mandate. (Gov't. Code §10070 et seq.)

The following individuals are exempt:

- Individuals who have received a certificate of exemption from the Exchange for hardship, religious conscience, or unaffordability. For California purposes, coverage is considered unaffordable in 2022 if the individual's required contribution is more than 8.09% (2022) of applicable household income (for details about how to apply, see: www.coveredca.com/learning-center/tax-penalty-details-and-exemptions/exemptions/) (Gov't. Code §100715; R&TC §61015);
- A member of a health care sharing ministry (as defined by IRC §5000A(d)(2)(B));
- Incarcerated individuals (other than those awaiting trial);
- Non-U.S. citizens or nationals who are not lawfully present in the U.S.;
- Members of an Indian tribe;
- U.S. citizens who have a tax home outside the U.S;
- Bona fide residents of another state or U.S. possession; and
- Individuals enrolled in limited or restricted scope coverage under the Medi-Cal program or similar state program.

COVERED CALIFORNIA MAY BE A BETTER DEAL THAN PRIVATE INSURANCE

The current 8.5% cap on contributions to health care premiums applies to all individuals during the 2021 through 2025 taxable years regardless of their income level, which means many people will find that they can save money by obtaining their health insurance through Covered California rather than through private insurance or through their employer's plans. For more information about available plans and pricing, see:

Website
www.coveredca.com

But remember, the federal Premium Tax Credit is only available if the employer's plan is not considered "affordable."

Caution

Taxpayers who file MFS are ineligible for both the federal Premium Tax Credit and the California advance premium subsidies.

©2022

Employer filing requirement

Employers must file information returns with the FTB by March 31 each year to report the coverage provided for their employees and their dependents for the prior calendar year. A statement must also be provided to the covered individual by January 31 following the covered year. The statute states that the current 1095-B, Health Coverage, and 1095-C, Employer-Provided Health Insurance Offer and Coverage, satisfy the requirement. See FTB Publications 3895B and 3895C for more information.

A penalty equal to $50 per applicable individual (covered employee, spouse and/or family member) will be imposed against employers that fail to file the information returns. However, the employer is not required to file the return if the health care plan files the required returns.

SELLING A NONRESIDENT'S INTEREST IN AN ENTITY

If your business client wants to become a nonresident, you must help carefully plan the exit when they plan to dispose of the business. Structuring a sale too soon can make the gain taxable to California. Waiting until the client is a nonresident could save big tax dollars.

Any taxpayer who wants to move to a nontax state prior to selling a business or other asset not sourced to California must make the move and become a nonresident before the sale. This can be a bit trickier than it might seem, and the FTB pays close attention.

In a series of cases and rulings, it is clear that the FTB has also been successful in finding ways to tax the income from the sales even if the taxpayer has become a nonresident.

At this stage, only taxpayers who sell their ownership interest in the entity after they establish residency in their new state can escape taxation on the sale. As discussed below, if the sale is treated as an asset sale, nonresident owners will likely be paying California taxes on the sale.

NONRESIDENT PARTNERS' SALE OF A PARTNERSHIP INTEREST

For years, taxpayers and their tax professionals treated the sale of a partnership interest as the sale of any other intangible and sourced all of the income from the sale to the partner's state of residence.

However, in July 2022, the FTB issued Legal Ruling 2022-02, and took a surprising position, which will result in many nonresidents who sell their interest in a partnership being subject to California tax on deemed income from the sale.

Although the nonresident's interest in the partnership is an intangible interest and the gain from the sale of the interest is sourced to the nonresident's state of residence, the partnership's unrealized receivables, including depreciation recapture, and inventories must also be taken into account at the time of the sale pursuant to IRC §751.

According to the FTB, the operation of IRC §751 requires that the sale of the partnership interest be treated as two distinct transactions:

- One in which the intangible partnership interest is sold by the partner, the gain from which is sourced to the partner-seller's state of residence; and
- One in which the underlying IRC §751 property is treated as sold by the partnership immediately before the partner disposes of its interest, leading to a deemed distribution to the partner.

If the partnership operates wholly within California, all the income from the sale of the IRC §751 items is considered California-source income. (18 Cal. Code Regs. §17951-4; R&TC §17952)

If the partnership operates both inside and outside California, the nonresident's income from the sale of the unrealized receivables and inventory is treated as apportionable business income. The income from the sale of the unrealized receivables and inventory must be apportioned using the sourcing rule appropriate to that item "sold." (18 Cal. Code Regs. §17951-4(d))

Example of how partnership interest sale is taxed

In 2022, Alice, a resident of Nevada, sells her 20% interest in the ABC Partnership to Bob for $50,000. The ABC Partnership sells school supplies to schools throughout the U.S. At the time of the sale, ABC had outstanding receivables of $800,000. ABC's California sales factor for 2022 is equal to 15%.

Alice is subject to California tax on $24,000 ($800,000 × 15% sales factor × 20% (Alice's partnership interest)). The remaining $26,000 is considered income from the sale of her interest in the partnership, which is sourced to Nevada, her state of residence.

✎ **Practice Pointer**

Nonresidents who sold an interest in a California partnership or a non-California partnership with California-source income may want to evaluate whether they need to file an original or amended California return.

Comment

Although this legal ruling summarizes the FTB's position, several commentators have indicated that they believe the FTB's interpretation is incorrect and anticipate that the FTB's position will likely be challenged in the courts.

S CORPORATION SHAREHOLDERS: THE CALIFORNIA TWO-STEP ANALYSIS

Whether income from a sale of an S corporation's assets, including the S corporation's goodwill, is sourced at the entity level or the shareholder level can have a huge impact on a nonresident shareholder's California tax liability. (***Appeal of Faries***, 2022-OTA-068)

In a recent case before the California Office of Tax Appeals (OTA), nonresident 100% shareholders (husband and wife) were assessed an additional $1.3 million in tax when the OTA determined that the FTB properly applied a two-step analysis to determine how much of the shareholder's income from the S corporation's almost $250 million gain should be sourced to California.

The taxpayers tried to argue that under IRC §1366(b) as followed by California (R&TC §17087.5), the character of any passthrough item included in a shareholder's *pro rata* share should be treated as if directly incurred by the S corporation. Because goodwill is an intangible, the taxpayers contended that the S corporation's gain from the sale of the intangible goodwill should flow through to them at the shareholder level and be sourced to their state of residence (Florida). (R&TC §17087.5)

The two-step analysis

The OTA held that although California does incorporate the federal treatment of S corporations, it is modified by California law, which requires that a two-step analysis be applied to determine how to source a nonresident's share of a multistate S corporation's income:

- **First, at the S corporation level:** Determine whether the income is apportionable business income, which would be divided up among all the states in which the S corporation does business, or allocable nonbusiness income at the S corporation level; and
- **Second, at the shareholder level:** If the income is apportionable business income, then the S corporation's income apportioned to California is treated as California-source income subject to California tax on the taxpayer's California nonresident personal income tax return. If the income is nonbusiness income, the income is sourced using the personal income tax sourcing rules, which generally source the income from intangibles to the state in which the nonresident resides.
(R&TC §§17087.5, 17951–17954; 18 Cal. Code Regs. §17951-4)

Example of two-step analysis

S Corporation, a multistate corporation, sold a patent for $5 million (treated as business income). Of S Corporation's business income, 20% was apportionable to California. Susan, a Florida resident, was a 10% owner of S Corporation. $100,000 of S Corporation's income from the patent sale (($5,000,000 × 20%) × 10%) was considered California-source income that Susan must report on her California nonresident return.

Business or nonbusiness income?

Income received from an S corporation's sale of goodwill is considered apportionable business income. (R&TC §25120(a); ***Appeal of Borden***, 77-SBE-007; ***Appeals of The 2009 Metropoulos Family Trust***, 2019-OTA-385P)

Whether an item sold is characterized as "tangible" or "intangible" property does not determine whether the income from the item is considered "business" or "nonbusiness" income. Business income can be from both tangible and intangible property as long as the property is essential to the taxpayer's business activities. The Board of Equalization (which heard appeals prior to the OTA) has previously held, "Goodwill is so essential to the viable conduct of a business that it has been held to be inseparable from the business as a whole." (***Appeal of Borden***, supra)

Determining the apportionment formula

The OTA also determined that the FTB properly excluded the gross receipts from California's sales factor. The apportionment formula's sales factor is used to measure a business's activity in a state (the numerator) in comparison to its activities throughout all the states in which it operates (the denominator).

Generally, a business must include all of its gross receipts in the calculation. (R&TC §25120(f)(1); 18 Cal. Code Regs. §25134) However, an FTB regulation excludes gross receipts from the sales factor calculation if the sale that generated the gross receipts is an "occasional" sale that generates "substantial" gross receipts. (R&TC §25137; 18 Cal. Code Regs. §25137(c)(1)(A))

A sale is:

- "Substantial" if excluding the gross receipts results in at least a 5% decrease in the sales factor denominator; and
- "Occasional" if the sale is outside the taxpayer's normal course of business and occurs infrequently.

In this case, excluding the $250 million in gross receipts was "substantial," and the S corporation's sale of all of its assets was an occasional sale.

Excluding occasional sales from the sales factor results in a larger apportionment factor in most of the states in which the business operates, meaning that these states get to tax more of the business's income.

In this case, excluding the gross receipts from the asset sales from California's sales factor resulted in increasing the S corporation's apportionment formula from 1.7362% to 6.5033%. Bottom line, California was able to tax almost an additional $11 million of the S corporation's business income.

Is this fair?

The taxpayer argued that excluding these gross receipts did not fairly reflect its business activity for the tax year at issue because although the sale of the assets generated close to a $250 million gain, the business's ordinary business operations actually generated a net loss of almost $13 million. The taxpayer claimed that this was distortive because the FTB was using the sales factor from its low-margin unprofitable business operations to apportion a high-margin $250 million gain.

However, the OTA rejected the argument finding that the sales factor is designed to attribute a business's income to the jurisdictions in which its goods and services are consumed "regardless of whether the business later turns a profit or loss on those purchases." Furthermore, the 6.5033% apportionment formula was far more consistent with the taxpayer's apportionment formula used in prior years than the lower apportionment formula advocated by the taxpayer.

 ©2022

Caution

In ***The 2009 Metropoulos Family Trust v. FTB*** ((May 27, 2022) Cal. Ct. App., 4th App. Dist., No. D078790), a California court of appeal came to a similar conclusion to the OTA's decision in ***Appeal of Faries***. However, the court also offered an alternative approach for reaching the same conclusion that a nonresident's income from the sale of goodwill from a business conducted both inside and outside California is subject to California taxation. And this reasoning may have significant fallout for nonresidents who sell sole proprietorships or even corporate stock and partnership interests in entities operating in California. The taxpayers appealed the ruling to the California Supreme Court, but the petition for review was denied in August 2022. This means the FTB must follow the appellate court's ruling in this case.

While acknowledging that the sale of an intangible, including an interest in an S corporation, is generally sourced to the nonresident's state under the *mobilia* doctrine (*mobilia sequuntur personam* – "movable property follows the person"), the court noted that R&TC §17952 contains an exception for property that "has acquired a business situs in this state." The court found that the S corporation's goodwill and brand in California established at least a partial "business situs" in California. The court stated that because the S corporation received protection and benefits from the state of California, it had established a business situs in California. Because the S corporation apportioned a percentage of its business income to California, it meant that the management and disposition of the intangible property making up that income constituted an integral part of its regular trade or business operations, and therefore, that portion of the goodwill had developed a business situs in the state. According to the court, the income from the intangible property could be divided among all the states in which the intangible property was an integral part of the business in the states.

It will be interesting to see how the FTB will apply the reasoning of ***Metropoulos*** going forward. The ***Metropoulos*** case involves the sale of the S corporation's assets and not the sale of stock. However, we will have to wait and see how the FTB applies the "business situs" reasoning to the sale of other types of intangibles.

SPOUSES WORKING IN DIFFERENT STATES: WHICH STATES GET TO TAX?

In two recent appeals, taxpayers with one spouse in California and one spouse in another state incorrectly reported their income taxable to California. Both taxpayers oversimplified the income reporting and failed to take into account community property rules and the California method for computing tax.

SPLIT IT DOWN THE MIDDLE

Taxpayers excluded the entirety of the taxpayer-husband's Texas wages from their California income. (***Appeal of Dencklau***, 2022-OTA-155) For the year at issue, the husband was a resident and domiciliary of Texas who had non-California wages, and the wife was a California resident but a Texas domiciliary who had California wages. The couple argued that only 50% of their combined income should be subject to California tax because their income is community income and therefore should be divided equally, and the husband was not a resident of California for the year at issue.

However, when making the determination of whether income is taxable to California, there is a two-step process:

1. Does the nonearning spouse have a marital property interest in the earning spouse's income?
2. If so, is the nonearning spouse's interest taxable in California?

Because Texas is a community property state, the taxpayer-wife had a one-half community property interest in the husband's earnings. These earnings were subject to California tax because the wife was a California resident, and California residents are taxed on all income, regardless of source.

On top of that, 100% of the wife's wages were taxable to California because:

- The wife was domiciled in Texas, a community property state, so her husband had a one-half community property interest in her wages; and
- Her wages were California source-income, so his share of her wages was subject to California taxation.

Because the wife was a California resident, her half of her wages were subject to California taxation as well.

METHOD TO THE MADNESS

In another case, the taxpayers argued against the California "taxation" of the taxpayer-husband's Washington income. In this case, the husband was a resident of Washington, also a community property state, and the wife was a California resident. While the FTB conceded he was a nonresident for the year at issue and therefore his half of his wages were not subject to California tax, the wife's share of his wages was subject to California tax because she was a California resident. But even though his half of his wages were not subject to tax, those wages factored into total California AGI for the purposes of computing the California rate of tax. (***Appeal of Noble***, 2022-OTA-159; R&TC §17041(a))

Nonresidents and part-year residents only pay tax on California-source income, but their worldwide income affects the rate at which their California-source income is taxed. This method of computing the tax rate is known as the "California method."

The California method of taxation does not tax out-of-state income that is received while a taxpayer is not a resident of California. Tax is calculated by multiplying the California-source taxable income of a nonresident or part-year resident by a rate equal to the tax computed on worldwide income as if the person were a resident.

Although this method has been challenged by numerous taxpayers as unconstitutional, it has consistently been upheld by the courts.

OTHER STATE TAX CREDIT REQUIRES DOUBLE-TAXED INCOME

Taxpayers who were part-year residents of California were denied the Other State Tax Credit (OSTC) where they had income from other states (Connecticut and Texas), but that income had not been double-taxed by California. (***Appeal of Guha and Murphy***, 2022-OTA-053) In order for the credit to apply, the income must have a source within the other state and be taxed by that state and California. (R&TC §§18001–18011)

The taxpayers reported that the Connecticut-taxed income was neither income received as a California resident nor received from California sources. On their Connecticut return, they reported $6,770 in Connecticut tax, and then claimed an OSTC of $6,770 on their California return.

The California return did not tax the Connecticut income; however, it did factor the Connecticut income into the rate used to determine tax on the taxpayers' California income. Part-year California residents, such as these taxpayers, are taxed on their entire taxable income for the period of their residency and only on income from California sources for the period of their nonresidency. (R&TC §§17041(b) and (i), 17951; ***Appeal of Bracamonte***, 2021-OTA-156P) However, California determines the applicable California tax rate of a part-year resident based on the part-year resident's income from all sources during the taxable year (i.e., the "California method"). (R&TC §17041(b); ***Appeal of Million*** (1987) 87-SBE-036)

Because it was clear that the two states were not taxing the same income (California did not tax the taxpayers' Connecticut-source income, and Connecticut did not tax the taxpayers' California-source income), there was no double-taxed income, and the credit was denied.

CREDIT OVERVIEW

Generally, the credit is allowed for individuals, estates, and trusts and is taken against double-taxed income on the taxpayer's resident return. However, there are a few exceptions. For certain states (referred to as "reverse credit" states), the credit is taken on the nonresident return. If you have income taxed by California and another state, use the chart below to determine where to take the credit.

The credit is not allowed for taxes paid to cities and counties. However, a portion of the taxes paid to Maryland counties is allowed in computing the credit for Maryland. The maximum amount includable in this credit is 20% of the state tax. (***Appeal of Daniel Q. and Janice R. Callister***, 99-SBE-003)

To qualify for the OSTC, the tax must also be paid to the other state by transferring property (usually cash) to the other state, not through the use of a tax credit generated by the taxpayer. A nonrefundable state tax credit is treated as a dollar-for-dollar reduction or potential reduction in the taxpayer's state tax liability, not as a payment of a state tax for which the OSTC may be claimed. (FTB Legal Ruling 2017-01)

Other State Tax Credit — Where to Take It
(R&TC §§18001 and 18002; California Schedule S)

Taxpayer is:	**Income is from:**	**Credit is taken on:**
California resident	Arizona, Guam, Oregon,* Virginia	Other state nonresident return
	Any state or U.S. possession not listed above	California resident tax return
California nonresident	Arizona, Guam, Oregon, Virginia	California nonresident tax return
	Any state or U.S. possession not listed above	Other state resident return

* There is an exception for California residents who paid tax to both California and Oregon on wages for services performed in Oregon in connection with a qualifying film production

CALCULATION OF CREDIT

In the case of income that is being taxed by two states, here is how the OSTC is calculated.

First step

Calculate the amount of income taxable by both California and the other state (Schedule S, Part I). Typically, they will be the same, although they may vary because of depreciation or other laws.

Revenue and Taxation Code §18001 defines double-taxed income for resident taxpayers claiming the credit to reflect only income that would be sourced to California to a nonresident. In other words, you cannot take the credit if the other state taxes the nonresident on the income, but California would not tax a nonresident on the same income.

Example of sourcing income for OSTC purposes

Joey is a California resident. He sold property in Hawaii and is receiving principal and interest payments on the property sale. Hawaii law requires him to pay tax on the principal and interest payments (under Hawaii law, all interest on the sale of property located in Hawaii has a situs there). California allows an OSTC on the principal payments but not on the interest payments. This is because, under California law, the interest is sourced to California, not Hawaii, and a Hawaii resident is not required to pay California tax on the interest if the interest does not have a California situs.

Second step

Calculate a percentage of the double-taxed income taxable by California divided by the California adjusted gross income (Schedule S, lines 3 through 5). The percentage cannot exceed 100%. This percentage is then multiplied by the California tax liability (Schedule S, line 6).

Third step

Calculate a percentage of the double-taxed income taxable by the other state divided by the other state's adjusted gross income (Schedule S, lines 8 through 10). The percentage cannot exceed 100%. This percentage is then multiplied by the income tax paid to the other state for the same year the income is taxed by California (Schedule S, line 11).

The credit is the lesser of the results of step two or step three (Schedule S, line 12).

Example of Schedule S calculation (Steps 2 and 3)

Maggie is a California resident and owns a rental property in New York City. Her net rental income is $30,000 for both California and New York purposes. Maggie's California AGI is $380,000, her New York AGI is $30,000 (because her only New York income is the rental property), and her double-taxed income is also the same $30,000 of New York rental income.

Other State Tax Credit Calculation		
Schedule S Line	**Description**	**Amount**
2	California tax liability (Form 540, line 35)	$30,447
3	Double-taxed income taxable by California	$30,000
4	California AGI (Form 540, line 17)	$380,000
5	Line 3 ÷ Line 4 (cannot exceed 100%)	0.0789
6	Line 2 × Line 5	$2,402
7	New York tax liability (NY Form IT-203, line 50)	$1,922
8	Double-taxed income taxable by New York	$30,000
9	New York AGI (NY Form IT-203, line 31)	$28,250
10	Line 8 ÷ Line 9 (cannot exceed 100%)	1.0
11	Line 7 × Line 10	$1,922
12	Other State Tax Credit (smaller of Line 6 or Line 11)	$1,922

ADDITIONAL TAX RELIEF PROVIDED TO LOW-INCOME TAXPAYERS

SB 201 (Ch. 22-72) expands tax relief available to California low-income taxpayers by:

- Expanding the Young Child Tax Credit beginning with the 2022 taxable year to:
  - o Make it available to taxpayers without earned income as long as they have a child younger than six years old. Taxpayers with net losses in excess of $30,000 are ineligible for the credit as are taxpayers with wages in excess of $30,000. These amounts are adjusted annually for inflation; and
  - o Require the amount of credit available to be indexed for inflation (in the same manner income tax brackets must be adjusted annually);
    (R&TC §17052.1)
- Enacting a new Foster Youth Tax Credit (see below); and
- Revising the Earned Income Tax Credit to require that the phaseout percentages for the prior taxable year be applied for taxable years after the taxable year in which the minimum wage is set at $15 per hour. (R&TC §17052)

FOSTER YOUTH TAX CREDIT

Beginning with the 2022 taxable year, qualified taxpayers may claim a new refundable Foster Youth Tax Credit equal to $1,000 ($1,083 (adjusted for inflation) multiplied by the current-year's Earned Income Tax Credit adjustment factor (85% for the 2022 taxable year)). (R&TC §17052.2) The credit is phased out by $20 (adjusted for inflation) for each $100, or fraction thereof, by which the qualified taxpayer's earned income exceeds $25,000.

A qualified taxpayer is an individual who:

- Is allowed a California Earned Income Tax Credit for the taxable year;
- Is 18 to 25 years old, inclusive, as of the last day of the taxable year; and
- Was in foster care while 13 years of age or older in county or tribal-approved placement.

 ©2022

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

5. What are among the details of the middle class tax refund included in California's budget deal?

   a) The refunds for married taxpayers range from $700 to $1,400
   b) To be eligible, a California resident must have filed a 2020 tax return by October 15, 2021
   c) The taxpayer must have been a California resident during the entire 2020 calendar year
   d) The payments are subject to withholding

 ©2022

SOLUTIONS TO REVIEW QUESTIONS

5. What are among the details of the middle class tax refund included in California's budget deal? **(Page 8-2)**

    a) Incorrect. For MFJ, the range is $400 to $1,050 depending on California AGI and dependent credits.
    b) Correct. Taxpayers without a Social Security number had until February 15, 2022, to file as long as they applied for an ITIN and had not received it by the filing deadline. In this case they will also qualify for the refund.
    c) Incorrect. The taxpayer must be a resident on the date the payment is issued and for a minimum of six months during 2020.
    d) Incorrect. They are not subject to withholding or levy for outstanding state tax liabilities, penalties, etc.

 ©2022

Chapter 9

California Business

CALIFORNIA BUSINESS

PASSTHROUGH ENTITY ELECTIVE TAX

In 2021, California passed AB 150 (Ch. 21-82), which allows, for the 2021 through 2025 taxable years, a qualified S corporation, partnership, or LLC taxed as a partnership or S corporation to make an election to pay a passthrough entity elective tax equal to 9.3% of its qualified net income. This tax decreases the federal net income included on the owners' K-1. (R&TC §§17052.10, 19900 et seq.)

California also allows the entity's consenting individual, estate, trust, and now certain single member LLC (SMLLC) owners to claim a credit on their California return of up to 100% of the tax paid on their behalf. (R&TC §17052.10)

AB 150 was modified by SB 113 (Ch. 22-3), which rectified many of the drawbacks to the tax as initially enacted as noted below.

> ***Comment***
>
> The passthrough entity tax is in addition to any other tax or fee that the passthrough entity may be subject to.

HOW THE PASSTHROUGH ENTITY ELECTIVE TAX AND CREDIT WORK

Qualified passthrough entities (described below) that make the election will pay the tax on behalf of consenting, qualified taxpayer owners (also discussed below).

The tax is deductible on the federal return (just like any other state tax) but not the state return. In essence, this allows the K-1 recipient to reduce federal AGI rather than having a state tax deduction on Schedule A, which would be subject to the $10,000 state and local tax (SALT) deduction limit. For federal purposes, the net income is reduced by the amount of the tax paid at the entity level.

For California, the state tax deducted on the federal return is added back into net income on the California K-1, but the consenting owners will receive a California tax credit of up to 100% of the state tax paid by the passthrough entity on behalf of its consenting qualified taxpayer owners.

> ***Example of making election***
>
> Making Money, Inc., a California S corporation, has qualified net income of $400,000. Two shareholders each have a 50% interest. If both shareholders qualify and the election is made, the S corporation makes a payment of $37,200 to the FTB. The S corporation then deducts the $37,200 on the federal return, which reduces each shareholder's net K-1 income from $200,000 to $181,400 (($400,000 - $37,200) × 50%).
>
> The California returns filed by each of the shareholders will report $200,000 of net income from Making Money because the passthrough entity tax is added back on the California return. However, each shareholder will receive a credit of $18,600 ($37,200 × 50%) to use against their individual California income tax.

If the federal $10,000 SALT limitation, as it read on January 1, 2021, is repealed, the elective passthrough entity tax will become inoperative on the following January 1. This type of SALT workaround has been approved by the IRS. (IRS Notice 2020-75)

QUALIFIED ENTITY

Only entities taxed as an S corporation, partnership, or an LLC taxed as a partnership or an S corporation are eligible to make the election and only if:

- The entity is not permitted or allowed to be in a combined return; or
- The entity is not a publicly traded partnership.
  (R&TC §19902)

AB 150 originally prohibited entities from making the election if any one of their owners was a partnership. SB 113 retroactively changed the law so that beginning with the 2021 taxable year, entities with partnership owners can make the election. However, the entity cannot pay the tax on behalf of the partnership owner.

Comment

Unlike most other states' passthrough entity elective tax regimes, California allows electing entity owners to opt out of having the entity pay the tax on their behalf.

When a qualified entity makes an election to pay the tax, each partner, shareholder, or member then has the option to consent to having the entity pay the tax on their behalf, or they may opt out. The entity may still elect to pay the tax even if some of its owners do not consent, but the entity will only pay tax on the shares of those owners that consent.

This essentially means that the decision whether to make the election will be made by the managing or controlling partner/member/shareholder.

Entities may want to amend their operating agreements to specify who is authorized to decide whether to make the election and under what conditions the election may be made.

Trusts are not qualified entities for purposes of this tax. This means that the tax may not be paid at the trust level. However, trusts are considered qualified taxpayers, so an S corporation or partnership can pay the tax on behalf of their trust owners. See page 9-3 for more information on qualified taxpayers.

Caution

The FTB has confirmed that an entity that is an otherwise qualified entity will still qualify if the owner has contributed their shares or interest to their living trust.

Single member LLCs

SMLLCs are not eligible to make the election unless they elect to be taxed as an S corporation, add a member, or in the case of married taxpayers in a community property state, they elect to be treated as a partnership.

 ©2022

Caution

Making these elections midyear will result in two short-year California returns and two $800 annual/minimum franchise tax payments. When a SMLLC elects to be taxed as an S corporation or adds a member, no filing is required with the California Secretary of State. However, a SMLLC that adds a member is required to get a new EIN. See page 5-22 for more information on when entity changes require new EINs.

Practice Pointer

To elect S corporation status to be eligible to make the passthrough entity tax election, S corporations must make the election by filing Form 2553, Election by a Small Business Corporation, within two months and 15 days after the beginning of the tax year the election is to take effect (although late elections are frequently granted routinely).

A husband and wife in a community property state elect to be taxed as a partnership, rather than an SMLLC, simply by filing a Form 1065, U.S. Return of Partnership Income, rather than reporting the LLC's income on a Schedule C. (Rev. Proc. 2002-69)

California filing requirement

To make the election, the entity must be "doing business" in California and required to file a California return, so out-of-state entities that are not considered to be doing business in California cannot make the election, even if their owners are California residents.

QUALIFIED TAXPAYER

An electing entity may only pay the tax on behalf of its owners that are qualified taxpayer(s). A "qualified taxpayer" is an individual, trust, or estate subject to California personal income tax that is a partner, shareholder, or member that consented to have a qualified entity pay tax on their *pro rata* or distributive share of the entity's income. (R&TC §17052.10(b)(3))

A qualified taxpayer does not include a corporation or a business entity, so the entity cannot pay the tax on behalf of its corporate or business owners. This includes businesses (other than SMLLCs) that are disregarded for federal tax purposes, "or the members or partners of a disregarded entity." (R&TC §17052.10(b)(3)(B))

Example of no qualified taxpayers

The S&S Partnership has two partners; both are S corporations.

Although S&S is technically a "qualified entity" for purposes of making the election, there is no reason for S&S to make the election because none of the partners are qualified taxpayers.

However, the two S corporation partners are qualified entities, and they may each make the election to pay the tax at the S corporation level, and they may include the income tax flowing through to them from the partnership.

Single member LLCs

As a result of changes made by SB 113 retroactive to the 2021 taxable year, an SMLLC owned by an individual, estate, or trust is a qualified taxpayer. Therefore, qualified entities can pay the tax on behalf of the SMLLC, and the owner of the SMLLC may claim the credit on their return for the tax paid on their behalf by the electing entity.

Example of SMLLC owner

ABC, LLC is an SMLLC owned by Alice. ABC is a partner in the PST Partnership.

PST is a qualified entity that elects to pay the passthrough entity tax. As a result of changes made by SB 113, PST may pay the tax on behalf of ABC, LLC.

Trusts

The FTB has confirmed that trusts are qualified taxpayers eligible to claim the credit and that the trust may pass through the Passthrough Entity Elective Tax Credit to its beneficiaries. This includes grantor trusts and intentionally defective grantor trusts, which may pass through the credit to their grantor. The credit will be reported to the beneficiary on the 541 K-1, line 13d, Other Credits.

See page 9-17 for a discussion of reporting the tax and credits for trusts and their beneficiaries.

QUALIFIED NET INCOME

The tax is 9.3% of "qualified net income." Qualified net income is the sum of the *pro rata* share, or distributive share, of income, and any guaranteed payments (as described in IRC §707(c)) of the entity's individual, trust, or estate owners, as long as the owners:

- Are subject to California taxation; and
- Consent to have their share of income subject to the passthrough entity elective tax.

Consenting owners

There are no specific agreements that consenting owners must sign, although we encourage businesses to draft some form of agreement and keep this with their records. The list of consenting owners will be provided to the FTB on Form 3804, Pass-Through Entity Elective Tax Calculation, which the entity must submit when they file their return.

The entity may still elect to pay the tax even if some of its owners do not consent. However, the amount of qualified net income will be reduced by the nonconsenting owners' share of the entity's income.

Expense allocation generally

For federal purposes, the passthrough entity elective tax payments are treated as an expense of the passthrough entity at the entity level. The payments are recorded as a Debit — Tax Expense.

Absent different guidance from the IRS, this would mean that the payments would be equally allocated to **all** owners based on their ownership percentage, even if they did not elect to have a payment made on their behalf. This means the consenting qualified owners who essentially "paid in" to get the higher state tax deduction will not be getting all that they paid for.

Expense allocation for S corporations

This is a major issue for S corporations. In a letter to the IRS, the AICPA has recommended that the IRS issue regulations stating that these payments are treated similarly to nonresident withholding or composite tax payments under Treas. Regs. §1.1361-1(l)(2)(ii). This would allow nonconsenting owners to receive proportionate compensating distributions without the creation of a second class of stock.

Example of equal deductions

Emerald, Inc., an S corporation, has three shareholders: Dorothy (one-third), Linus (one-third), and Em (one-third). Emerald has $1.5 million of qualified net income for purposes of the passthrough entity tax. Dorothy and Linus consent to have Emerald pay tax on their behalf, but Em does not.

Emerald makes a $93,000 passthrough entity tax payment ($1,000,000 × 9.3%), which reduces their federal income to $1,407,000. That amount flows through to Dorothy, Linus, and Em on their K-1s, reducing the income on each of their K-1s to $469,000 (($1,500,000 - $93,000) ÷ 3). Even though Em does not consent have Emerald pay the tax on her behalf, her K-1 income is reduced.

Expense allocation of partnerships

Partnerships are permitted to specially allocate deductions (so long as the partnership/operating agreement allows); however, these entities must compensate for these payments being made for some partners and not others.

✐ Practice Pointer

We've heard that some practitioners are having clients debit state tax expense but create a new account to separately track it and credit cash. The expense would then need to be specially allocated to each participating owner's capital account when closing out P&L to retained earnings.

Whatever approach is taken, partnerships should amend their partnership operating agreements to specify how the passthrough entity elective tax deduction and any compensating distributions will be allocated.

Guaranteed payments

Although many other states include guaranteed payments in net income subject to the passthrough entity elective tax, the FTB originally took the position that AB 150 excluded guaranteed payments from the calculation. However, SB 113 retroactively clarified that guaranteed payments are specifically included in qualified net income. (R&TC §19902)

Example of guaranteed payments

John and Frank are 50/50 partners in the JF partnership. John manages the business and is compensated with a guaranteed payment of $50,000. The remaining net income from the entity is $200,000.

The total net income for purposes of the passthrough entity tax is $250,000 (John's $50,000 guaranteed payment + $200,000 net income). This results in a $23,250 ($250,000 × 9.3%) passthrough entity elective tax payment.

John and Frank amend their partnership agreement to allow them to specially allocate $13,950 of the payment to John ($50,000 + $100,000) × 9.3%), and $9,300 to Frank ($100,000 × 9.3%), rather than splitting it 50/50.

Capital gains and investment income

The tax is paid on all income reported on the K-1 including interest, dividends, and capital gains.

Caution

Although it is clear this income is included in net income for purposes of the passthrough entity tax, absent further guidance from the IRS we do have concerns about where these payments are deducted at the federal level for investment entities that have no line 1 trade or business activity.

Will it be treated as a stand-alone trade or business expense? Does it offset the investment income? Or would it be treated as a miscellaneous itemized deduction (which won't benefit your clients)?

The good news is that for taxpayers that will fully benefit from the California credit, the only drawback to making the payment is that they may not ultimately benefit from the federal deduction.

Sourcing of income

The entity will include in its qualified net income calculation all of the consenting resident owners' distributive or *pro rata* share of income. For nonresident owners, only their post-apportioned share of the entity's income is included in the entity's qualified net income.

Example of sourcing qualified net income

ABC, Inc. is an S corporation with $1.3 million in net taxable income, $800,000 in California-source income, and $500,000 in Georgia-source income. ABC has two 50% shareholders, Ralph and Alice. Ralph is a Georgia resident, and Alice is a California resident.

If both Ralph and Alice consent to have ABC pay the tax on their behalf, ABC's qualified net income for purposes of the passthrough entity tax would be calculated as follows:

Ralph's share ($800,000 × 50%)	$ 400,000
Alice's share ($1,300,000 × 50%)	650,000
Total	$1,050,000

 ©2022

Computing qualified net income

The FTB has stated that the *pro rata*/distributive share of income can generally be computed:

- For S corporation shareholders, by taking the sum of lines 1–10 minus lines 11 and 12 from the K-1 (100S); and
- For partners, by taking sum of lines 1, 2, 3, and 4c through 11 minus lines 12 and 13 for the K-1 (565/568).

In general terms, this means the partner's/shareholder's share of the entity's rental income, interest income, dividends, royalties, and capital and IRC §1231 gains is included less IRC §179 deductions, charitable contributions, and investment interest expense. The FTB has also confirmed that IRC 743(b) adjustments are included in the qualified net income calculation.

Comment

We asked the FTB to provide examples when the "general" rule would not apply, and we were assured that it would only be in unusual and isolated instances when the figures reported on the lines listed above would not be included.

Interest paid on debt-financed distributions

The FTB has confirmed that the expense for interest on partnership debt that is used to finance distributions is a deduction item included in the qualified taxpayer's distributive share of partnership income in computing qualified net income for the passthrough entity elective tax.

According to the FTB, the distributive share of a qualified taxpayer-owner's qualified net income is the sum of lines 1–11 minus the sum of lines 12 and 13 on the Schedule K-1 (Forms 565 and 568), and the partnership reports the interest from the debt-financed distributions in box 13.

Several tax professionals questioned whether the interest payments should be counted in the qualified net income calculation as it is not a partnership expense, rather it is paid by the partnership on behalf of the owners. Because the partnership does not know how the partners will utilize the distributions, it's unclear whether the interest will ultimately be deductible or not. (IRS Notice 89-5) The FTB's position is that the interest should be included in the calculation.

THE FEDERAL DEDUCTION

The IRS gave its stamp of approval to this type of passthrough entity tax in IRS Notice 2020-75 and stated that they intend to issue proposed implementing regulations clarifying the treatment of taxes on both the entity's and owners' returns. To date, the IRS has not yet issued any proposed regulations or additional guidance.

The notice appears to state that the passthrough entity would deduct the tax in the year the tax is paid and that the tax payment would reduce the passthrough entity's distributable net income reported on the owner's K-1 for the year the tax is paid.

This would mean that a tax payment made in 2022 for the 2021 tax year would be deducted on the entity's 2022 tax return and passed through on the 2022 K-1.

Open questions: fiscal-year and accrual basis taxpayers

There is nothing in Notice 2020-75 that specifically addresses fiscal-year taxpayers. Many commentators are taking the position that fiscal-year taxpayers should be able to rely on the statement made in Notice 2020-75 that taxpayers claim the deduction in the year the tax is paid. But until we get additional guidance from the IRS, this is still an open question.

Because the notice states that the deduction is taken in the year paid, there is a question as to whether accrual basis taxpayers may take a 2021 deduction for payments made in 2021. The conservative position is that they are also required to take the deduction in the year the tax is paid. However, some are taking the more aggressive position that these taxes can be accrued.

Tax overpayments

The IRS has not addressed whether a taxpayer that overpays the tax in 2021 is limited to deducting the amount of tax that will actually be due, or whether they may claim the deduction for the amount paid in 2021, and then include in their 2022 taxable income any amount actually refunded. Many commentators are taking the position that, absent contrary guidance being issued by the IRS, the amount of tax actually paid should be deducted in the year paid, and any overpayment refunded should be included as a taxable refund in the following tax year.

MAKING THE ELECTION

The election is made annually, is irrevocable, and can only be made on an original, timely filed return, including extensions. (R&TC §19900) To make the election, the entity must attach Form 3804, Pass-Through Entity Elective Tax Calculation, to its return. Form 3804 lists all of the electing entity's owners for whom the tax was paid and the amount of tax paid on their behalf.

Comment

Beginning with the 2022 taxable year, although the election can technically be made by the extended return date, if the taxpayer fails to make the prepayment by June 15 of the taxable year, it is prohibited from making the election. This means starting in 2022, the entity will have to decide whether it will be making the election by June 15 of the taxable year.

Extended returns

For 2021, taxpayers were able to make an election on the extended return to pay the tax, and the entity owners qualified for a 2021 credit. Failure to pay by March 15 does not mean the taxpayer may not elect to pay the tax for 2021. It simply means the tax is late and will be subject to late-payment penalties and interest. For 2022 and later, taxpayers may elect on extended returns, but only if they make payments by June 15.

Superseding returns

The passthrough entity tax election must be made on an original, timely filed return (including extensions). Many taxpayers are asking if they can make or revoke an election on a superseding return. The FTB has said no. For purposes of the passthrough entity elective tax, the FTB is treating any return filed after the original return is filed as an amended return. The tax is exactly 9.3%.

 ©2022

What if the tax is underpaid?

For all years, if amounts paid by the original due date of the return are less than 9.3% of the entity's qualified net income calculated when the return is filed, the remainder will be due with the return, and the entity will be subject to late-payment penalties and interest. (FTB's webpage, "Help with pass-through elective tax") Unless there is reasonable cause, taxpayers that do not pay the total amount due shown on the tax return by the original due date (not including extensions) are subject to a penalty of 5% of the unpaid tax, plus 0.5% of the unpaid tax for each month, or part of the month, the tax remains unpaid, up to 40 months. The penalty cannot exceed 25% of the unpaid tax. (R&TC §19132)

Example of underpaid tax

Partnership A made an election to pay the passthrough entity elective tax for 2021 on behalf of three of its individual partners. The partnership pays an entity-level tax of $27,900 based on estimated qualified net income of $300,000 on March 15, 2022. This entitles each partner to a Passthrough Entity Elective Tax Credit of $9,300 on their 2021 California individual returns.

When the partnership files its extended return in July of 2022, it determines that its qualified net income is actually $330,000. The partnership must pay an additional $2,790 ($30,000 × 9.3%) with the extended return, plus interest and penalties on that amount.

This also increases each partner's corresponding credit on their 2021 California return by $930.

What if the tax is overpaid?

The entity will be refunded the overpaid amount, subject to any outstanding tax liabilities or offsets, once it files its return.

Comment

At this time, there is no mechanism to apply overpayments of 2021 passthrough entity elective tax as 2022 passthrough entity elective tax payments. However, both Form 100S, California S Corporation Franchise or Income Tax Return, and Form 568, Limited Liability Company Return of Income, allow for overpayments to be applied to the entity's 2022 estimated tax liabilities (or fees for LLCs). Otherwise, the entity will have to wait to have the overpayment refunded when they file their 2022 tax return.

Note: Partnerships do not have estimated tax or fee liabilities, so these entities will receive refunds of their overpayments.

PAYING THE TAX

For the 2021 taxable year, the tax was due by the due date of the original return, without regard to extensions (March 15, 2022, for calendar-year taxpayers).

2022–2025

For the 2022 through 2025 taxable years, the entity must make two payments. The first payment is due by June 15 of the taxable year. The amount due is the **greater** of:

- 50% of the elective tax paid for the prior year; or
- $1,000.

The remaining amount is due by the entity's original filing date deadline (March 15 for calendar-year taxpayers). If the June prepayment is underpaid, then the taxpayer is ineligible to make the election for that taxable year. (R&TC §19904)

Comment

The June 15 payment deadline applies to both calendar- and fiscal-year taxpayers.

Taxpayers that did not pay the tax in the prior year only need to pay a $1,000 prepayment.

Taxpayers whose prior-year return is on extension and has not been filed by June 15 of the current year must estimate the prior-year liability.

No exception to 50% requirement

There are no exceptions to the 50% of prior-year tax requirement for the June 15 payment.

R&TC §19904 states that an amount equal to, or greater than, either 50% of the elective tax paid the prior taxable year or $1,000, whichever is greater, must be paid on or before June 15 of the taxable year of election. The statute does not provide for exceptions to the June 15 payment requirement.

Example of lower income in next year

Partnership A, a calendar-year taxpayer, made an election in 2021 to pay the entity-level tax on behalf of its partners. The 2021 tax was $50,000.

Partnership A also wants to elect to pay the tax for the 2022 taxable year. The entity must pay $25,000 by June 15, 2022 (50% × $50,000), even if its income will be significantly lower in 2022.

June 15 payment considerations

If the June prepayment is underpaid, then the taxpayer is ineligible to make the election for that taxable year. There are currently no exceptions to this rule.

Adjustments to 2021 returns could jeopardize 2022 elections

As discussed above, the passthrough entity elective tax statute does not provide any exceptions to the June prepayment requirement.

Example of discovered income

ABC Partnership filed a timely 2021 tax return, and all of the partners elected to pay the passthrough entity elective tax. The original return reported $1 million of income and a passthrough entity elective tax liability of $93,000.

On June 1, 2022, ABC made a 2022 passthrough entity elective tax prepayment of $46,500 ($93,000 × 50%).

In August of 2022, ABC discovers that it failed to report $100,000 of income. When ABC amends the 2021 return, the 2021 passthrough entity tax liability is increased to $102,300. This increases ABC's 2022 passthrough entity elective tax prepayment requirement to $51,500. As a result, ABC may no longer make a 2022 passthrough entity tax election.

 ©2022

Comment

Although a taxpayer is ineligible to make the election for the current year if it files an amended return that increases its prior-year liability sufficiently that its June 15 payment did not satisfy the 50% requirement, the FTB has stated that "generally, if the adjustment is the result of an audit, the election and corresponding credits will not be retroactively disallowed."

✐ **Practice Pointer**

Many taxpayers learned the hard way that its best to cushion their June 15 prepayment amount to make sure they will not lose the option to make the election for the current year. Tax professionals should advise their clients to add a cushion to their June 15, 2023, prepayment for the 2023 taxable year.

Paid in or paid for?

Many tax professionals have been asking what the "paid the prior taxable year" language found in the passthrough entity elective tax statute means. Does it mean the amount paid in the prior taxable year or the amount paid for the prior taxable year? The FTB has clarified that it is the amount "paid for" the prior taxable year.

Example of paid for

In December 2021, the ABC Partnership paid $50,000 in passthrough entity elective tax on behalf of two of its partners, Alice and Bob, for the 2021 taxable year. When ABC filed its return in March 2022, it determined that it only owed an additional $10,000 of passthrough entity elective tax, and that amount was paid with the return.

If ABC wants to make an election to pay the passthrough entity elective tax for 2022, it must pay $30,000 (($50,000 + $10,000) × 50%) by June 15, 2022.

What about new entities?

If a passthrough entity is not in existence on June 15, then it does not have to make a prepayment. It will pay the full amount of tax owed for the short year return by the due date of the return.

This would also apply to SMLLCs that convert to multimember LLCs or S corporations after June 15. The FTB has issued an FAQ that states, "Qualified entities whose taxable year does not include 6/15 in its short period taxable year are not subject to the 6/15 prepayment requirement for that taxable year." (www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/help.html)

Fiscal-year taxpayers

The statute specifically states that the prepayment must be made by June 15 of the "taxable" year of the election. This applies whether the taxpayer is a calendar-year or a fiscal-year taxpayer.

Example of fiscal-year passthrough entity

Dynasty, Inc. is a June 30 fiscal year-end S corporation that wants to make the election for the 2022 taxable year. Dynasty must make the 2022 passthrough entity elective tax prepayment by June 15, 2023, because the entity's 2022 taxable year runs from July 1, 2022, through June 30, 2023.

Because a shareholder or partner claims a credit related to income from an S corporation or partnership in the tax year that the entity's fiscal year ends, in the example above individual shareholders or partners on whose behalf Dynasty paid the 2022 passthrough entity elective tax would claim the Passthrough Entity Elective Tax Credit on their 2023 tax returns.

Erroneous June 15 payment refunds

We continue to hear from practitioners whose clients are receiving refunds of passthrough entity elective tax payments made with 2022 vouchers.

The FTB has acknowledged that due to issues with the 2022 Form FTB 3893, Passthrough Entity Elective Tax Payment Voucher, many June 2022 passthrough entity elective tax prepayments were incorrectly applied to the 2021 tax year, resulting in erroneous refunds of these payments. As more extended 2021 returns are filed, we expect to see more of these refunds.

This is a significant problem because in order to preserve the right to make the passthrough entity tax election for 2022, taxpayers must meet the June 15 prepayment requirement discussed above. If the payment is not posted, taxpayers will not be able to make the election for 2022.

The FTB is allowing taxpayers to return these erroneous refunds to preserve their right to make the election. Although the FTB has not indicated a specific deadline to return these refunds, we recommend that taxpayers do this as soon as possible to avoid problems with 2022 passthrough entity tax elections. The method for returning a payment depends on how the payment was refunded to the taxpayer and what the taxpayer did with it.

If check not cashed

If your client received a check, and still has that check, they are required to return it. Mail a copy of the Form FTB 3893, Pass-Through Entity Elective Tax Payment Voucher, along with the explanation "PTE Elective Tax Erroneous Refund," to:

Address
Franchise Tax Board
P.O. Box 2288
Sacramento, CA 95741-2288

If check cashed or deposited

If your client cashed the check or received a refund by direct deposit, they need to resubmit the 2022 passthrough entity elective tax prepayment by submitting the payment on Web Pay or sending another check with a Form FTB 3893 Voucher, along with the explanation "PTE Elective Tax Erroneous Refund" to the same address. For taxpayers paying by check, write the entity ID and tax year 2022 on the memo line.

 ©2022

Verify with clients

We recommend that practitioners reach out to their clients that made June 2022 passthrough entity elective tax payments to ensure that they did not receive a refund or direct deposit of those amounts. This is especially important for direct deposit recipients who may not even realize they received the refund. If these amounts are not resubmitted to the FTB, taxpayers will be unable to make 2022 passthrough entity tax elections.

We've created a client letter addressing this issue, which can be found at:

Multiple payments in one year

Many practitioners have asked whether a taxpayer that made a 2021 passthrough entity elective tax payment in 2022, and then make 2022 passthrough entity elective tax payments in June and December of 2022 can deduct all three payments on their 2022 federal tax return.

The answer is yes. The federal deductions for passthrough entity elective tax payments under IRS Notice 2020-75 are taken in the year the tax is paid. There is no provision that limits the number of deductible payments that can be made each year. If a taxpayer makes three passthrough entity elective tax payments in 2022, all three will be deducted on the 2022 federal return.

HOW THE PAYMENT IS MADE

If the payment is made by check, the check must be sent with Form FTB 3893, Pass-Through Entity Elective Tax Payment Voucher. Taxpayers will use the 2022 payment voucher for all payments made for 2022 net income, even if those payments are made in 2023.

Alternatively, entities may pay the tax through Web Pay, in which case no Form 3893 is required.

Web Pay payments are made at:

Website
https://webapp.ftb.ca.gov/webpay/login/belogin?Submit=Use+Web+Pay+business

Reporting the payment on California return

When the entity files its return, it will report the tax in two different places as follows:

- **Electing LLCs:** The total amount of the elective tax that was previously paid in with the Form FTB 3893, or through Web Pay, is reported on Form 568, line 9. Any additional amounts that must be paid with the return are reported on Form FTB 3804, Part I, Elective Tax, line 3 and on Form 568, line 4.
- **Electing partnerships:** The total amount of the elective tax that was previously paid in with the Form FTB 3893, or through Web Pay, is reported on Form 565, line 30. Any additional amounts that must be paid with the return are reported on Form FTB 3804, Part I, Elective Tax, line 3 and on Form 565, line 25.
- **Electing S corporations:** The total amount of the elective tax that was previously paid in with the Form FTB 3893, or through Web Pay, is reported on Form 100S, line 35. Any additional amounts that must be paid with the return are reported on Form FTB 3804, Part I, Elective Tax, line 3 and reported on Form 100S, line 29.

CONFIRM PAYMENTS ON MyFTB

These payments are shown in two places within the passthrough entity's MyFTB account:

- **Payment History:** This page will list the date, amount, and account period for the payment; and
- **Estimate Payments & Credits:** This page will include passthrough entity elective tax payments, along with estimates, extensions, and credits that can be claimed on the entity's tax return.

Note that MyFTB does not display the amount of credit the owner of the passthrough entity can claim on their 2021 individual income tax return. The credit amount will be included on the Schedule K-1 (100S, 541, 565, or 586) the owner receives from the passthrough entity.

INTERPLAY WITH MANDATORY E-PAY

A common question being raised by tax professionals is whether these payments subject the entity and its owners to California's e-payment mandates. (R&TC §§19011, 19011.5) Individuals and corporations are subject to the mandate once they make an estimate or extension payment exceeding $20,000 or file an original tax return with a total tax liability over $80,000. Once the taxpayer meets this threshold, all subsequent payments regardless of amount, tax type, or taxable year must be sent electronically.

Keep in mind that these passthrough entity elective tax payments are made by the entity, not the individual owner, so they will never trigger mandatory e-pay for the owners. However, they may trigger a mandatory e-pay requirement for the entities.

Partnerships and LLCs taxed as partnerships are not subject to the electronic payment mandate, so passthrough entity elective tax payments made by these entities will not trigger a mandatory e-pay requirement, regardless of the amount involved.

For S corporations making payments on behalf of their consenting owners, if the corporation already has a mandatory e-pay requirement, the payment must be made electronically because once a taxpayer is subject to the e-pay mandate, all future payments must be made electronically.

For S corporations not previously subject to the mandate, it's important to keep in mind that these payments are not considered estimated tax or extension payments, so they will not trigger the mandate if the payment is $20,000 or above but less than $80,000. Additionally, prepayments of this tax are not considered part of the "final tax liability," so they won't trigger mandatory e-pay there. However, they will be included on the S corporation's "final tax liability" when the S corporation's return is filed, so the e-pay requirement may be triggered if the S corporation's final tax liability is over $80,000 when the return is filed.

Even if the FTB has not notified the taxpayer, once the return showing the tax liability is filed, all future payments must be made electronically.

Example of triggering mandatory e-pay

XYZ Corp. is an S corporation that typically has income of approximately $1 million, which results in a total California tax liability on Form 100S of about $15,000 ($1 million × 1.5%). XYZ has never been subject to mandatory e-pay.

For the 2021 taxable year, XYZ elected to pay the passthrough entity elective tax, which resulted in an additional California tax liability of $93,000 ($1 million × 9.3%). XYZ files its 2021 return on April 1, 2022, listing total tax on line 30 of Form 100S of $108,000. Unfortunately, the April Fools' joke is on them.

Because XYZ has filed a return with a California tax liability in excess of $80,000, all future payments must be made electronically. When XYZ made its estimated tax payment on April 18, 2022, that payment had to be made electronically.

S corporations previously subject to mandatory e-pay

Many S corporations received e-pay penalty notices for failing to make their passthrough entity elective tax payments electronically. These penalties were not caused by passthrough entity tax payments triggering the mandatory e-pay requirement, however. The penalties applied to S corporations that were subject to the mandatory e-pay requirement prior to making their passthrough entity tax payments but made these payments with a check using Form FTB 3893, Pass-Through Entity Elective Tax Payment Voucher.

The FTB is working with taxpayers

Spidell reached out to the FTB and asked them to provide automatic relief from these penalties because:

- It was unclear to many taxpayers that this new category of tax payments had to be made electronically; and
- Many taxpayers were unable to utilize Web Pay due to a variety of technical glitches, and confusion because of the recent elimination of the ability to use the entity's federal EIN (FEIN) to make Web Pay payments.

The FTB has stated that they will not provide automatic penalty relief, but they will offer penalty relief on a case-by-case basis for the e-pay penalties.

Taxpayers must request penalty abatement and explain the reasonable cause basis for the relief. The FTB has stated that one example of reasonable cause is explaining that the taxpayer experienced difficulties with Web Pay and was instructed by the FTB to pay via check.

We recommend noting the issues with the FTB's Web Pay system and citing the FTB's December 17 Tax News Flash, which recommended that taxpayers having difficulty using Web Pay "mail in a payment." (www.ftb.ca.gov/about-ftb/newsroom/news-releases/2021-11-making-pass-through-entity-elective-tax-payments.html)

For all other scenarios, the FTB noted that taxpayers should include all relevant facts and circumstances in the taxpayer's abatement request. We recommend including the following:

- With the passthrough entity elective tax enacted late in the year, many taxpayers were scrambling to get information and make payments by December 31, 2021; and
- The original version of Form FTB 3893, Pass-Through Entity Elective Tax Payment Voucher, did not state that S corporations required to make payments electronically were required to make these payments electronically, though the instructions have since been updated to reflect that information.

Requesting e-pay waivers

Taxpayers may request a waiver of the electronic funds transfer (EFT) requirements by submitting Form FTB 3816, Electronic Funds Transfer Election to Discontinue or Waiver Request. The FTB may grant a waiver if they determine that the amounts paid in excess of the threshold amounts were not representative of the taxpayer's tax liability. In addition, taxpayers not meeting either threshold amount for the prior year may use this form to elect to discontinue making payments by EFT.

Submit the request at:

Address
EFT UNIT MS F-284
Franchise Tax Board
P.O. Box 1468
Sacramento, CA 95812-1468

Fax
(916) 855-5556

For additional business entity e-pay penalty questions, contact the FTB at:

☎ **Telephone**
(916) 845-4025

CALIFORNIA CREDITS TO OWNERS

"Qualified taxpayers" may claim a nonrefundable personal income tax credit on the California return for up to 100% of the amount of the passthrough entity elective tax paid on the taxpayer's *pro rata* or distributive share of the passthrough entity's qualified net income. (R&TC §17052.10)

Timing of the credit

Regardless of what year the tax is paid in, when the credit is based on 2022 qualified net income, and the election is made with the 2022 tax return, owners will take the credits against their 2022 California tax liabilities. This means that even if the entity does not pay the 2022 tax until the 2023 calendar year, the owner may claim the credit on his or her 2022 tax return. The credit is allowed in full for nonresidents and part-year residents, and no proration is required. (R&TC §17055)

 ©2022

Credit against all regular tax

The credit is not limited to income from the passthrough entity; it may be applied against all regular tax on the owner's California tax return. However, the 1% mental health surcharge is an addition to regular tax and is not reduced by the Passthrough Entity Elective Tax Credit.

Forms

The credits will be reported to the entity owners by the entity on Schedule K-1. The entity will report to the FTB the amount that each consenting owner is entitled to claim as a credit on Form FTB 3804, Passthrough Entity Elective Tax Calculation. The owner will claim the credit on Form FTB 3804-CR, Pass-Through Entity Elective Tax Credit, which must be attached to the owner's return.

Trusts

When the entity pays the passthrough entity elective tax, it will list the trust name and FEIN on Part II of Form 3804 as a Qualified Taxpayer. The entity may either apply the credits to tax at the entity level, pass the credits through to the beneficiaries, or split the credits between the trust and the beneficiaries:

- If all of the credit is claimed at the trust level, Form 3804-CR will be completed by the trust, and attached to the trust return;
- If all of the credit is passed through to the beneficiaries, it will be listed on Line 13d of the K-1, and the beneficiary will complete Form 3804-CR, listing the name and ID number of the Qualified Entity that paid the tax on line 1 (not the trust name and ID); and
- If the credit is split between the trust and the beneficiaries, the trust should complete Form 3804-CR for the credit the trust is claiming, and the beneficiary should file Form 3804-CR for the credit they are claiming on their return.

Carryover

Unused credits may be carried forward for up to five years and are then lost.

✐ Practice Pointer

Tax professionals should examine the amount of carryovers from prior years and the taxpayer's anticipated income going forward to determine if it makes sense for the taxpayer to consent to the election in future years. If it appears that the taxpayer may not have sufficient income to offset prior-year carryovers over the next five years, it may not make sense to have the entity pay the tax on behalf of the taxpayer again in future years.

Comment

Although the tax may not be paid for taxable years beginning after 2025, credit carryforwards will continue to apply to 2026 and later returns.

Tentative minimum tax credit limitation

As originally enacted by AB 150, the Passthrough Entity Elective Tax Credit did not reduce a taxpayer's California TMT. (R&TC §§17039, 23036(d)) This dramatically limited the amount of benefit that many taxpayers could receive from this credit. SB 113 repealed this TMT limitation, retroactively beginning with the 2021 tax year.

Interplay with estimated tax payments

The passthrough entity elective tax is not an estimated tax payment on behalf of the owner. However, it may decrease the owner's ultimate tax liability, which results in reduced estimated tax payment amounts.

Example of overpayments

Carol is a partner in a partnership, which is her primary source of income. Prior to the enactment of AB 150, Carol made first and second quarter estimated tax payments totaling $100,000.

Carol's partnership elected to make a passthrough entity elective tax payment, and Carol consented to have a payment made on her behalf. Her share of the partnership income was $1 million, so her tax payment was $93,000.

Carol did not make a fourth quarter estimated tax payment.

When Carol files her 2021 California tax return, assume her tax liability is $110,000. Her liability will first be reduced by the $93,000 Passthrough Entity Elective Tax Credit. The remaining $17,000 ($110,000 - $93,000) will then be satisfied with her estimated tax payments.

The remaining $83,000 ($100,000 - $17,000) will then be refunded to her or applied to the following year.

If prepayments of passthrough entity tax (including the June 15 payment) reflect the entity's actual 2022 passthrough entity elective tax liability, these payments can be considered when calculating the owners' estimated tax payments. This is because Passthrough Entity Elective Tax Credits reduce the owners' California tax liability before estimates are applied.

Example of credit and estimated tax interplay

Peter estimates that he will have a 2022 $500,000 tax liability before application of his $50,000 Passthrough Entity Elective Tax Credit. Although he cannot treat the $50,000 tax paid on his behalf by the passthrough entity as an estimated tax payment, he can reduce his anticipated $500,000 liability to $450,000 for purposes of computing the amount of his 2022 estimated tax payments.

However, if the June 15 payment is more than the 2022 passthrough entity elective tax liability will be, we do not recommend reducing owners' estimates based on that payment. This is because the excess passthrough entity elective tax payment will be refunded to the entity and will not pass through to the owners as a credit.

Example of applying June 15 payments to estimates

Jane is the sole shareholder of her S corporation. In 2021 the S corporation had a better-than-expected year and sold some assets. As a result, the S corporation paid a passthrough entity elective tax of $100,000. Based on this amount, to preserve the passthrough entity elective tax election for 2022, the S corporation must make a $50,000 payment on June 15, 2022.

If Jane expects the 2022 passthrough entity tax liability to be at least $50,000, she can safely reduce her 2022 estimated tax payments by $50,000.

If Jane expects the 2022 passthrough entity tax liability to be less than $50,000, she should only reduce her estimated tax payments by the estimated 2022 passthrough entity tax liability that will ultimately flow through to her as a credit.

CREDIT ORDERING RULES

We've had numerous questions regarding the order that credits must be taken on the California return. For example, can you apply the Passthrough Entity Elective Tax Credit before other credits to maximize the use of the credit?

Under California law, credits are taken in the following order:

1. Credits that do not contain carryover or refundable provisions, except the minimum tax credit or those that are allowed to reduce the net tax below the tentative minimum tax (described in (4) and (5) below);
2. Credits that contain carryover provisions but do not contain refundable provisions (e.g., the New Employment Credit), except for those that are allowed to reduce "net tax" below the tentative minimum tax;
3. Credits that contain both carryover and refundable provisions;
4. The minimum tax credit;
5. Credits that are allowed to reduce "net tax" below the tentative minimum tax, such as the Passthrough Entity Elective Tax Credit for the 2021 tax year only and the Research Credit;
6. Other State Tax Credits;
7. Beginning with the 2022 taxable year, the Passthrough Entity Elective Tax Credit; and
8. Credits that contain refundable provisions but do not contain carryover provisions. (R&TC §§17039(a), 23036(c))

As originally enacted under AB 150, the Passthrough Entity Elective Tax Credit was a Category 2 credit, but as a result of SB 113, the Passthrough Entity Elective Tax Credit is now a Category 5 credit for the 2021 tax year only. This means it is taken after Category 2 credits, like the New Employment Credit, but before the OSTC.

Beginning with the 2022 taxable year, the Passthrough Entity Elective Tax Credit is claimed after the OSTC. The Schedule P (540, 540NR, 541), Alternative Minimum Tax and Credit Limitations, has been revised to add a new line B4 to now list the Passthrough Entity Elective Tax Credit after the OSTC.

As a result of the change in the ordering rules, many of us believed owners of multistate entities would get much more bang for their buck by consenting to have the passthrough entity pay tax on their behalf.

Interplay between OSTC and Passthrough Entity Elective Tax Credit

For pre-2022 tax years, for taxpayers with income from both inside and outside California, the interplay between the OSTC and the Passthrough Entity Elective Tax Credit impacted whether a taxpayer chose to have an entity pay the passthrough entity elective tax on their behalf.

The OSTC is designed to provide relief to taxpayers whose income is being taxed by two different states. However, the credit is only available if the same income is being taxed by both states. This can occur when a California resident has income sourced to, and taxed by, another state, such as when a California resident has income from a passthrough entity conducting business in another state.

While this is undoubtedly welcome relief for most taxpayers, we found that many taxpayers who claimed the Passthrough Entity Elective Tax Credit for 2021 saw a significant decrease in the amount of OSTC they could claim.

The problem

When calculating the OSTC on the Schedule S, Other State Tax Credit, taxpayers determine the ratio of their double-taxed income taxable to California to California AGI and multiply that amount by the taxpayer's California tax liability. (R&TC §18001; Instructions to Schedule S, Other State Tax Credit) This is compared with the ratio of double-taxed income taxable to the other state to the other state's AGI, multiplied by the tax liability paid to the other state. The amount of the OSTC is the lesser of the two products.

The problem that arose during the 2021 tax year when the Passthrough Entity Elective Tax Credit came into play was that when a taxpayer computed the amount of their California tax liability, the Schedule S instructions required taxpayers to reduce the amount of their California tax liability by the amount of the Passthrough Entity Elective Tax Credit. This reduction significantly reduced, if not eliminated, their California tax liability. The result was a substantially reduced OSTC.

Although SB 113 changed the credit ordering rules for tax years beginning after 2021 so that the OSTC is claimed prior to the Passthrough Entity Elective Tax Credit, according to the FTB it did not change how the OSTC was calculated. This meant that taxpayers would continue to see a dramatically reduced OSTC that a California resident taxpayer could claim.

The fix

SB 851 (Ch. 22-705) fixed this issue by increasing the amount of the California "net tax" used to calculate the OSTC by the amount of the Passthrough Entity Elective Tax Credit claimed, thereby allowing taxpayers who claim both credits to receive the full amount of the OSTC they would have claimed if they had not claimed the Passthrough Entity Elective Tax Credit. This fix applies to post-2021 tax years. (R&TC §17052.10(e))

More good news

As discussed above, the OSTC is based on the lesser of the tax paid to California or the other state on the double-taxed income. While according to the FTB a taxpayer's California tax liability is reduced by the Passthrough Entity Elective Tax Credit when computing the California tax paid on the double-taxed income, this same result does not occur when computing the other state's tax liability on the double-taxed income.

According to the FTB, when calculating the tax liability paid to another state, the passthrough entity elective tax paid by the entity to the other state should be included in the amount of the other state's tax liability. This is true even if the amount of tax paid by the individual to the other state is

eliminated or drastically reduced because the other state allows the individual passthrough entity owner to claim a credit or deduction for the tax paid by the entity on their behalf.

Under R&TC §18006, a partnership or S corporation is treated as if they directly paid their *pro rata* or distributive share of net income tax to another state. So even if the individual taxpayer's tax liability is dramatically reduced or eliminated by a credit or deduction related to the other state's elective passthrough entity tax, the individual's tax liability is increased on line 7 of the Schedule S by the amount of the individual's share of the tax paid by the entity.

Example of tax paid to another state

Fran is a California resident with K-1 income from a partnership that is taxed to New York. Fran has $100,000 of income that is taxed to New York, and she elects to pay the passthrough entity elective tax, which is $6,850.

Fran's individual tax on the New York state return is approximately $5,890, and the New York passthrough entity tax credit will eliminate her New York tax liability.

Fran is treated as if she paid her passthrough entity elective tax directly to New York. So, although she pays no tax with her individual New York tax return, line 7 of the California Schedule S will show $6,850.

Extended statute of limitations

Refunds attributable to the OSTC have an extended filing period beyond the normal statute of limitations. (R&TC §19311.5)

A taxpayer who pays tax to another state has one year from the date the tax is paid to claim the California OSTC with the FTB, even if the normal statute of limitations has already expired. This provision helps taxpayers who do not file tax returns with a nonresident state and are notified after the California statute has expired.

The normal statute of limitations for a claim for refund is the later of:

- Four years from the due date of the return without regard to extensions;
- Four years from the date the return was filed (if filed by the extended date); or
- One year from the date of overpayment.
  (R&TC §19306)

In addition to being able to claim a credit for the amount of the net income tax paid directly by the taxpayer to another state, under California's OSTC provisions, passthrough entity owners may also claim a credit for their share of net income taxes paid by the passthrough entity to another state. (R&TC §18006) This includes an entity's payment of the Passthrough Entity Elective Tax Credit.

The extended statute of limitations for taxes paid to another state will likely provide welcome relief given the proliferation of passthrough entity elective taxes enacted by the majority of the states over the last two years.

The chances of taxpayers miscalculating the amount of passthrough entity elective tax due to another state, given the numerous differences between all the different states' passthrough entity elective tax rules, make it likely that taxpayers will either discover or be notified that they underpaid their tax liability to another state. If this should happen outside the normal statute of limitations period, taxpayers will at least still be able to claim a refund due to their eligibility for an increased OSTC stemming from the additional tax paid to the other state.

Interplay with nonresident withholding

In a pleasant surprise for taxpayers, the FTB informed Spidell that it will continue to apply nonresident withholding after the Passthrough Entity Elective Tax Credit in post-2021 tax years. SB 1131 (Ch. 22-3) changed the credit ordering rule so that the Passthrough Entity Elective Tax Credit is applied after the Other State Tax Credit.

R&TC §17039(b) states that nonresident withholding is applied in the same order as the Other State Tax Credit. Based on R&TC §17039(b), Spidell, as well as other tax commentators, interpreted this change to mean that the Passthrough Entity Elective Tax Credit would also be applied after nonresident withholding. This would result in decreasing the amount of Passthrough Entity Elective Tax Credit that could be claimed.

However, the FTB has stated that the reference in R&TC §17039(b) has been incorrect since 2001 and they will be pursuing a technical correction in the next legislative session. In the interim, the FTB will continue to apply nonresident withholding on line 83 of the Form 540NR, after the Passthrough Entity Elective Tax Credit.

This is welcome relief to nonresident taxpayers who had nonresident withholding and will be claiming the Passthrough Entity Elective Tax Credit, because they will now be able to claim the credit against their tax liability prior to having the tax liability reduced by the amount of nonresident withholding.

NONRESIDENT WITHHOLDING

The passthrough entity tax is in addition to any other tax or fee that the passthrough entity may be subject to, including nonresident withholding.

There is no provision that would reduce the nonresident withholding required for distributions to nonresident shareholders, partners, or members that consent to having the passthrough entity elective tax paid on their behalf. This means that if an entity elected to pay the passthrough entity elective tax and distributed all of its net income, the nonresident owner would essentially pay 16.3% in withholding (7% nonresident withholding + 9.3% passthrough entity elective tax) to California on that income.

The passthrough entity does not file the FTB Form 592-PTE, Pass-Through Entity Annual Withholding Return, to report the passthrough entity elective tax. The passthrough entity elective tax is not considered withholding.

Nonresident withholding waivers

The FTB will not approve a waiver of the nonresident withholding requirement for entities because they have elected to pay the passthrough entity elective tax on behalf of their nonresident individual owners. However, there are some situations where taxpayers may qualify for a waiver.

The FTB generally grants a waiver in any of these cases:

- The nonresident consistently files California returns and makes estimated tax payments;
- The nonresident is a partnership or LLC that will withhold on its distributions;
- The nonresident is included in a group return (individuals who are nonresidents may elect under R&TC §18535 to file a group return);
- The nonresident, nonqualified corporation is included in a combined reporting group with a corporation that does have a permanent place of business in California;
- The nonresident is a newly admitted investor (e.g., S corporation shareholder admitted after the end of the taxable year);
- The entity is a publicly traded partnership;

- The nonresident can demonstrate that the 7% rate will result in overwithholding. An LLC member could be subject to overwithholding because the LLC member failed to sign Form FTB 3832, Limited Liability Company Nonresident Members' Consent, and the LLC will withhold based on R&TC §18633.5; or
- The entity is encountering administrative problems setting up the withholding program.

In general, the payee must file FTB Form 588, Nonresident Withholding Waiver Request, and show either that a specific exemption to withholding applies or that the payee has a history of timely filing and payment. There is no statutory authority for the FTB to waive withholding for foreign partners or members, but the FTB may allow a reduced withholding amount.

FTB Form 588 may be submitted via MyFTB.

Practice Pointer

Payees must file Form 588 at least 21 business days prior to the expected payment so the FTB can issue a determination letter before the withholding is due. Taxpayers considering waivers should submit their requests as soon as possible.

CLIENT LETTER

To access Spidell's passthrough entity tax client letter, go to:

Website
www.caltax.com/cl-peet

FREQUENTLY ASKED QUESTIONS

For a list of frequently asked questions from Spidell customers concerning the passthrough entity elective tax, go to:

Website
www.caltax.com/files/2022/peetfaqs.pdf

NET OPERATING LOSS SUSPENSION REPEALED

SB 113 (Ch. 22-3) repeals the NOL suspension for the 2022 taxable year. California NOLs were suspended for the 2020 and 2021 taxable years for businesses that were:

- Subject to the personal income tax if they had net business income and modified adjusted gross income of $1 million or more; and
- Subject to the corporation income or franchise tax if their business income subject to California taxation was $1 million or more.
(R&TC §§17276.3, 24416.23)

For any NOL or NOL carryover disallowed as a result of the NOL suspension, the 20-year maximum carryover period will be extended as follows:

- By one year for NOLs incurred during the 2021 taxable year;
- By two years for NOLs incurred during the 2020 taxable year; and
- By three years for NOLs incurred prior to the 2020 taxable year.

BUSINESS CREDIT LIMITATION REPEALED

SB 113 (Ch. 22-3) ends one year early the $5 million business credit limitation by repealing the limitation for the 2022 taxable year. This means the limitation was only in effect for the 2020 and 2021 tax years. (R&TC §§6902.5, 12209, 17039.3, 23036.3) For those years, total business credits claimed may not reduce a taxpayer's "net tax" as defined by R&TC §17039 for personal income taxpayers, or the "tax" as defined by R&TC §23036 for corporate taxpayers, by more than $5 million.

The carryover period for credits that could not be claimed as a result of the limitation in place during 2020 or 2021 is extended by the year(s) the limitation applied.

CANNABIS BUSINESSES RECEIVE MAJOR TAX RELIEF

In an effort to combat the unlicensed cannabis growers and market in California, California has enacted AB 195 (Ch. 22-56) to lower the tax burden on licensed growers and other licensed cannabis businesses.

AB 195 makes the following tax changes:

- Repeals the cannabis cultivation tax, effective July 1, 2022. (R&TC §34012) Prior to its repeal, the rate was over $16 per pound. Any cultivation tax paid on cannabis that enters the market after June 30, 2022, must be either returned to the cultivator or paid to the CDTFA;
- Shifts responsibility for collecting the cannabis excise tax from the distributor to the retailer, effective January 1, 2023, and prohibits the CDTFA from increasing the excise tax rate for three years (see below for more details) (R&TC §34011.2);
- Provides equity retailer licensees with an excise tax "vendor compensation credit" (see below);
- Imposes the cultivation/excise tax against an unlicensed person possessing, keeping, storing, or selling cannabis or cannabis products as well as an additional 25% penalty (minimum of $500) (R&TC §34015.1);
- Provides a new income tax credit for qualified cannabis business taxpayers (see below) (R&TC §§17053.64, 23664);
- Enacts a new Cannabis Equity Tax Credit against personal income and corporation franchise and income taxes (see below) (R&TC §§17053.83, 23682);
- Imposes additional reporting requirements (see below); and
- Extends the sales and use tax and CDTFA fee exemption from the electronic funds transfer penalty available to licensed cannabis businesses indefinitely and provides relief from any such penalties that might be otherwise imposed during 2022 (R&TC §§6479.3, 34013).

EXCISE TAX CHANGES

As noted above, retailers, rather than distributors, must begin collecting and remitting the cannabis excise tax, effective January 1, 2023. (R&TC §34011.2)

Cannabis distributors

Starting January 1, 2023, distributors (including microbusiness distributors) of cannabis or cannabis products will stop collecting the 15% cannabis excise tax from cannabis retailers.

These businesses will no longer be required to hold a cannabis tax account with the CDTFA. Distributor cannabis tax accounts will automatically be closed out, and additional information will be sent to affected account holders sometime this fall.

Distributors will file their last cannabis tax return for December 2022 (for monthly filers) or fourth quarter 2022 (for quarterly filers) on January 31, 2023.

Cannabis retailers

Retailers must obtain a separate cannabis tax permit from the CDTFA at no cost. (R&TC §34014) Retailers that are licensed with the Department of Cannabis Control (DCC) will be automatically registered with the CDTFA. If a retailer is already approved for a license fee waiver with the DCC, licensees can apply to the CDTFA to retain vendor compensation equal to 20% of cannabis tax due. The CDTFA will provide additional information regarding how a cannabis retailer can do this.

Persons who fail to obtain and maintain a permit are guilty of a misdemeanor.

Retailers must remit the cannabis excise tax quarterly on or before the last day of the month following the end of the quarter and must also e-file a cannabis excise tax quarterly return. (R&TC §34015)

Any amount owed by a cannabis retailer to a distributor prior to January 1, 2023, should be paid by the retailer to the distributor by April 1, 2023. (R&TC §34011.01) A cannabis retailer may claim a credit on the cannabis excise tax return for cannabis excise tax amounts paid to a distributor before January 1, 2023, on cannabis or cannabis products sold to a purchaser after 2022, for which the retailer is required to remit to the CDTFA.

The CDTFA is mandated to adjust the excise tax rate beginning with the 2025–26 fiscal year and every two years thereafter. (R&TC §34011.2) The CDTFA must adjust the rate by a percentage that will generate sufficient revenues to compensate for the loss of the now-repealed cultivation tax, up to a maximum rate of 19%.

NEW REPORTING REQUIREMENTS

Effective January 1, 2023, the CDTFA is authorized to require any person engaged in the cultivation, distribution, manufacturing, or retail sale of cannabis or cannabis products or any cannabis licensees to e-file by the 25th day of each month a report listing the person's inventory, purchases, and sales during the preceding month and any other information the CDTFA may require. (R&TC §34015(b))

EQUITY LICENSEE EXCISE TAX CREDIT

Effective January 1, 2023, through 2025, approved equity cannabis licensee retailers may retain "vendor compensation" equal to 20% of the cannabis excise tax due. (R&TC §34011.1) To obtain approval, those cannabis retailers who received a fee waiver from the Department of Cannabis Control must submit a one-page application to the CDTFA.

The approval generally remains in effect for a year and must be renewed annually. However, it will expire on the last day of the calendar quarter following notification by the Department of Cannabis Control to the CDTFA that the licensee is no longer eligible for a fee waiver.

HIGH ROAD CANNABIS TAX CREDIT

For the 2023 through 2027 tax years, qualified cannabis businesses can claim a High Road Cannabis Tax Credit of up to 25% of their qualified expenditures in the tax year, up to a $250,000

maximum credit. (R&TC §§17053.64, 23664) The $250,000 limit is determined on a combined reporting group basis for taxpayers included in a combined report (i.e., corporate taxpayers involved in a unitary business).

A qualified cannabis business is a state-licensed commercial cannabis business that is a licensed retail or microbusiness licensee (aka “high road” cannabis business) that provides all of the following benefits to its full-time employees:

- Employment compensation, including the monetary value of the following benefits:
  - Employer-provided group health insurance benefits;
  - Child care benefits;
  - Employer contributions to employer-provided retirement benefits; or
  - Employer contributions to pension benefits;
    Note: It’s unclear from the way the law is written if businesses that pay their employees less than 150% of the applicable minimum wage or more than 350% of the applicable minimum wage (including the benefits described above) are not considered “qualified taxpayers.” We will have to await further guidance from the FTB on this;
- Employer-provided group health insurance; and
- Employer-provided retirement benefits or pension benefits. This can include stock in the licensed cannabis business under stock ownership plans if the employer pays for the full value of the stock.

Qualified expenditures are limited to:

- Employment compensation equal to at least 150% but not more than 350% of the applicable minimum wage. Businesses may include the monetary value of the employee compensation benefits described above;
- Safety-related equipment, training, and services (as defined in R&TC §17053.64(b)(3)(B)); and
- Employee workforce development and safety training (as defined in R&TC §17053.64(b)(3)(C)).

Taxpayers must reserve the credit with the FTB each July or within 30 days of the start of their taxable year if the taxpayer’s taxable year begins after July. The total amount of credits that can be allocated by the FTB is limited to $20 million for all taxable years, cumulatively.

The credit is not refundable. Unused credits may be carried over for eight succeeding tax years.

Other credits or deductions otherwise available to the taxpayer must be reduced by the amount of the credit claimed. For example, if a taxpayer claims the credit for wages paid, they must reduce the amount of wage expenses deducted by the amount of the credit claimed for those wages.

CANNABIS EQUITY TAX CREDIT

Also, for the 2023 through 2027 tax years, cannabis equity licensees (those who qualify for the California Department of Cannabis Control’s license fee and deferral waiver program) may claim a credit against the personal income or corporation franchise and income tax equal to $10,000. (R&TC §§17053.82, 23682)

Beginning January 1, 2024, and every six months thereafter, the Department of Cannabis Control will provide a list of qualified taxpayers to the FTB.

The credit is not refundable. Unused credits may be claimed for up to eight succeeding taxable years.

 ©2022

REMOTE WORKERS

One lingering effect of the COVID-19 pandemic is that more and more workers continue to work remotely. This can have significant tax consequences. Although many states, including California, provided some relief for workers "temporarily" working remotely due to COVID-19, this relief is no longer available. Below are some key issues to keep in mind when dealing with remote workers.

HIDDEN COST TO EMPLOYERS

Nexus

Generally speaking, an employee working in a state will create income tax and sales and use tax nexus in that state.

If a California business has an employee that decides to move to and work from another state in which the business has no other contact, the presence of the employee in that state will likely create income tax nexus. This means the California business must file a tax return and potentially pay a tax in the other state. The business may also have to register in the other state for sales and use tax purposes.

Conversely, if a business located outside California, has an employee who moves to and works remotely from California, the non-California business will likely have California nexus and will have to file a California return and, if the business is a corporation, LLC, or limited partnership, it will have to pay at least the California $800 minimum franchise or annual tax.

Payroll taxes

Generally, a worker's income tax and payroll withholding are sourced to the state where the worker performs the majority of the services. However, see caution box below regarding those states that use the "convenience of the employer" test.

If the remote worker is working in California, the business must pay payroll taxes to California. Conversely, if a California business has an employee who moves to and performs their work in the other state, then the employee is no longer considered a California W-2 employee, and the California business will have to register in and pay payroll taxes to the employee's new state of residence.

Apportionment

Having an employee in a different state may also impact a multistate business's apportionment factor in those states that still utilize a payroll factor or that use a cost-of-performance method to source sales of services or intangibles for purposes of the sales factor.

HIDDEN COSTS FOR EMPLOYEES

Employees may pay hidden costs as a result of working remotely as well. How this plays out depends on whether the employee is working remotely inside California or outside California and whether the employer properly reports the payroll taxes.

Working in California

For income tax purposes, if a nonresident has come to California and performs the work in California as an employee, it is California-source income and taxable to California. (18 Cal. Code Regs. §17951-5) The "nonresident" employee is subject to California tax on all California-source

income. However, the out-of-state employer will likely not be required to withhold California income tax if the employer is not doing business in California. This means that not only will the telecommuting employee have to pay tax on the California-source income, the employee's California tax liability come April 15 also will be much larger because no taxes were withheld. Also, some states continue to tax the income to that state as well. The only remedy is to take the credit for tax paid to the other state for the double-taxed income.

Example of nonresident employee working in California

Harold is a research analyst and works and lives in New Jersey. His employer closed their offices during COVID-19 and now allows their employees to work remotely from anywhere. Harold has always wanted to spend time in California, and so he works from San Diego for three months during the winter. The New Jersey employer continues to withhold New Jersey income taxes, rather than California taxes, from his paycheck. Harold has California-source income and should file a California return to report his California-source income.

Because he will be taxable to New Jersey on the income because he is a resident of New Jersey, he will claim a credit for tax paid to California on his New Jersey resident return.

Working outside of California

Conversely, if a California worker is telecommuting from another state and has not abandoned their California residency, California will continue to tax that income because California residents are taxed on their worldwide income. However, the taxpayer will likely be able to claim an Other State Tax Credit (OSTC) on the California return (or the nonresident return if the taxpayer is telecommuting from Arizona, Oregon, or Virginia). (R&TC §18001)

We assume other states have similar rules.

Comment

The big question is, if the employee doesn't use their temporary address on their tax return, how will the FTB or these other states know that the employee is working temporarily in their state if the employer is not withholding taxes?

Caution

In the majority of cases, the OSTC will address the double taxation issue that arises when two states tax the same wage income. However, this may not be the case in those states that have adopted the "Convenience of the Employer" test (Connecticut, Delaware, Nebraska, New York, and Pennsylvania).

In these states, the remote employee's wages are subject to tax in the employer's state and not where the employee performs the work, unless the employee can show that the reason they are working outside the employer's state is due solely to the employer's necessity rather than the employer's or employee's convenience.

Because other states do not follow the Convenience of the Employer test, they may not recognize the income as "double taxed" and may not allow the employee working for an employer in one of the Convenience to the Employer states to claim the OSTC.

Employment taxes

The first step in the reporting process is to determine whether the employee's wages are subject to California UI, ETT, and SDI. If some services are performed in California, the EDD recommends that employers apply these tests, in this order:

1. **Localization test:** If most of the services are performed in California, with only incidental services performed elsewhere, the services of an employee are subject to California employment taxes;
2. **Base of operations test:** If the first test does not apply in any state, the employee's services are still considered subject to California jurisdiction if some services are performed in California, and the individual's base of operations is in California (the EDD considers the base of operations to be the place of more or less permanent nature from which the employee customarily starts work and returns within the terms of the same contract);
3. **Place of direction and control test:** If the first and second tests don't apply in any state, an employee's services are considered subject to California jurisdiction if some services are performed in California and the place from which the employer exercises general direction and control over the employee's services is in California; and
4. **Residence of employee test:** If none of the above applies in any state, an employee's services are considered subject to California taxes if some services are performed in California and the individual's residence is in California.
   (EDD Publication 231D, Multistate Employment)

These tests only apply if the employee has performed some services in California.

When all of an employee's services are performed in another state and the employee lives in that state, the employer should not report the wages to California for UI, ETT, and SDI purposes. (UIC §§602, 603, 604) This means the employee should not be classified as a California employee for employment tax purposes.

Example of living in another state and performing all services there

Pearl moved to Sparks, Nevada, to care for her mother during the pandemic. Six months after she arrived, she realized she would need to stay permanently and gave up her apartment in California, and transferred all her bank accounts, etc., to Nevada. However, she continued to work for Gem Depot, a California company, as a salesperson. She now works out of her home in Sparks, Nevada, and sends her orders by fax and e-mail. She does not work in California. The wages are not subject to any California taxes.

Personal income taxes

Deciding jurisdiction for an employee's PIT withholding is much easier. Generally, an employee's wages are taxable to California if the individual works in California or is a California resident.

Example of personal income taxes and performing services in California

Wade is a Washington resident who provides scuba lessons. Wade works for Washington Scuba Company (WSC), which has no base of operations in California but contracts in California. Wade works for WSC in California at various hotels for about two months during the year. Wade is subject to California PIT because he performs some services in California. Wade is not subject to SDI, UI, or ETT because he does not meet any of the tests discussed above.

Example of working for California-based company

Jed Setter works as an airline food critic for a California-based company, but he is a Nevada resident. His job requires him to work for three- to four-month periods in New York City, Miami, and Seattle, and he spends about one month a year at a Los Angeles office.

Jed is subject to California employment taxes because he performs some services in California, and his base of operations is in California. He also receives direction from Los Angeles. Jed is also subject to California PIT withholding for the services he performs in California but not for work he performs in other states.

Employers may not follow these rules

We have had a number of questions from tax professionals where the employer has continued to report the wages to California, sometimes withholding California PIT and sometimes not.

In these cases, the client fits Pearl’s circumstances in the first example. Because she is no longer a California resident and she performs no services in California, the wages are not subject to California taxes. However, her employer has classified her as a California employee and is withholding California taxes from her wages.

This is a common scenario because having an employee in another state is not only a lot more work than reporting all workers to the home state, as we discuss above, it may also create nexus in the other state, meaning the employer should register to do business in that state. This means filing and paying any fees and taxes required by that state. Often, this is why employers don’t register — they simply misclassify these employees as California employees.

Clients are then left with three options:

1. Request that the employer correct the problem and treat them as employees in the proper state;
2. File in both California and their home state, and rely on the OSTC to reduce the double taxation of the income; or
3. File a California nonresident return, show zero income taxable to California, and explain the error and that the employer won’t correct the problem. We suggest you attach a copy of the other state’s tax return to show that the taxpayer filed and reported the income. Then prepare to argue with the FTB, and prepare to take your case to the Office of Tax Appeals and potentially have a very unhappy employer.

Most likely the client will be stuck with the second or third option. While this results in more tax being paid by the client, the alternative is often looking for another job.

MARKET-BASED SOURCING RULES: FTB REVERSES INTERPRETATION

In Legal Ruling 2022-01, the FTB examines how to apply California’s market-based sourcing rules to assign sales to California’s apportionment formula’s sales factor numerator in three different situations involving nonmarketing services.

While the ruling provides much needed clarity, many tax professionals were taken by surprise because it reversed and revoked previously issued Chief Counsel Rulings concerning where to source revenues received by a subcontractor for services provided to a customer’s customer.

SUBCONTRACTOR SERVICES

Legal Ruling 2022-01 adopts a look-through approach and sources the revenues to the location of the taxpayer's customer's customer. The FTB states:

When the service provided by the taxpayer is directed at the customer's customer(s), the benefit received by the customer is likely located at the customer's customer(s)' location. This is most common when the taxpayer's services directly engage or principally concern the customer's customer(s). Common examples of direct engagement include sales and marketing services, customer support services, in-person services involving a third-party contractor, and subcontracting arrangements …

In particular, subcontracting arrangements by a business entity with a corporate subcontractor may involve the location of the customer's customer, because the service provided is directed towards persons or things other than the subcontractor's customer. ***There should be no difference in where gross receipts are assigned when the service is performed by a subcontractor instead of directly by the subcontractor's customer*** [emphasis added].

The FTB applies this reasoning in an example in the letter ruling to a situation in which a subcontractor provides processing and fulfillment of prescription drug claims submitted by its health care plan customer's customers. In this situation, the revenues received by the subcontractor from its health care plan customer are assigned to the state(s) in which the health plan customer's customers are located.

BAIT AND SWITCH

The conclusion reached in Legal Ruling 2022-01 opposes the conclusion reached in Chief Counsel Ruling 2017-01, in which the FTB stated that the location where the benefit of a service is received is where the contractor is relieved from its obligation to provide the service. Applying that reasoning, the FTB determined that the benefit received by a health care plan customer who contracted with a subcontractor to provide services to the health plan's customers was received at the location where the health care plan would have processed its customer's claims if the services had been provided in-house and not where the health care customer's customer was located. The conclusion reached in Chief Counsel Ruling 2017-01 was consistent with the FTB guidance issued in Chief Counsel Ruling 2015-03.

WHAT DOES THIS MEAN?

As a result of the FTB's reversal as to how the market-based sourcing rules are applied, subcontractors that provided services to their California customer's customers located outside California may want to reexamine all open tax year returns to determine if they should file a claim for refund. Alternatively, subcontractors located outside California with no other contacts with California may now find that they have a California filing requirement if they have provided services to their non-California customer's California customers.

Example of ruling's application

We Support U, Inc., a Nevada company providing customer support services to cellphone users, was hired by Let's Talk, Inc., a California cellphone company, to provide customer support to its customers, who are located throughout the U.S. Prior to contracting with Let's Talk, We Support did not have a California filing requirement.

Based on We Support's interpretation of Chief Counsel Ruling 2017-01, We Support filed a California return and sourced all its revenues from its customer support contract with Let's Talk to California because Let's Talk would have provided the customer support from its California offices. As a result of the latest guidance in Legal Ruling 2022-01, We Support should file amended returns for all open tax years and source its revenues from the contract to the location of Let's Talk's customers, a high percentage of which were located outside California. If the location of Let's Talk's customers cannot be determined based on the contract or We Support's books and records, then it can be determined based on reasonable approximation. (18 Cal. Code Regs. §25136-2(c)(2))

If Let's Talk was headquartered in Washington state rather than California but had a lot of California customers for which We Support provided assistance, We Support would be required to retroactively file a California return and include its revenues attributable to the services provided to Let's Talk's California customers.

OTHER SITUATIONS ADDRESSED

The legal ruling also addresses two other situations to determine where the benefit of the service was received under California's market-based sourcing rules and held that:

- An event planner located in Oregon who contracts with a California company to hold a corporate charity event in Las Vegas would source the revenues from the contract to Nevada, where the event was held, because that is where the benefit of the service is received. It does not matter that:
  - The customer contracting for the service was located in California; or
  - That the event planner performed the majority of its work in its Oregon offices;
- A California subcontractor hired by an Arizona energy-efficiency consulting company to assist in conducting its energy-efficiency analysis for its manufacturing plant customer located in Utah would source its revenues from the subcontract to Utah. Although the California subcontractor's customer was the Arizona consulting company, the service was actually provided to the Utah manufacturer and that's where the Arizona consulting company received the benefit of the services provided by the subcontractor.

PENALTY RELIEF

In a news release issued by the FTB, they acknowledge that taxpayers may have relied on the now-revoked Chief Counsel Rulings in determining their tax liabilities for previously filed returns. The FTB has stated that they will not assess a large corporate understatement penalty or an accuracy-related penalty against taxpayers that filed California returns and understated their liabilities based on the guidance provided in the rulings. Disappointingly though, the FTB will neither abate any interest nor will they waive any delinquency penalties assessed against taxpayers that did not file a California return because they relied on the rulings' analysis to determine they did not have a filing requirement.

Although California law allows penalties and interest to be abated if the taxpayer's underpayment is due to their reliance on written guidance issued by the FTB, this relief is limited to those taxpayers who requested the Chief Counsel Ruling. (R&TC §21012; FTB Notice 2009-09)

This means taxpayers must request a reasonable cause abatement for the delinquency penalty. We believe a subcontractor providing services to non-California customers may be able to establish that they exercised ordinary care and prudence when they applied the reasoning outlined in the Chief Counsel Rulings to their fact situations and determined that they did not have a California filing requirement.

OUT-OF-STATE ENTITIES BEWARE

In three Office of Tax Appeal cases released in 2022, we were reminded yet again of the traps that can catch unwary entities that are formed outside California and mistakenly believe that they do not have to file a California return or pay the $800 annual or minimum franchise tax. If an entity is "doing business" in California, it is subject to the $800 tax and must file a return even if it was formed outside California. (R&TC §§17935, 17941, 17948, 23101, 23153)

For partnerships, LLCs, and S corporations, this mistake can be especially costly.

BEWARE THOSE 1099s

A Delaware corporation headquartered in New York was found to be "doing business" in California for the 2018 tax year because it had received a 1099-MISC from a third party that listed a California address for the taxpayer. (***Appeal of Dar Williams Project, Inc.***, 2022-OTA-092) The taxpayer argued that the California address was an old address of the taxpayer's business manager/accountant who had moved out of California in 2015. However, that didn't explain why the taxpayer itself had issued a 2018 Form W-2 to its employee/sole shareholder and listed the same California address on the W-2.

The taxpayer was liable for the $800 minimum tax, a late-filing penalty of $200, a demand penalty of $200, an S corporation late-filing penalty of $432, and a filing enforcement fee of $83, plus interest.

PREPARER IGNORANCE IS NO EXCUSE

In the second case, a Texas S corporation was liable for the $800 minimum franchise tax, and an additional $158 in penalties and interest. (***Appeal of Digital Marketing Strategy***, 2022-OTA-100) The taxpayer hired a Texas tax preparer to file its 2018 "initial and final" California tax return. The return indicated that the taxpayer began doing business in California on December 1, 2018, and dissolved on December 31, 2018.

The taxpayer did not pay the $800 minimum franchise tax, believing that it qualified for the first-year minimum franchise tax exemption. However, because the taxpayer was neither incorporated nor registered with the California Secretary of State's office, the taxpayer did not qualify for the exemption. (R&TC §23153(f))

The taxpayer tried to argue that the late-payment penalty should be abated because it reasonably relied on its tax preparer, who informed it that there was no liability for the minimum franchise tax. However, the taxpayer failed to show that the Texas preparer was competent in California tax law and that it had fully disclosed all the relevant information to the preparer.

The OTA stated that any preparer competent in California tax law would understand the minimum franchise tax requirements, and the fact that the preparer was an Enrolled Agent exempt from the California Tax Educational Counsel (CTEC) requirements did not establish that the preparer was competent in California tax law.

PER-OWNER PENALTIES ADD UP

The per-owner penalties imposed against entities that fail to timely file a return can add up quickly in California. In the third OTA case, a limited partnership filed its 2018 return in June 2020. It indicated that it was subject to the annual tax on the return and that it had timely paid the $800 annual tax. However, because the return was filed late, the FTB assessed an additional $9,936 in per-partner penalties. (***Appeal of Allen Harrison Multifamily Fund II LP***, 2022-OTA-102)

Under California law, partnerships, LLCs, and S corporations are not only subject to the standard late-payment penalty but are also subject to an $18 per-partner/member/shareholder penalty for every month the return is late, up to a 12-month maximum. (R&TC §§19172, 19172.5) As this case demonstrates, the penalties can add up quickly.

The taxpayer tried to argue reasonable cause based on the fact that their CFO had left in 2019, and the individual responsible for filing the return after the CFO left inadvertently failed to timely file the return but filed it immediately upon discovering their error. However, such inadvertent oversights do not overcome the "fixed and clear" nondelegable duty to timely file a return.

OTHER RECENT TRAPS

Throughout the past few years, we've seen numerous instances where the FTB successfully argued that out-of-state entities were required to file a return and pay at least the $800 annual/minimum franchise tax. Examples include:

- Two out-of-state LLCs with less than a 6% passive ownership interest in a California LLC were doing business in California because their distributive share of the LLC's property exceeded the economic nexus threshold (discussed in the box "California's 'doing business' rules" below) (***Appeal of LA Hotel Investments #3, LLC***, 2021-OTA-218P);
- An Arizona LLC whose only asset was undeveloped land in Arizona and that had no income or activities was commercially domiciled in and therefore doing business in California because its two members were California residents (***Appeal of DPMG Juniper, LLC***, 2021-OTA-146);
- A foreign LLC was doing business in California because it paid $12,427 in wages to a California employee over a 15-month period (***Appeal of ProPharma Sales, LLC***, 2020-OTA-296);
- An out-of-state S corporation that registered with the California Secretary of State's office in anticipation of being awarded a contract in California was subject to the $800 minimum franchise tax each year until it cancelled its registration, even though the contract never materialized, and the S corporation never did any business in California (***Appeal of PRT Consulting, Inc.***, 2020-OTA-111); and
- An out-of-state business whose only connection to California was sales of tangible personal property and was therefore immune from state income taxation under federal Public Law 86-272 was liable for over $16,200 in late-filing and per-shareholder penalties. Even though Public Law 86-272 protected the taxpayer's income from its sales from California's franchise tax, it was still required to file a California return and pay the $800 minimum franchise tax because the minimum franchise tax is not based on a taxpayer's net income and therefore not covered by Public Law 86-272 protections. (***Appeal of American Orthodontics Corp.*** (August 5, 2014) Calif. St. Bd. of Equal., Case No. 71153)

California's "doing business" rules

California has two different "doing business" tests for purposes of determining whether a taxpayer has nexus with the state and therefore is required to file a return and pay the $800 annual or minimum franchise tax. A taxpayer is considered "doing business" if it:

1. Actively engages in any transaction for the purpose of financial or pecuniary gain or profit (R&TC §23101(a)); or
2. Meets the factor-threshold economic nexus test by:
    a. Being organized or commercially domiciled in California;
    b. Having California sales exceeding $690,144 (2022);
    c. Having California real or tangible personal property (valued at original cost) exceeding $69,015 (2022);
    d. Having California compensation exceeding $69,015 (2022); or
    e. Having California sales, property, or compensation that exceed 25% of the business's total sales, property, or payroll.

    (R&TC §23101(b))

Also, the property, payroll, and sales of the taxpayer include the taxpayer's *pro rata* or distributive share of partnerships or S corporations. (R&TC §23101(d))

P.L. 86-272 PROTECTIONS MAY NO LONGER BE AVAILABLE

On Valentine's Day 2022, the FTB released new guidance that will subject many out-of-state businesses selling tangible personal property to California customers to California taxes for the first time.

Previously, these businesses were immune from California taxation as a result of the federal Public Law 86-272, which prohibits a state from imposing a net income tax on income derived within that state from interstate commerce if the only business activity within the state is the solicitation of orders. As a result, if an out-of-state business's activities in California stay within the protections of P.L. 86-272, a taxpayer also remains protected from the imposition of those taxes that are computed based on net income, namely, the California franchise and income tax.

Remember, P.L. 86-272 does not provide protection for the following:

- Sales of services, unless ancillary to the sale of tangible personal property, *de minimis*, or performed by an independent contractor;
- Sales/licensing of intangible property;
- Leasing of tangible personal property; or
- Renting/sales of real property.

MTC REEXAMINES P.L. 86-272 PROTECTIONS

With the Supreme Court's decision in ***South Dakota v. Wayfair, Inc.*** ((2018) 585 U.S. ___, 138 S.Ct. 2080), many tax professionals and tax administrators questioned whether the states' interpretation of P.L. 86-272 protections were too expansive in today's e-commerce economy. They argue that even though a business may be physically located in another state, their activities conducted over the internet with in-state customers purchasing tangible personal property exceeded the P.L. 86-272 solicitation activities.

In 2021, The Multistate Tax Commission approved a revised MTC Statement of Information on P.L. 86-272, addressing when tangible personal property transactions between an out-of-state company and a state resident over the internet are "protected" activities. The revision limits the activities that are protected, meaning that more out-of-state companies will be subject to state income taxation on their internet sales.

CALIFORNIA TAKES THE LEAD

Although the MTC adopted this restrictive interpretation of P.L. 86-272 immunity, their guidance is not binding on any states until officially adopted by a state by statute, regulation, or other administrative guidance. With the issuance of TAM 2022-01, the FTB has now made California the first state to follow the MTC's lead.

Specifically, under TAM 2022-01, an out-of-state business selling tangible personal property to a California customer will lose their P.L. 86-272 immunity from California taxation if the business:

- Places internet "cookies" onto California customers' computers or other electronic devices, which allows the business to gather customer information to adjust its production schedules and inventory amounts, develop new products, or identify new items to offer for sale;
- Contracts with a marketplace facilitator to sell its products over the marketplace, and the facilitator maintains the business's inventory in its California fulfillment centers;
- Remotely fixes or upgrades products previously purchased by California customers by transmitting code or other electronic instructions via the internet;
- Offers and sells extended warranty plans via its website to California customers who purchased the business's products;
- Has an employee who is working remotely in California, unless the employee's activities constitute solicitation of sales or are entirely ancillary to the solicitation of sales;
- Regularly provides post-sale assistance to California customers via electronic chat or e-mails that customers initiate by clicking on an icon on the business's website;
- Solicits and receives online applications from California customers for its branded credit card via the business's website;
- Website invites California viewers to apply for nonsales employment with the company by allowing viewers to fill out and submit an electronic job application; and or
- Sells videos or music to be streamed to a California customer's device.

PROTECTED ACTIVITIES

The following activities are still protected P.L. 86-272 activities, meaning they will not subject an out-of-state business selling tangible personal property to California taxation:

- The business provides post-sale assistance to California customers by posting a list of static FAQs with answers on its website;
- The business placed internet cookies onto its California customers' computers or other devices, and the information gathered is only used for purposes entirely ancillary to the solicitation of orders of tangible personal property such as to remember items that were stored in a customer's shopping cart, storing personal information so customers won't have to reenter the information for future orders, etc.; and
- The business offers only items of tangible personal property on its website and does not engage in any other activities described above.

IMPACT ON CALIFORNIA BUSINESSES

While California's new restrictive interpretation of P.L. 86-272 will not have any impact on California businesses because they are already subject to California tax, it is likely that many more states will begin to follow suit. This means that if a California business is selling tangible personal property to customers in other states that adopt a similar restrictive P.L. 86-272 interpretation, the California business will then have a filing requirement in that state.

However, this may actually be a win for California businesses because those sales will no longer be thrown back and treated as California sales under California's sales factor apportionment formula throwback rules.

Litigation has already begun

The American Catalog Mailer's Association has filed a lawsuit challenging the FTB's new restrictive interpretation of P.L. 86-272, which prohibits a state from imposing a net income tax against out-of-state sellers whose only connection with the state is the solicitation of orders of tangible personal property. (***American Catalog Mailers Association v. FTB***, Superior Ct. of San Francisco County, Case No. CGC-22-601363, filed August 19, 2022)

According to the complaint, the FTB has stated that their latest guidance will be applied retroactively. This means that remote sellers that did not file California returns based on their reliance on the FTB's previous P.L. 86-272 guidance are now subject to audit for all prior years in which they sold items to California residents over the internet. There is no statute of limitations for nonfilers. (R&TC §19087)

The lawsuit is requesting that the court declare the FTB's latest guidance invalid, or if the court finds that the guidance is not invalid, that the FTB be prohibited from applying the guidance retroactively.

TAXATION OF NONRESIDENT SOLE PROPRIETORS

A Tennessee sole proprietor who provided consulting services to a California insurance agency had California-source income that was taxable by California, even though the sole proprietor performed all his services in Tennessee and was never physically present in California. (***Appeal of Bass***, 2022-OTA-145) All of the trainings and consulting services conducted by the sole proprietor for his California customer and its employees were conducted from Tennessee via Skype or personal phone calls, or physically in Tennessee.

Under the OTA's precedential decision in ***Appeal of Bindley***, 2019-OTA-179P, physical presence is not required to tax the income received by a nonresident sole proprietor if their customer receives the benefit of the services in California. In addition, California's nonresident sourcing regulation (18 Cal. Code Regs. §17951-4) incorporates California's corporate apportionment rules (R&TC §25120 et seq.), including the market-based sourcing rules (R&TC §21536; 18 Cal. Code Regs. §25136-2) if a nonresident sole proprietor conducts a unitary business both inside and outside California.

Under the reasoning adopted by the OTA in ***Bindley,*** a sole proprietor conducts a unitary business if they are in a single line of business, in this case "consulting." Furthermore, because the taxpayer operated in Tennessee but had customers in California, he was conducting business both inside and outside California and therefore was subject to California's corporate apportionment rules.

The OTA rejected the taxpayer's argument that his case was distinguishable from the ***Bindley*** case because ***Bindley*** involved a taxpayer who produced a tangible product, a screenplay, for his California customer. The OTA in ***Bindley*** applied the market-based sourcing rules related to the taxation of services (the writing of a screen play) and not the delivery of tangible personal property, so the reasoning of ***Bindley*** was on point.

ALL IS NOT LOST

Even though the OTA held that the $59,950 in income received by the sole proprietor from his California customer was California-source income, the OTA did not uphold the FTB's assessment, which subjected the full $59,950 to California taxation. Rather, the OTA ruled that the FTB was required to apply California's single sales factor apportionment formula to determine how much of the $59,950 in consulting service income was actually subject to California taxation.

According to the information provided by the FTB to the OTA, the total everywhere gross receipts reported by the taxpayer on his Schedule C was $207,423. Therefore, the single sales factor apportionment formula was 28.9% ($59,950 ÷ $207,423). Applying the 28.9% sales factor to the taxpayer's total net unitary business income of $143,425 resulted in California-source income of $41,453, not the $59,950 computed by the FTB.

Nonresident sole proprietor checklist

As a result of earlier OTA decisions (***Appeal of Wood***, 2019-OTA-264; ***Appeal of Krown***, 2021-OTA-078) and guidance issued by the FTB (FTB Legal Ruling 2022-01), we now have a series of factors to evaluate when a nonresident sole proprietor receives an assessment from the FTB. And trust us, if a California business issues a 1099-NEC to a nonresident sole proprietor who has not filed a California return, they will receive an assessment from the FTB.

Under California's market-based sourcing rules, the key to determining whether the income is California-source income subject to California taxation is determining where the benefit is received. To make this determination, the FTB in Legal Ruling 2022-01 outlined the following factors to consider:

<table>
<tr><th colspan="3">Nonresident Sole Proprietor Checklist</th></tr>
<tr><td>☐</td><td>Who is the customer?</td><td>If the taxpayer's paying customer is located in California, the benefit of the service may be received in California, but it's important to remember that this is not a foregone conclusion. Taxpayers and their tax professionals should work through all the factors below to see whether the benefit of the service is actually received in California, and if so, how much of the income is subject to California taxation.</td></tr>
<tr><td>☐</td><td>What is the service being provided?</td><td>This will likely be identifiable in the written or verbal contract between the sole proprietor and their customer.</td></tr>
<tr><td>☐</td><td>What is the benefit being received?</td><td>Key to determining where the benefit is received is determining what the benefit actually is. Examples include marketing services that will boost the customer's overall market, event planning for an event in a specific location, or employee training, customer support, etc.</td></tr>
<tr><td>☐</td><td>Where is the benefit received by the customer?</td><td>This is often the most nuanced factor to evaluate. If the customer is located in California and the service is provided directly to the customer in California, the benefit is received in California. However, if the taxpayer provides services to the customer at a location outside California, such as providing event services for an event located in Las Vegas, the benefit will be received at the event location. In cases involving subcontracting services to a customer's customer, the FTB is now applying a look-through analysis, and the benefit of the service will be received where the customer's customer receives the benefit of the service. See page 9-30.</td></tr>
<tr><td>☐</td><td>How to measure where the location of the benefit is received?</td><td>To determine how to measure where the benefit is received, the market-based sourcing regulation provides a list of cascading rules for taxpayers with business customers (18 Cal. Code Regs. §25136-2(c)(2)) (a different set of cascading rules applies for individual customers). If the upper rule provides the answer, then the lower-listed rules do not have to be considered. Taxpayers should first look to:
• Does the contract specifically state where the benefit is going to be received?
• If the contract doesn't accurately specify where the benefit of the service is to be received, the taxpayer or the FTB can look to the taxpayer's books or records;
• If neither the contract nor the books or records accurately reflect where the benefit is to be received, the taxpayer can reasonably approximate where the benefit is received; and
• If none of the rules above can be utilized, the benefit of the service will be assigned to the customer's billing address.
(18 Cal. Code Regs. §25136-2(c)(1))</td></tr>
<tr><td>☐</td><td>What is the sales factor apportionment formula?</td><td>As the Bass appeal shows, if the taxpayer has income from both inside and outside California, all the California-source income is not automatically subject to California taxation. Rather, only the net income apportioned to California is subject to California taxation. For most taxpayers, this will be determined using California's single sales factor.</td></tr>
</table>

Example of applying cascading rules

Katerpiller, Inc. subcontracts with a California construction company to provide equipment training to the California company's employees. The contract does not specify where the employees are located. However, Katerpiller's records show that the employees are located in several states where the construction company has major construction contracts. Katerpiller can assign the income based on the location of where the employees are located. If a total of 20 employees were trained, and only five of them were located in California, then only 25% of the income is considered California-source income.

SALES OF REAL ESTATE AND LLC GROSS RECEIPTS FEE

The LLC fee is based on "total income from all sources derived from or attributable to this state." (R&TC §17942) Total income for purposes of calculating the LLC fee is defined in R&TC §17942 as "gross income … plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer."

The ruling states that "cost of goods sold as used by RTC §17942(b)(1)(A) includes real property held for sale to customers in the ordinary course of a trade or business."

DEALER VERSUS INVESTOR

The FTB's ruling is consistent with federal cases and rulings where the courts found that a taxpayer in the trade or business of buying and selling property, such as a house flipper, must treat the property as inventory. (***Sutton v. Comm.***, TCS 2013-6; ***Flood v. Comm.***, TCM 2012-243; ***Garrison v. Comm.***, TCM 2010-261)

The ***Sutton*** court cited the following factors in determining whether property is held primarily for sale to customers in the ordinary course of business:

- The taxpayer's purpose in acquiring the property;
- The purpose for which the property was subsequently held;
- The taxpayer's everyday business and the relationship of the income from the property to the taxpayer's total income;
- The frequency, continuity, and substantiality of sales of property;
- The extent of developing and improving the property to increase the sales revenue;
- The extent to which the taxpayer used advertising, promotion, or other activities to increase sales;
- The use of a business office for the sale of property;
- The character and degree of supervision or control the taxpayer exercised over any representative selling the property; and
- The time and effort the taxpayer habitually devoted to the sales.

PAYROLL TAX INCREASES COMING IN JANUARY

As a result of all the unemployment claims paid during COVID-19, California is projected to owe over $19 billion to the federal government for its loan to the Unemployment Insurance Fund. As part of the California budget deal, California will pay $1 billion toward the loan over a two-year

 ©2022

period ($250 million in 2022, with a nonbinding agreement to pay an additional $750 million in 2023), which means California will continue to owe over $18 billion to the federal government.

Unfortunately, as described in more detail below, when a state has an outstanding balance due to the federal government for two consecutive years, employers wind up having to pay additional payroll taxes. This means come January 2023, California employers will be paying an additional 0.3% on the first $7,000 of wages paid to their employees.

HOW THE FUTA RATE IS DETERMINED

The standard FUTA rate is 6.0%, but generally employers with a good claim rate history receive a 5.4% credit against the 6.0% rate (leaving the base minimum rate of 0.6%). However, this credit is reduced in states that have an outstanding loan balance with the federal government, effectively increasing the FUTA rate.

When a state borrows money from the federal government to pay unemployment benefits to its residents, it's the state's employers that essentially make payments on the loan through a FUTA credit rate reduction. The FUTA credit is reduced when a state has an outstanding loan balance on January 1 for two consecutive years, and the loan is not repaid by November 10 of the second year. (IRC §3302(c)(2); Treas. Regs. §31.3302(c)-1)

The credit reduction is 0.3% for the first year and an additional 0.3% for each succeeding year until the loan is repaid. From the third year onward, there may be additional reductions in the credit, although in the past California has received waivers from these additional reductions.

According to the California Legislative Analyst's Office, all things remaining the same, it will take at least until 2030 until the fund is paid off. ("Repaying the State's Federal Unemployment Insurance Loan" (May 26, 2021) Legislative Analyst's Office) This means an additional $21 per employee in 2023, which could increase to as high as $189 per employee by 2030. The repayment period could be shorter if the state pays off more of the loan directly, or it could be longer if unemployment rates should rise again.

This has happened before

It feels like it was just yesterday that California had finally paid off its last loan to the federal government, and the standard payroll rate of 0.6% was reinstated.

California borrowed funds from the federal government in 2009, and because California did not repay its loan until May 2018, California employers paid more in federal FUTA taxes in 2011 through 2017. For 2017, employers paid an additional 2.1% in FUTA taxes per employee. The FUTA rate finally returned to 0.6% when employers paid their FUTA taxes for 2018 in January 2019.

Now California is the leader in outstanding loan balances once again. As of September 2021, California's balance was over $19 billion; the next state was New York with less than $9 billion in debt. Only 10 states in total had outstanding balances. (See: https://taxfoundation.org/state-unemployment-trust-funds-2021/)

CALSAVERS

The CalSavers program is a state-administered Roth-like retirement plan available to California employees working for businesses that don't offer a retirement plan. (Gov't. Code §100000 et seq.; 10 Cal. Code Regs. §10000 et seq.)

Employers who already offer a retirement plan to their employees are "exempt" and cannot enroll in the program.

MOST NONEXEMPT BUSINESSES MUST REGISTER BY 2026

As noted in the chart below, employers with five or more California W-2 employees, at least one of whom is at least age 18, were required to register no later than June 30, 2022. Nonexempt employers with more than 50 employees and more than 100 employees were already required to register in 2021 and 2020, respectively.

SB 1126 (Ch. 22-192) expands the program to require eligible employers that have one or more eligible employee and that do not provide a retirement savings program to register with the CalSavers program by December 31, 2025. (Gov't. Code §100000(d))

Sole proprietors, self-employed individuals, or other business entities that don't employ any individuals other than the owners of the business are excluded from this new requirement.

CalSavers Requirements	
Employer size	**Registration deadline**
More than 100 employees	Extended from June 30, 2020, to September 30, 2020*
More than 50 employees	June 30, 2021
5 or more employees	June 30, 2022*
1 or more employees	December 31, 2025
* Deadline has passed. Register today	

Comment

The CalSavers program estimates that an additional 750,000 businesses will be impacted by SB 1126's expansion of the program. Dropping the mandatory registration of the program to businesses with only one employee is raising a lot of questions, such as:

- How will spousal employees be treated? Will the employee spouse be considered an owner so if the only "employee" is an owner's spouse, the business will not be required to register?
- Will having a household employee require a nonbusiness taxpayer to register with the CalSavers program?

We anticipate that CalSavers will be providing answers to these questions and more as the December 31, 2025, deadline approaches.

REGISTERING WITH CALSAVERS

The CalSavers program will notify employers via letter of their requirement to register in the program. When the employer registers (or shortly thereafter), they need to enter an employee roster into their CalSavers account, providing basic employee information like name, address, phone number, e-mail address (if available), and external payroll ID (and this is all done on an Excel spreadsheet).

The employer will also have to update the roster with information for employees hired after the initial roster is submitted.

CalSavers will contact the employees directly about whether the employee will opt out, and if not, what their contribution rate will be.

NEW BUSINESSES

An employer that becomes an eligible employer after July 1, 2019, must register with CalSavers by the later of:

- The applicable date listed in the chart above, based on the employer's number of employees listed above; or
- Within 24 months of the employer becoming an eligible employer.
  (10 Cal. Code Regs. §10002(b))

Example of registration deadline for new businesses

Company X opens its California business on January 1, 2021, with 60 employees and does not offer a retirement plan. Even though the general rule is that businesses with more than 50 employees without a retirement plan must register with CalSavers by June 30, 2021, because Company X didn't open its business until after July 1, 2019, it does not have to register with CalSavers until January 1, 2023 (24 months after it opened).

CALSAVERS PENALTIES

Employers that fail to comply with the CalSavers program requirements will be subject to a $250 per-employee penalty after receiving a notice of noncompliance from the FTB. (Gov't. Code §100033; R&TC §19286) The penalty will be increased to $500 per employee if the employer doesn't comply within 180 days.

The FTB and the CalSavers Retirement Savings Board have already begun issuing penalty notices to midsize to large employers deemed by the CalSavers Retirement Savings Board to be noncompliant with the CalSavers requirements. We believe they'll be issuing notices to smaller noncompliant employers soon.

CalSavers will determine whether a penalty should be imposed for an employer's failure to comply with program requirements without good cause. If CalSavers determines the penalty should be imposed, it then refers the case to the FTB, and the FTB is responsible for collecting the penalty.

Common reasons for the penalty notice would be:

- Failing to register;
- Failing to provide eligible employee information to CalSavers on time;
- Failing to provide new eligible employee information to CalSavers on time; and/or
- Failing to remit employee contributions.

An employer will first receive a notice of its failure to comply without good cause from the CalSavers program. The employer then has 90 days to come into compliance.

After that 90-day period, the FTB will send the first penalty notice on Form FTB 4230A, which imposes a $250 per-employee penalty. If noncompliance continues for 180 or more days, the FTB will send a final notice on Form FTB 4230B, which increases the penalty by an additional $500 for a total of $750 per employee. (R&TC §19286 et seq.) Clearly, these penalties can add up quickly even for small employers.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

6. Which choice below accurately describes how passthrough entity elective tax payments relate to California's e-payment mandates?

    a) The payments will trigger the mandatory e-pay requirement for the entity owners
    b) Passthrough entity tax payments made by partnerships will trigger the mandatory e-pay requirement, no matter how large the amount
    c) Tax payments made by S corporations on behalf of consenting owners will trigger the e-pay requirement
    d) The FTB will not provide automatic penalty relief to S corporations that were previously subject to mandatory e-pay but didn't make their elective tax payments electronically

7. What is true about nonresident withholding and the passthrough entity elective tax?

    a) The FTB will grant a waiver of the nonresident withholding requirement for entities because they elected to pay the passthrough entity tax on behalf of their nonresident owners
    b) For nonresident shareholders or partners that consent to have the passthrough entity elective tax paid on their behalf, there is no reduction of nonresident withholding
    c) The passthrough entity subject to nonresident withholding must file FTB Form 592-PTE, Pass-Through Entity Annual Withholding Return, to report payment of the tax
    d) The passthrough entity elective tax is considered to be withholding

8. What are among the cannabis excise tax changes released by the CDTFA?

    a) The bill shifts the responsibility for collection of taxes from retailers to distributors effective in 2023
    b) Effective on January 1, 2023, cannabis distributors must be registered with the CDTFA for a cannabis tax account
    c) Starting January 1, 2023, cannabis retailers must e-file a cannabis excise tax quarterly return
    d) Under AB 195, an unlicensed person or cannabis business that possesses, keeps, stores, or retains for sale cannabis or cannabis products is liable for cannabis taxes, to which a penalty of the greater of 25% of the tax due or $1,000 will be added to the assessment

SOLUTIONS TO REVIEW QUESTIONS

6. Which choice below accurately describes how passthrough entity elective tax payments relate to California's e-payment mandates? **(Page 9-15)**

   a) Incorrect. The payments are made by the entity, so they don't trigger mandatory e-pay for the owner.
   b) Incorrect. Partnerships and LLCs taxed as partnerships are not subject to mandatory e-pay.
   c) Incorrect. If the S corporation already is subject to the e-pay mandate, then the payment must be made electronically. If the corporation is not subject to the mandate already, because they are not estimated or extension payments and are not considered part of the final tax liability, they will not trigger the mandate if the payment is $20,000 or above but less than $80,000.
   d) Correct. The FTB stated that they will provide e-pay penalty relief on a case-by-case basis.

7. What is true about nonresident withholding and the passthrough entity elective tax? **(Page 9-22)**

   a) Incorrect. The FTB won't approve a waiver for this reason.
   b) Correct. The nonresident owner will end up paying 16.3% in withholding – 7% nonresident withholding plus the 9.3% passthrough entity tax.
   c) Incorrect. Payment of the tax is not considered withholding, so there is no reporting on this form.
   d) Incorrect. It is not withholding.

8. What are among the cannabis excise tax changes released by the CDTFA? **(Page 9-25)**

   a) Incorrect. The responsibility for collection and remittance shifts from distributors to retailers as of January 1, 2023.
   b) Incorrect. Cannabis distributors will no longer be required to hold a tax account with the CDTFA, so all distributor cannabis tax accounts will closed.
   c) Correct. Retailers must also remit the cannabis excise tax each quarter on or before the last day of the month following the end of the quarter.
   d) Incorrect. The penalty is the greater of 25% of the tax due or $500.

Chapter 10

California Miscellaneous

CALIFORNIA MISCELLANEOUS

FTB

FTB FORM CHANGES FOR 2022 TAX YEAR

New forms coming

The following new forms will be available for 2022 tax returns filed in 2023:

- Form FTB 3831, Homeless Hiring Tax Credit, and Form FTB 5020, Homeless Hiring Tax Credit Certificate. See page 6-15 more information about this credit; and
- Form FTB 3835, State Historic Rehabilitation Credit. This credit was enacted by SB 4511 in 2019 but was not funded until 2022. The Office of Historic Preservation has yet to adopt implementing regulations or release application forms for this new credit. Once the program is up and running, taxpayers will be able to claim a credit for the qualified costs incurred in the rehabilitation of certified historic structures.

Obsolete forms removed

The following forms will no longer be available:

- Form FTB 3835, Main Street Small Business Credit. This credit was only available during the 2021 tax year. Although there is a five-year carryover of the credit, the carryover will be claimed on Form FTB 3540, Credit Carryover and Recapture Summary; and
- Form FTB 3849, Premium Assistance Subsidy. Because the Inflation Reduction Act of 2022 extended the availability of the increased federal health care subsidies provided by the Premium Tax Credit, California will not be providing additional premium assistance subsidies through 2025. Lines 64 and 77 on the FTB Form 540 and lines 74 and 87 on the FTB Form 540NR, related to premium subsidies and premium subsidy repayments, are also being removed.

Other form changes

Below are some of the other changes being made to California tax forms for the 2023 filing season:

- Schedule CA (540 and 540NR), California Adjustments, will be revised to mirror the changes made to federal Form 1040, Schedule 1 and Schedule A, which expanded lines (i.e., Form 1040, line 1 is now lines 1a-z);
- Schedule P (540, 540NR, 541), Alternative Minimum Tax and Credit Limitations, will be modified to add a new "B4" section so that the Passthrough Entity Elective Tax Credit will now be claimed after the Other State Tax Credit because of legislative changes made by SB 113 (Ch. 22-3);
- Form FTB 3514, California Earned Income Tax Credit, will be modified to add a new checkbox for MFS filers. California automatically conformed to the American Rescue Plan Act's expansion of the Earned Income Tax Credit that allows MFS filers to claim the credit if they have a qualifying child who lived with them for more than half of the tax year and if the taxpayer meets the spousal separation requirements; and

- Form FTB 4197, Information on Tax Expenditures, will be revised so taxpayers may report the following tax benefits (if applicable):
  - o Wildfire settlement exclusions enacted by AB 1249 and SB 1246 (see page 6-11);
  - o Turf replacement rebates, vouchers, or other financial incentives (see page 6-12); and
  - o The exemption from the $800 minimum franchise and annual tax available for deployed military members.

  Note: Taxpayers will also continue to report on the Form 4197 exclusions from gross income, if applicable, of Paycheck Protection Program loan forgiveness, EIDL advance grants, Restaurant Revitalization Fund grants, Shuttered Venue Operator Grants, and related eligible expense deductions. Cannabis businesses and their owners must also continue to complete and attach the Form 4197 to their returns.

No penalties for failing to file Form 4197

No penalties will be imposed for taxpayers that fail to file Form 4197 with their tax return. Taxpayers that received various tax benefits described above are asked to complete this form to assist the FTB in fulfilling its state-mandated data collection requirements regarding recently enacted tax benefits. However, because this form is not an "information return," there is no consequence for failing to file the form.

FTB "OUTREACH" CAMPAIGNS

The FTB has continued with their "outreach campaigns" where they send out blanket letters to taxpayers whose deductions are significantly higher than those expected than those normally claimed by taxpayers in their income range. The two most recent letter campaigns include:

- Form 4709 ENS/Schedule A itemized deduction letters, "Review Your State Tax Return — Total Itemized Deductions" to taxpayers who reported large Schedule A itemized deductions on their 2019 tax returns that are "significantly higher than expected" for taxpayers within the taxpayer's income range (FTB Tax News, June 2022); and
- Form 4709 to taxpayers who reported large Schedule C expenses.

According to the FTB, "The purpose of the review letter is to encourage taxpayers to review their 2019 tax return, and current tax years, for any discrepancies." The letters indicate that:

- **For Schedule A filers:** "Deductions commonly overstated may include medical expenses, charitable contributions, mortgage interest, and unreimbursed employee business expenses;" and
- **For Schedule C filers:** The FTB stated that they're not looking at any particular expenses, just the Schedule C in general. But common Schedule C audit areas include business meals and travel, and car and truck expenses like mileage. When these issues are appealed, the taxpayer will lose if they have little to no substantiation to back up the large deductions they claimed. Also, deduction amounts that aren't normal for the size of the business could be an audit trigger (for example, a real estate agent taking a course that costs $30,000 that promises to teach them how to make to make $1 million — this large of an education expense for a small real estate pro could be questioned).

This review letter does not constitute an audit, but the 2019 return does remain subject to audit until the statute of limitations expires. Taxpayers should review their return and make sure that the amounts claimed are accurate that that they have the proper documentation to substantiate their deductions.

The FTB started this outreach effort by sending a small volume of review letters in May and will increase the volume over the next several months.

ACCOUNTING FOR REAL ESTATE WITHHOLDING

Withholding at source is required from the proceeds of the sale of California real property by both residents and nonresidents of California, and for certain business entities, unless certain exceptions are met. (R&TC §18662(e)) The rate of withholding is 3⅓% of the gross sales price, unless an election is made to use an alternative rate based on the amount of gain from the sale. The withholding is reported using Form 593, Real Estate Withholding Statement.

However, there have been numerous cases where taxpayers have missed out on withholding credits due to claiming the withholding credit too late, a mismatched name and Social Security number, or where the withholding just wasn't credited to the return. This last scenario frequently occurs when property is held by an irrevocable trust, but the beneficiary claims the withholding credit.

Claiming the credits too late

In ***Appeal of Azzolino***, the FTB received $15,302 in real estate withholding for property the taxpayer sold in 2016. (***Appeal of Azzolino***, 2022-OTA-154) The taxpayer failed to claim the withholding on his 2016 tax return. Although the FTB sent the taxpayer a notice in 2020 informing him that that there was unclaimed withholding credit available for the 2016 tax year, the taxpayer did not file an amended 2016 return until July 15, 2021, after the statute of limitations had lapsed. The OTA upheld the FTB's denial of the refund, resulting in a loss of the $15,302 withholding credit. A similar result was reached in ***Appeal of Fang***, where a taxpayer didn't file an amended 2015 return to claim over $21,000 in real estate withholding withheld in 2015 until April 2021. (***Appeal of Fang***, 2022-OTA-267)

In another appeal, the OTA ruled that a taxpayer/trust's claim for refund of the real estate withholding paid in 2014 was also barred by the statute of limitations. (***Appeal of Jacqueline Mairghread Patterson Trust***, 2021-OTA-187P) The trust exchanged property in a §1031 like-kind exchange with $200,683 of boot, including $3,642 sent to the FTB as real estate withholding. However, the withholding agent (it's unclear if it was an escrow company or the buyer) sent a $3,642 check to the FTB with a voucher, but neither the check nor the voucher included the taxpayer's name or federal employer identification number. The withholding agent did not submit a Form 593, Real Estate Withholding Statement, to the FTB until November 19, 2019.

These cases provide an important reminder to check with new clients to see if they had any withholding taken out of California real property sales in the last four years to confirm that these withholding payments are properly accounted for on their California tax returns. Imagine your finding $15,000, $20,000, or more in lost withholding credits for your new, now lifelong, clients.

Mismatched withholding

In some cases, Form 593 may be filed with a mismatched name and Social Security number. For example, a taxpayer may not be properly credited for the withheld amounts from the sale of real estate because the property was held in a revocable living (grantor) trust, so the Form 593 may list the trust's name with the taxpayer's Social Security number.

The FTB:

- Manually processes payments that can't be matched to an account. This might include contacting the real estate escrow company if there is an error on Form 593, such as incorrect tax ID numbers and missing information; and
- Validates the Notice of Tax Return Change (TRC) to ensure accuracy prior to mailing a TRC with withholding credit problems.

This manual effort seems to have reduced the number of notices sent by the FTB. However, it might slow the processing of these returns.

Real estate and nonresident withholding is posted to your client's MyFTB account, although it is not posted to the fiduciary account, so you may need to verify whether the real estate withholding has been credited properly.

The same problem arises when a property is sold by a single member LLC. The property is titled in the name of the SMLLC, but the member's Social Security number is used.

Passing withholding to beneficiary

When property is sold by an irrevocable (nongrantor) trust, the escrow company completes a Form 593 listing the name of the irrevocable trust as the seller. The trustee will receive a Form 593 in the name of the trust. If there was withholding on the sale, the trust must then file an FTB Form 592, Resident and Nonresident Withholding Statement, to transfer the withholding to the beneficiary and provide the beneficiary with an FTB Form 592-B, Resident and Nonresident Withholding Tax Statement.

Unfortunately, the current process does not allow the trust to pass through the withholding using the state withholding line on Schedule K-1.

Real estate withholding tips

When your client sells California property:

- Check the client's MyFTB account to see if the withholding is posted to the beneficiary's account (unfortunately, fiduciary accounts are not currently available online);
- Look for FTB Form 593. Be sure the taxpayer's name and tax ID numbers are correct;
- If there is no FTB Form 593, look at the seller's closing statement to see if there was withholding subtracted from the proceeds. Also, have the client contact the escrow company for a copy of Form 593; and
- Alert your client that there may be a problem and that they should contact you if they receive correspondence from the FTB.

If there is a problem, contact the FTB's Withholding Services and Compliance Section at:

☎ **Telephone**
(888) 792-4900

FTB SETTLES SOME LLC FEE PROTECTIVE REFUND CLAIMS

The FTB has reached a partial settlement with attorneys representing a class of taxpayers that paid LLC gross receipts fees based on the LLC's worldwide income, rather than income attributable to California, as was required under California law for pre-2007 tax years. (FTB Notice 2022-02)

In previous litigation, taxpayers successfully challenged the pre-2007 LLC fee calculation on behalf of:

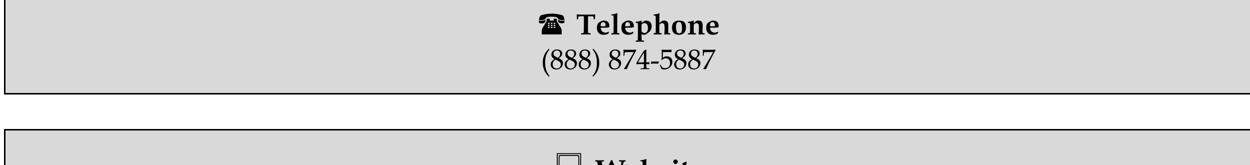
- LLCs located outside California with no income attributable to California, requiring a full refund of all LLC fees paid (***Northwest Energetic Services, LLC v. FTB*** (2008) 159 Cal.App.4th 841); and
- LLCs with income attributable to activities both within and without California, requiring a partial refund based on the portion of the fees paid attributable to activities outside California. (***Ventas Finance, I, LLC v. FTB*** (2008) 165 Cal.App.4th 1207)

 ©2022

After these cases were decided, the FTB solicited potentially impacted taxpayers to file protective refund claims and processed thousands of claims they determined were eligible for refunds under the ***Northwest*** and ***Ventas*** decisions. However, the FTB did not process claims for those LLCs they determined had income only from sources attributable to California. (**Note:** The issue of whether the entire pre-2007 law was invalid is still being litigated.)

In discovery conducted in the ongoing LLC fee class action case (***FTB Limited Liability Corporation Tax Refund Cases***, Cal. Ct. of App., 1st App. Dist., Case No. A140518), it was revealed that many of the taxpayers with unprocessed refund claims were entitled to refunds under the ***Northwest*** and ***Ventas*** decisions. The FTB has agreed to settle such claims.

The Settlement Administrator is mailing notices of the settlement and claim forms to all class members. Taxpayers who believe they are in the impacted class but do not receive a notice of settlement may contact the Settlement Administrator at:



☎ **Telephone**
(888) 874-5887

Website
www.ftbllctaxsettlement.com

Do not contact the FTB directly, as they have no role in processing of refund claims approved by the Settlement Administrator.

DISHONORED PAYMENT PENALTY FOR REJECTED DUPLICATE PAYMENT

Taxpayers who inadvertently made a duplicate $94,000 payment to the FTB (which was dishonored because of insufficient funds) were liable for the dishonored payment penalty. (***Appeal of Chan***, 2022-OTA-151SCP) The taxpayers' CPA had prepared a duplicate extension request for the 2019 tax year, including a second payment, which the taxpayers were unaware of. Because they, too, had made an identical $94,000 payment, their account became overdrawn when the second $94,000 payment was made. The taxpayers argued for reasonable cause abatement of the penalty, which can be abated if the taxpayers reasonably believed that the amount would be paid. But there is no standard in the law for the taxpayers' situation: where no payment was ever due to be paid to the FTB in the first place. And although the IRS has discretionary powers to abate the federal dishonored payment penalty, the OTA cannot compel the FTB to abate a penalty. (IRC §6657; R&TC §19134)

PARTIAL INTEREST ABATEMENT

In ***Appeal of Kain***, 2022-OTA-258, the OTA upheld the partial abatement of interest that was assessed during the period a taxpayer was protesting the FTB's assessment of additional tax. The time period that the abatement applied to was marked by what was determined to be an unreasonable delay on the part of the FTB.

The interest at issue was assessed starting April 20, 2020 (the day the taxpayer filed her protest), through April 21, 2021 (the date the taxpayer paid her additional tax and interest). The taxpayer argued that the FTB took almost a year to respond to her protest, which constituted an unreasonable delay. The FTB conceded that during the time period April 20, 2020, through April 21, 2021, the average time it took to assign staff to a protest was six months. Therefore, the FTB abated the interest from October 21, 2020 (six months after receiving the taxpayer's protest), through December 7, 2020

(the date staff was actually assigned to the case). For the period December 7, 2020, through April 21, 2021, the FTB declined to abate any interest because it was actively working on the taxpayer's protest.

The OTA accepted the FTB's basis for abating interest based on the extra time it took to assign the case.

FASTER ACCESS TO MyFTB ACCOUNT

The FTB has implemented a new feature to allow tax professionals and individual taxpayers to register a new MyFTB account in "real time" without waiting for a personal identification number (PIN) to be sent via mail. (FTB Tax News (January 2022))

With this new process, tax professionals and individual taxpayers will have the option to provide information that the FTB will validate using a third-party service offered through TransUnion. If the registrant's identity can be validated, they will not have to wait for a PIN to be mailed to them. Instead, they will receive an e-mail to activate their account within a few minutes.

Individuals and tax professionals may choose how to activate their MyFTB account using this new process. They may either continue to have a PIN letter mailed using the existing service or choose to be verified through TransUnion.

What information will be required?

The registrant can provide additional information during registration, like their complete address, date of birth, phone number, etc., and answer questions specific to their personal information. These questions will be similar to other online applications that ask things like, "What's your monthly mortgage payment?" or "Which of the following phone numbers are you associated with?" or "Which of the following street addresses have you lived at?" If they pass the validation questions, they'll be able to establish their MyFTB account right away.

What if verification fails?

If a registrant doesn't pass the validation process, they'll still be able to create a MyFTB account, but they'll have to follow the existing process and receive a PIN letter via mail, which takes five to seven days.

The PIN is valid for 21 days from the date of registration, but if the registrant doesn't use the PIN within the 21 days, it expires, and the registration process must be restarted. For security purposes, the FTB will not give out the PIN over the phone. The registrant can go to any field office and show a valid ID to be given a copy of their PIN letter.

CHANGES TO MyFTB PASSWORD EXPIRATION

Effective June 22, 2022, MyFTB passwords will expire every 120 days instead of every 365 days. (FTB Tax News (July 2022))

MyFTB users will continue to receive an e-mail 30 days prior to the password expiration date that their current password will expire. If a password expires as a result of this change, the next time the user logs in, they will be prompted to change their password.

The FTB implemented this change to better protect tax professionals and their clients' information.

BOARD SETTLEMENT APPROVAL THRESHOLD INCREASED

FTB staff must only obtain the approval of the three-member Franchise Tax Board for tax litigation settlements of $500,000 or more. Previously the threshold was $250,000. (FTB Board Resolution 2022-04) The three-member board must receive written notice from the Executive Officer of any litigation settlement amount of $250,000 or more and less than $500,000. As before the three-member board must also approve any litigation settlement that involves an important principle of law having substantial implications with respect to taxpayers or the state.

CERTIFICATES OF MAILING PROCEDURES FOR LARGE TAX DEFICIENCIES

FTB staff must utilize the certificate of mailing procedure to objectively establish that notices of action of protested deficiencies were mailed only for protested deficiencies of $100,000 or greater. (FTB Board Resolution 2022-01) Previously this procedure was required for all notices of action.

Note that a certificate of mailing is different than certified mail, which would require the recipient's signature.

COLLECTION AND FILING ENFORCEMENT FEES

For the 2022–23 fiscal year, the collection cost recovery fees and filing cost recovery fees are:

- **$334:** Collection cost recovery fee for corporations and limited liability companies (LLCs) classified as corporations for California income tax purposes;
- **$100:** Filing enforcement cost recovery fee for corporations and LLCs classified as corporations for California income tax purposes;
- **$307:** Collection cost recovery fee for individuals, partnerships, LLCs classified as partnerships for California income tax purpose, or fiduciaries; and
- **$81:** Filing enforcement cost recovery fee for individuals, partnerships, LLCs classified as partnerships for California income tax purposes, or fiduciaries.

FILING EXTENSIONS FOR WILDFIRE VICTIMS

California conforms to IRC §7508A, which grants the IRS authority to extend various tax-related deadlines, including filing deadlines for victims of federally declared disaster areas. (R&TC §18572) This means that California automatically conforms to any IRS extensions provided to affected taxpayers in federally declared disasters areas.

However, due to California's January 1, 2015, specified conformity date, California does not conform to an amendment made to IRC §7508A by the federal Infrastructure Investment and Jobs Act (P.L. 117-58) that expands the IRS's authority to provide extension relief to victims of "significant fires" for which federal assistance is provided even if the impacted area is not designated as a federally declared disaster area. This means going forward, California will not automatically conform to filing extensions provided by the IRS to victims of "significant fires." California taxpayers will only be eligible for extensions if the FTB provides similar relief.

PROPERTY TAX

SOLAR PROPERTY NEW CONSTRUCTION EXCLUSION

SB 1340 (Ch. 22-425) extends the new construction property tax reassessment exclusion for active solar energy systems for two years through the 2025–26 fiscal year. (R&TC §73)

EMERGENCY PROPOSITION 19 RULES ADOPTED

The Board of Equalization adopted emergency rules that clarify the parent–child and grandparent–grandchild property tax transfers as well as the base-year value transfers for taxpayers who are over age 55, disabled, or disaster victims as revised by Proposition 19 (see below for a Proposition 19 overview). The rules are effective July 18, 2022, and will remain in effect until January 14, 2023 (180 days from the July 18, 2022, effective date). (18 Cal. Code Regs. §§462.520, 462.540)

Intergenerational transfer changes

Highlights of the intergenerational property transfer changes adopted in the emergency rules include, but are not limited to:

- Making clear that a parent–child/grandparent–grandchild transferee is eligible for a refund of overpaid taxes if they timely filed a claim for the exclusion and filed the homeowners' exemption or Disabled Veterans' Exemption within one year of the transfer of the family home;
- If they used their home as their primary residence but failed to file the homeowners' or Disabled Veterans' Exemption claim within one year of the transfer, they do not qualify for a refund of any increased taxes paid but do qualify for prospective relief from the increased property taxes. If they did not use the home as their principal residence within one year of the transfer, they are ineligible for the exclusion;
- Providing examples of how the exclusion is calculated when the transfer involves the transfer of a legal parcel that contains both a principal residence and a family farm. Transferees may claim separate exclusions for both the principal residence and the family farm. If the transferee moves out of the primary residence, the transferee will lose the primary residence exclusion but will still retain the exclusion for the family farm; and
- Clarifying that a qualifying principal residence includes property owned by a decedent's estate, whether directly or through a trust, if it was the decedent's principal residence immediately prior to their death. A principal residence also includes any accessory dwelling unit or junior accessory dwelling unit located on the parcel transferred.
  (18 Cal. Code Regs. §462.520)

Base-year value transfers

Highlights of the changes adopted concerning base-year value transfers include, but are not limited to, clarifying that:

- Taxpayers who are severely and permanently disabled as defined in R&TC §74.3(b) qualify for the base-year value transfer. Proposition 19 only referred to taxpayers who were severely disabled, but the implementing legislation clarified that taxpayers must be both severely and permanently disabled;
- Disaster victims are eligible for the base-year value transfer if the residence was their original primary residence at the time the property was substantially damaged or destroyed by the misfortune or calamity, even if the original principal residence was not their principal residence at the time of the transfer;
- If a property was substantially damaged or destroyed by a wildfire, natural disaster, or misfortune or calamity, and the owner does not rebuild, the full cash value of the original property is the full cash value prior to the misfortune or calamity. Property is "substantially damaged or destroyed by misfortune or calamity" if either the land or the improvements sustain physical damage amounting to more than 50% of either the land's or the

improvement's full cash value immediately prior to the misfortune or calamity. Damage includes a diminution in the value of property as a result of restricted access to the property where the restricted access was caused by the misfortune or calamity;

- Replacement property land can be acquired more than two years prior to the sale of the original property, and the full cash value of both the land and the improvement is to be determined as of the new construction completion date; and
- The presence of an accessory dwelling unit or junior accessory dwelling unit does not convert a property into a multiunit property, which means that the entire base-year value of the original property can be transferred to a replacement property. Accessory dwelling units or junior accessory dwelling units are not considered a separate primary residence or a separate replacement primary residence if:
  - There is a dwelling unit on the property;
  - The only other units on the real property are accessory dwelling units or junior accessory dwelling units;
  - Any accessory dwelling units and junior accessory dwelling units are not separately alienable from the title of any other dwelling unit on the property; and
  - The taxpayer occupies one of the structures as their primary residence.

(18 Cal. Code Regs. §462.540)

In addition, the emergency regulations revise the example of how to compute the new base-year value of the replacement primary residence when the replacement primary residence is of greater value than the full cash value of the original primary residence.

Example of computing replacement residence new base-year value

The factored base-year value of Jose's original primary residence is $300,000. Jose sells his original primary residence for $550,000 on June 1, 2021.

Jose purchases a replacement primary residence for $600,000 on August 1, 2021. Since the full cash value of Jose's replacement primary residence ($600,000) is greater than 105% of the full cash value of the original primary residence ($550,000 × 1.05 = $577,500), the new base-year value of the replacement primary residence is calculated as follows:

Full cash value of replacement residence	$600,000
Adjusted cash value of original residence	(577,500)
Increase to base-year value	22,500
Original base-year value	300,000
New base-year value	$322,500

Counties may be required to defer tax payments due to processing delays

SB 989 (Ch. 22-712) requires Los Angeles County to defer property tax payments, without penalty or interest, if the county has failed to timely process the base year value transfer. The taxpayer must request deferment within one calendar year (but before January 1, 2024), of receiving the first tax bill for the property.

The Board of Supervisors of other counties may adopt a resolution to implement similar provisions. (R&TC §2636.1)

Quick Law: Proposition 19 overview

Proposition 19 and California's implementing legislation (SB 539 (Ch. 21-427)) made major changes concerning intergenerational property tax transfers and base-year value transfers for seniors and the disabled.

Intergenerational property transfers

Proposition 19 dramatically limited the property tax relief available to parents transferring their properties to their children (or vice versa).

Applicable to transfers that occurred on or after February 16, 2021, property transferring from parent to child avoids reassessment only for:

- Transfers of principal residences and family farms (transfers of nonprincipal residences/family farms no longer qualify for relief from a change-of-ownership reassessment);
- The first $1 million of additional assessed value of the principal residence (anything above this amount will be subject to reassessment); and
- Property that is used as the child's/grandchild's principal residence/family farm. (If the child/grandchild does not use the home as their principal residence, the entire value of the property will be subject to reassessment).

As before, the same exclusion applies to transfers between grandparents and grandchildren as long as both of the grandchild's parents are deceased as of the date of the transfer.

Base-year value transfers

For transfers on or after April 1, 2021, Proposition 19 allows taxpayers who are over age 55, severely disabled, or a victim of a wildfire or other natural disaster to transfer their property tax adjusted base-year value to a replacement property anywhere in the state.

Taxpayers who are over age 55 or disabled at the time the original property is sold may transfer the base-year value of the relinquished property up to three times. Disaster victims can make these transfers for an unlimited number of disaster-related transfers.

In addition, these taxpayers are no longer limited to replacement properties of equal or lesser value. If they purchase a replacement property with a higher FMV than their original property, the assessed value of the replacement property would be equal to the assessed value of the original property, plus the difference in FMV between the original property and the FMV of the replacement property.

PROPERTY TAX INCREASES FOR PARTIAL TRANSFERS

A change in ownership of real property results in a reassessment for property tax purposes for the portion of the property that has changed ownership unless an exclusion applies. (R&TC §§75.8, 110.1) This is true whether the property is transferred by sale, gift, inheritance, or any other transfer of ownership. (R&TC §§60–69.5; Property Tax Rule 462.001) However, the rules are slightly different when the property is owned directly versus when it is owned through an entity.

When property is held through a legal entity, if there is a change of more than 50% of ownership or control of that entity, all of the real property owned by the entity is reassessed for property tax purposes. (R&TC §64)

It is important for your clients to understand the differences in these rules before they place their property in an entity, especially if they are considering selling or gifting interests later.

Changes in direct ownership

When a property is held directly, and any portion of that ownership is transferred, the new owner's interest is reassessed to fair market value (FMV) for property tax purposes. Even if more than 50% of the ownership is transferred, only the new owner's portion is reassessed. (R&TC §61)

Example of TIC transfer

Jack and Jill own 123 Hill Street, a residential rental property, as tenants in common. Jack owns 60%, and Jill owns the remaining 40%. The property has a FMV of $1 million and an assessed value for property tax purposes of $600,000.

Jack gifts his 60% interest to his daughter Jackie on August 1, 2021.

The transfer of Jack's 60% ownership is a change in ownership, and that 60% of the property that is now owned by Jackie will be reassessed to FMV for property tax purposes. Jill's 40% interest in the property remains unchanged and is not reassessed.

Original property tax basis	
Jack (60% of $600,000)	$360,000
Jill (40% of $600,000)	$240,000
New property tax basis	
Jackie (60% of $1 million)	$600,000
Jill (40% of $600,000)	$240,000

Example of sale of joint tenancy interest

Abby, Brian, and Chris own a property as joint tenants. The property has a FMV of $900,000, and an assessed value for property tax purposes of $600,000.

Brian sells his interest to Dawn for $300,000. Dawn received an undivided one-third interest in the property, and her one-third interest is reassessed to $300,000. Abby and Brian each hold a one-third interest with an assessed value of $200,000 ($600,000 × 1/3).

Example of inherited joint tenancy interest

Alex, Bob, and Chad own a property as joint tenants. The property has a FMV of $900,000, and an assessed value for property tax purposes of $600,000.

Chad dies, and his one-third interest is passed to Alex and Bob, the surviving joint tenants. Alex and Bob, now each hold an undivided one-half interest in the property valued as follows for property tax purposes:

Original property tax basis	
Alex (1/3 of $600,000)	$200,000
Bob (1/3 of $600,000)	200,000
Chad (1/3 of $600,000)	200,000
Total	$600,000
New property tax basis	
Alex (original property tax basis)	$200,000
Inherited from Chad (1/2 of $300,000)	150,000
Bob (original property tax basis)	200,000
Inherited from Chad (1/2 of $300,000)	150,000
Total	$700,000

Change of ownership of entity

When any legal entity or any person directly or indirectly obtains control or ownership of more than 50% of the total ownership interests or voting shares of another legal entity, there is a change in ownership, and all of the California real property owned by that entity is subject to reappraisal. (R&TC §64(c)) This is true even if the percentage change in ownership occurs through multiple transfers. Once the total cumulative change from the original ownership is more than 50%, a reassessment is triggered.

Example of cumulative transfer

Missy and John each own 50% of the stock of Corporation X. Corporation X owns an apartment complex.

In 2020, Missy sells 30% of the stock in the corporation to Frank. There is no reassessment on this transfer because not more than 50% of the ownership in the entity has been transferred.

In 2021, John sells 25% of the stock in the corporation to Edward. Now a total of 55% of the original ownership has been transferred (30% + 25%), so the apartment complex will be reassessed for property tax purposes.

2023 DISABLED VETERANS' EXEMPTION

The BOE has announced increases in both the property tax exemption amounts and the household income limit for the Disabled Veterans' Exemption for 2023. (California SBE Letter to Assessors No. 2022/018 (April 28, 2022))

For the 2023 assessment year, the exemption amounts are $161,083 for the basic exemption and $241,627 for the low-income exemption, and the household income limit for those claiming the low-income exemption is $72,335.

 ©2022

EDD

WORKER CLASSIFICATION UPDATES

Truckers now subject to ABC worker classification test

A federal district court has formally lifted the injunction blocking California's enforcement of the AB 5 ABC test against motor carriers and independent truck owner-operators conducting business in the state. This means AB 5 will go into effect immediately for these transportation workers. Application of the ABC test under AB 5 will mean reclassifying drivers as employees in most cases.

The injunction had remained in place while the California Trucking Association (CTA) waited to see whether its case would be heard by the U.S. Supreme Court. But in June, the U.S. Supreme Court denied the petition to review ***California Trucking Association v. Bonta***. ((April 28, 2021) U.S. Court of Appeal, Ninth Circuit, Case No. 3:18-cv-02458)

Although the CTA's legal challenge will continue to be heard, truckers are now subject to AB 5 while the case proceeds.

Of concern for the trucking industry is the B prong of the ABC test, which defines an independent contractor as a worker who "performs work that is outside the usual course of the hiring entity's business." A trucking company hiring an independent owner–operator would presumably fail the B prong of the ABC test; all prongs must be met for the worker to be an independent contractor. (Labor Code §2775(b)(1))

However, truckers should evaluate if they may qualify for the business-to-business contracting exemption from the ABC test under Labor Code §2776.

Business-to-business exemption

To qualify for the business-to-business exemption, the contract must be in writing, specify the amount to be paid and the due date, and the business service provider must:

- Be free from the control and direction of the contracting business entity, both under the contract for the performance of the work and in fact;
- Provide services to the contracting business rather than to customers of the contracting business, unless the business service provider's employees are providing the services under the business service provider's name and the business service provider regularly contracts with other businesses;
- Have a required business license or tax registration if the work is performed in a jurisdiction that requires such;
- Maintain a business location, which may include the business service provider's residence, that is separate from the business or work location of the contracting business;
- Be customarily engaged in an independently established business of the same nature as that involved in the work performed, contract with other businesses to provide the same or similar services, and maintain a clientele without restrictions from the hiring entity;
- Advertise and hold itself out to the public as available to provide the same or similar services;
- Consistent with the nature of the work, provide its own tools, vehicles, and equipment to perform the services, not including any proprietary materials that may be necessary to perform the contracted services;
- Negotiate its own rates and set its own hours and location of work; and
- Not be performing the type of work for which a license from the Contractors State License Board (CSLB) is required, pursuant to Business & Professions Code §7000 et seq.
  (Labor Code §2776)

Uber/Lyft and delivery app-based drivers' challenge

On November 3, 2020, voters approved Proposition 22, which allows app-based drivers to be treated as independent contractors but requires the network companies that employ them to provide certain benefits to these drivers. Proposition 22 only applies to app-based transportation (rideshare) and delivery companies (collectively referred to as "network companies") and only if these network companies do not place certain restrictions on the workers. Also, Proposition 22 does not apply to all app-based companies that use gig workers. Non-rideshare/delivery app-based companies must use AB 5/AB 2257 to determine if the worker is an employee or independent contractor.

On August 20, 2021, a California superior court in ***Castellanos v. California*** struck down Proposition 22 as unconstitutional, which would mean that app-based drivers would be classified as employees under the ABC test. The court's decision has been stayed pending appeal. (***Castellanos v. California*** (August 20, 2021) Cal. Superior Ct., County of Alameda, Case No. RG2108872)

On September 20, 2021, the U.S. Ninth Circuit Court of Appeals ruled that Proposition 22 only applied prospectively, and therefore the law did not abate a driver's wage and hours claim filed prior to Proposition 22's effective date. (***Lawson v. Grubhub, Inc.*** (September 20, 2021) U.S. Court of Appeal, Ninth Circuit, Case No. 18-15386)

In February 2022, Uber reached an $8.4 million settlement deal with 1,300 California drivers who worked for the company between February 28, 2019, and December 17, 2020. (In 2019, Uber reached a $20 million settlement agreement with drivers from California and Massachusetts. Lyft has also settled with drivers in several class action suits.) However, these settlements don't answer the question of whether these drivers are employees or independent contractors, which is the topic of the pending ***Castellanos*** case.

Commercial fisher exemption extended

AB 2955 (Ch. 22-443) extends until January 1, 2026, the ABC test specific occupations worker classification exemption for commercial fishers working on an American vessel. (Labor Code §2783)

 ©2022

Proposed changes to federal worker classification rules

In January 2021, the Department of Labor issued a five-factor test to determine whether a worker is an independent contractor or an employee (the current rule). (https://public-inspection.federalregister.gov/2020-29274.pdf) The five factors are:

- The nature and degree of the worker's control over the work;
- The worker's opportunity for profit or loss based on initiative, investment, or both;
- The skill required of the work performed;
- The permanence of the working relationship between the payor and worker; and
- The "integrated unit" factor (whether the work is part of an integrated unit of production).

Under the current rule, the first two factors are referred to as "core" factors and carry more weight than the other three factors. The current rule went into effect on March 8, 2021, and remains in effect today.

New proposed rule

On October 13, 2022, the Department of Labor published a new proposed rule that will revise and replace the current rule once it is made final (the proposed rule). (29 Code of Fed. Regs. §795.110) The proposed rule uses a multifactor economic reality test as a totality-of-the-circumstances test that analyzes the following non-exhaustive factors:

- The nature and degree of the purported employer's control as to the manner in which the work is performed;
- The worker's opportunity for profit or loss depending upon their managerial skill;
- The worker's investment in equipment or materials required for the task, or the worker's employment of other workers;
- Whether the services rendered by the worker require special skill;
- The degree of permanency and duration of the working relationship; and
- The extent to which the services rendered by the worker are an integral part of the purported employer's business.

The proposed rule eliminates the "core" factors approach under the current rule where certain factors automatically carry more weight than others. The Department of Labor is accepting public comments on the proposed rules through December 13, 2022, and will issue a final rule after that.

Comment

The competing rules issued by the Department of Labor under the current and the proposed rules reflect the divergent policy positions regarding worker classification. The current rule provides more certainty for employers as to whether workers are properly classified as independent contractors, and the proposed rule will provide less certainty and may open the door to classify more app-based gig workers as employees rather than independent contractors.

SIMPLIFIED APPLICATION PROCESS FOR WORK SHARING PROGRAM

AB 1854 (Ch. 22-112) extends indefinitely the simplified, online application process and automatic one-year approval period for employers who successfully apply for the EDD's Work Sharing Program. The Work Sharing Program allows workers to work part-time for an employer and collect unemployment benefits as well. (UIC §1279.7)

Comment

This program was utilized by over 200,000 California employers during the great recession in the late 2000s. Should another recession occur, this program provides an alternative to employers laying off their employees by:

- Allowing employers to reduce their employees' hours and wages; and
- Having the EDD supplement the employee's reduced wages by paying a portion of the unemployment compensation benefits to which the worker would be entitled if they had been laid off.

The program also allows employers to bring back furloughed or laid-off employees at reduced hours as business conditions approve.

Program benefits

The program allows employers to retain trained employees and minimize business disruptions. Employees are able to have more money coming in than if they were just receiving unemployment compensation. Plus, they get to keep their health and retirement benefits (if the business provided these benefits).

Eligibility

To participate in the program, an employer must:

- Have a minimum of two employees, and at least 10% of the regular work force must be impacted by hour/wage reductions;
- Reduce impacted employees' wages by at least 10% but no more than 60%; and
- Maintain the employees' health and retirement benefits.

Applying for the program

Employers may submit their application online at:

Website
www.edd.ca.gov/unemployment/Work_Sharing_Program.htm

CREDIT FOR WITHHOLDING WHEN NO WITHHOLDING SENT TO EDD

In a precedential opinion, the former president and CEO of a staffing company was not able to prove that amounts withheld from his paycheck were actually remitted to the EDD; therefore, he could not claim a refund of withholding credits. (***Appeal of Carr***, 2022-OTA-157P) While most employees can claim a withholding credit if they show the amount is withheld (R&TC §19002(a); ***Appeal of DeAmicis***, 82-SBE-114), an employee who actually has control over payroll withholding (e.g., a president or CFO) must actually show that the amounts were remitted to the EDD in order to claim the withholding credit. (See ***May v. Comm.*** (2011) 137 TC 147, 153)

When the FTB was unable to verify the income tax withholding the taxpayer reported for 2016 and 2017, they requested that the taxpayer provide proof that the withheld amounts were submitted to the EDD. The taxpayer provided EDD e-Services printouts showing his claimed withholding amount for 2016 and a Form DE 9C, Quarterly Return and Report of Wages, for 2017. The FTB did

not accept these documents as proof of withholding paid because they only showed the amounts reported, rather than the amounts paid.

The FTB argued that the taxpayer was not a typical rank-and-file employee who has no control over payroll tax withholdings and remittances. Instead, the taxpayer was the president and CEO for the years at issue, and his duties included oversight of payroll tax withholding and reporting. Therefore, he had to show proof that the funds were actually remitted to the EDD.

Functional control test

The OTA looked to ***May v. Comm.*** regarding whether the withholding funds "functionally left the control of a taxpayer." In ***May***, the fact that the funds were technically withheld by the employer-corporation was insufficient to show they had passed beyond the functional control of the employee–taxpayer. The taxpayer in ***May*** was also the corporate CEO, and he had misappropriated the funds back to the corporate account that he controlled, using them to continue operation of the corporation that paid him an annual salary. He was therefore not entitled to claim the withholding credits.

The OTA noted that when considering the functional control test, it didn't matter if the taxpayer in ***Carr*** was considered a responsible person who was personally liable for failing to remit the withheld tax, only that he exerted control over the withholdings as both an employer and an employee–taxpayer.

The taxpayer was unable to convincingly prove to the OTA that he lacked the ability to control the company's payroll withholding and reporting for the years at issue. He also did not establish proof of the amounts actually withheld and that these amounts left his control as president and CEO of the company.

CDTFA

EXEMPTION FOR THRIFT STORE ON MILITARY BASES

SB 1041 (Ch. 22-225) extends indefinitely the sales and use tax exemption for retail items sold by certain thrift stores located on a military installation. (R&TC §6363.4)

STATE OF EMERGENCY EXTENSIONS

SB 1496 (Ch. 22-474) grants the CDTFA the authority to postpone up to a period of three months the filing of any tax return or payment of any tax under its jurisdiction for any person in an area identified as a state of emergency. Taxpayers are no longer required to file an extension request. The CDTFA's authority only applies during the first 12 months following the issuance of the state of emergency or the duration of the state of emergency, whichever is less. (R&TC §§6459.5, 7656.5, 8754.5, 30185.5, 38405.5, 40065.5, 41054.5, 43154.5, 45152.5, 46153.5, 50111.5, 55041.5, 60208.5)

In addition, the CDTFA may waive any sales and use tax late-filing or late-payment penalties and interest imposed against persons located in areas identified in the state of emergency proclamation. (R&TC §§6592, 6593, 7657, 7658, 8877, 8878, 30282, 30283, 32471.5, 38452, 38453, 40102, 40103, 41096, 41097, 43157, 43158, 45155, 45156, 46156, 46157, 50112.2, 50112.3, 55044, 55046.5, 60209, 60211)

OFFERS-IN-COMPROMISE

SB 1496 (Ch. 22-474) extends the CDTFA's authority to enter into an offer –in compromise (OIC) agreement for an additional five years, until January 1, 2028. (R&TC §§7093.6, 9278, 30459.15, 41171.5, 46628, 55332.5, 60637)

USED CAR DEALERS

SB 1496 (Ch. 22-474) authorizes the CDTFA to postpone the starting date for used car dealers to remit sales and use taxes to the Department of Motor Vehicles from January 1, 2023, up until January 1, 2026, for dealers that made more than 300 retail vehicle sales in the previous calendar year and are not otherwise licensed as new car dealers. (R&TC §6295)

EXCESS SALES TAX REIMBURSEMENTS

The OTA ruled in a pending precedential decision that when a retailer collects too much sales tax from its customers, if the excess is not returned to the customer or to the taxing jurisdiction, then it belongs to California even if the customers are located in another state. (***Appeal of BodyWise International, LLC***, 2022-OTA-340P)

The taxpayer was a California retailer of weight loss and nutritional products that sold its products to customers throughout the country. The taxpayer's tax software was erroneously programmed to charge a "Tax Amount" (aka sales tax) on all sales, including exempt sales and sales to customers in states where the taxpayer was not registered to collect sales tax.

During an audit, the CDTFA determined that the taxpayer must either refund the excess sales tax it collected from customers or remit it to California, which resulted in an initial assessment of over $2 million. However, after the taxpayer protested the assessment, the CDTFA provided a credit for instances where the taxpayer had remitted excess sales tax to other states in which the taxpayer was registered, which reduced the assessment to a little over $100,000.

The remaining $100,000 represented tax collected in jurisdictions outside of California where the taxpayer was not registered to collect tax, which were neither refunded to the customer nor paid to that jurisdiction. Regarding these amounts, the CDTFA claimed that they must be remitted to California as an "excess sales tax reimbursement."

Who does it belong to?

The OTA looked to California tax law, which explains that a retailer must return excess sales tax reimbursements to the customer once it is notified (either by the CDTFA or the customer themself) that excess tax was collected. If the taxpayer fails to return the excess amount collected to the customer, then it must return the amount to the CDTFA. (R&TC §6901.5)

But the OTA noted that a sale, purchase, or any other type of transfer for consideration does not need to actually be subject to California's sales tax for the excess tax reimbursement provisions above to apply.

To prove that the taxpayer did collect "sales tax reimbursement," the CDTFA needed to show that the taxpayer:

- Sold tangible personal property;
- At retail to the purchaser; and
- Charged an amount for sales tax reimbursement on a document of sale.
  (Civ. Code §1656.1(a))

The CDTFA and the taxpayer disagreed on the third element. The taxpayer argued that it did not represent to its customers that the "Tax Amount" was reimbursement for California sales tax, and so it does not constitute California excess tax reimbursement. Instead, the "Tax Amount" represented a collection for another state's sales or use tax. The OTA disagreed that the exact phrase "California sales tax reimbursement" needed to be present to meet the third element.

The OTA held that once the three requirements above were met, it was presumed that the taxpayer collected reimbursement for California sales tax. Because the sales at issue were exempt interstate sales, the amounts collected were therefore excess sales tax reimbursement.

The OTA noted that California had sufficient nexus over these excess reimbursements because:

- The sales occurred in California (they were shipped via common carrier from a California warehouse, and there was no evidence that title passed outside California);
- The taxpayer operated out of California; and
- The taxpayer had a California seller's permit.

Finally, the taxpayer's argument that the taxpayer owed the tax to the destination state where the customers were located was also rejected because the taxpayer was not registered in those states, never remitted taxes to those states, and conceded that it "inadvertently" set up its sales tax software to collect taxes in those states.

Bottom line, the OTA agreed with the CDTFA that the amounts collected and not paid to the other states or refunded to customers were excess sales tax reimbursements that must be paid to California.

Sticky fingers

There has been some pushback from the tax professional community regarding this decision and the OTA's application of California law to non-California tax reimbursement that should have been paid to another state. The U.S. Supreme Court's decision in ***Wayfair*** made it clear that a retailer is responsible for collecting sales tax regardless of whether it is registered in a particular state. (***South Dakota v. Wayfair, Inc.*** (2018) 585 U.S. ___, 138 S.Ct. 2080) Therefore, a lack of registration shouldn't mean that sales tax collected from a customer in one state automatically funnels back to the state where the retailer who mistakenly collected the tax is located. We will have to wait to see what the courts say if this decision is appealed.

SUBSIDIARY DOING WORK FOR PARENT IS A SEPARATE ENTITY

For the purpose of determining whether fabrication labor sales were taxable, two companies could not be treated as one where they had the same owners but performed different services. (***Appeal of Peacock Powder Coating, Inc.***, 2022-OTA-059; PFR den. 2022-OTA-060)

Iron Knob Corporation (IKC), a construction contractor company, formed Peacock Powder Coating and subcontracted powder coating work to Peacock. The two companies operated out of the same facility. During the tax years under audit (2008–2012), Peacock did not charge IKC sales tax on $1.7 million of fabrication labor for applying powder coating to IKC's tangible personal property (TPP). Peacock also never held a seller's permit nor filed sales and use tax returns.

Peacock argued that the common ownership of the businesses meant they should be treated as one entity for tax purposes, and that the work represented a transfer between two businesses owned by the same persons and were not sales at all. However, a parent corporation's ownership of all the stock of its subsidiary does not, alone, establish that the separate parent and subsidiary entities should be

treated as one and the same for sales and use tax purposes. (***Appeal of Bachor***, 2020-OTA-172P) In determining whether an entity can be disregarded for tax purposes, the general rule is that courts should not disregard separate legal entities merely to grant tax relief, even when one corporation wholly owns the other and the corporations share corporate directors and officers. (***Mapo, Inc. v. State Board of Equalization*** (1975) 53 Cal.App.3d 245, 248)

IKC and Peacock maintained separate books and records and had distinct business purposes: IKC installed fences, gates, railings, window guards, and other metal products, while Peacock was in the business of applying durable finishes. Peacock recorded and reported its sales to IKC, and did work for other customers as well; Peacock also advertised its services to the public on its website.

Peacock did not provide any evidence, other than a common ownership, that the two entities should be treated as one. Therefore, the sales of fabrication labor were subject to tax.

Taxing fabrication labor

A retail sale of tangible personal property (TPP) includes producing, fabricating, or processing TPP for consumers who furnish the materials used. (R&TC §6006(b); 18 Cal. Code Regs. §1526(a)) Unless an exclusion or exemption applies, charges for fabricating TPP for a consumer are subject to sales tax.

Fabrication labor is taxable except:

- Repair (restoring property to its original condition);
- Installation; and
- Services not in connection with the sale.

CALCULATING OVERPAYMENT PERCENTAGE ON AUDIT

In an audit of a taxpayer's claim for refund of use tax that was erroneously paid, to determine the percentage of overpayment to apply to all years covered by the claim, the taxpayer used the 2010 tax year as a "test year." (***Appeal of Pomona Valley Community Hospital, Ltd.***, 2022-OTA-089)

In 2010, the taxpayer had erroneously paid use tax on the electronic transmission of two pieces of software it purchased from 3M. However, prior to filing the claim, 3M had issued credit memos to the taxpayer for the use tax on those two purchases.

The CDTFA argued that those two sales should not be counted as "errors" for the purposes of determining the percentage of overpayment in 2010 since they had been previously resolved. (CDTFA Audit Manual §1305.25) Further, the CDTFA argued that these were not recurring sales of the type that would occur in other years covered by the claim. The OTA agreed that in using a test year to determine the percentage of overpayment, there is an inherent assumption that the types of errors identified were likely to occur again in the remainder of the claim period. (CDTFA Audit Manual §0405.20) Since the transactions were not recurring transactions, and because the overpaid use tax was resolved prior to audit, they were not included for the purposes of calculating the overpayment percentage.

SALES TAX MEDICAL EXEMPTION: PACKAGING IS EVERYTHING

A surgical device that deploys fasteners used in esophageal surgery did not qualify for the sales and use tax exemption for medicines. (***Appeal of Pomona Valley Community Hospital, Ltd.***, 2022-OTA-089; R&TC §6369) Surgical instruments and devices are excluded from the definition of medicines for sales and use tax purposes. The fasteners, which were akin to sutures, qualify as "medicines" for sales and use tax purposes, but the device that deployed the fasteners did not because although the fasteners and device

were sold as one unit, the fasteners were not preloaded in the device, and therefore the device was not acting as a container. (R&TC §6364(a); 18 Cal. Code Regs. §1589(b)(1)(A); CDTFA Annotation 425.0926)

SOS

SOS FILING FEES SUSPENDED

SB 154 (Ch. 22-43) sets the Secretary of State's (SOS) processing fees for California and out-of-state corporation, LLC, and limited partnership initial filings such as articles of organization, articles of incorporation, and registrations at $0 for the period of July 1, 2022, through June 30, 2023. All other noninitial filing processing fees still apply, including fees for counter services, expedited services, certified copies, etc.

If the SOS office receives checks with paper initial filings, they will be returned and the filing processed. If the SOS office receives a check with both the processing fee and a certified copy fee, they will retain the check and refund the difference (this may take up to several weeks).

CORPORATE CONVERSIONS

SB 49 (Ch. 22-237) establishes a procedure for California domestic corporations to convert to a foreign corporation or a foreign business entity provided the law in the other state authorizes the formation of a business entity or corporation pursuant to a conversion. SB 49 is effective January 1, 2023. (Corp. Code §1150 et seq.)

Prior law only provided this simplified process for partnerships or LLCs to convert to a foreign business entity. Corporations wanting to move to another state were required to either:

- Convert to a different type of domestic entity (e.g., partnership or LLC) and then convert to a foreign business entity;
- Shut down their California operations and then reform in another state; or
- Create another corporation in another state and merge into the other corporation.

SB 49 simplifies this whole process and avoids unwanted legal and tax consequences. The same conversion rules that apply to converting a domestic corporation into a domestic foreign business entity will apply to domestic corporations that would like to convert to a foreign business entity or foreign corporation.

SOS ENTITY NUMBERS

The SOS office currently issues 7-digit SOS numbers to new corporations and 12-digit SOS numbers to new LLCs, LPs, and LLPs. Eventually, all new entities (including corporations) will be issued a 12-digit SOS number.

INFLATION-ADJUSTED MINIMUM WAGE STARTING IN 2023

Because 2022 inflation exceeded 7% in 2021–22, an accelerated increase of the state's minimum wage was triggered, which increases the minimum wage to $15.50 per hour regardless of employer size starting in January 2023.

The 2016 wage law signed by then-Governor Brown requires that any inflation growth above 7% triggers an even higher minimum wage. Prior to the Governor's announcement, the minimum wage was set to reach $15 for all employers and be indexed for inflation starting January 2023.

CalKIDS COLLEGE SAVINGS PROGRAM LAUNCHES

The California Kids Investment and Development Savings (CalKIDS) Program has launched, which will provide newborns and eligible low-income public-school children in California an initial deposit plus other financial incentives to help them save for higher education. The program was enacted as part of the budget in 2017 and was expanded by AB 132 (Ch. 21-144) in 2021.

All babies born in California on or after July 1, 2022, will receive up to $100 in a college savings account ($25 at time of birth, an additional $25 when the parent/child "registers" with CalKIDS, and an additional $50 if the individual "links" the CalKIDS account with an existing §529 plan). Additionally, eligible low-income public-school students may qualify to receive up to $1,500 in college savings for their future. CalKIDS accounts can also be linked with new or existing §529 accounts, which means savers will see the accounts displayed on the same page when accessing their accounts).

CalKIDS funds can be used at eligible educational institutions nationwide and some abroad, including community colleges, universities, and vocational and professional schools, as long as the student was a resident of California for the 12 months prior to the withdrawal. The funds in a CalKIDS account can be used to pay for qualified higher education expenses, such as:

- Tuition and related fees;
- Books and required supplies;
- Certain room and board costs; and
- Computer equipment.

For more information, see:

Website
https://calkids.org/

 ©2022

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

9. What are among some of the California form changes for the 2023 filing season?

   a) Form FTB 3835, Main Street Small Business Credit, has been extended for use until 2026, the end of the five-year carryover period
   b) Penalties will be imposed for taxpayers that fail to file Form 4197, Information on Tax Expenditures, with their tax return
   c) Form FTB 3849, Premium Assistance Subsidy, has been removed
   d) Form FTB 3835, Homeless Hiring Tax Credit, is a new form for 2022 tax returns filed in 2023

10. What are among the details pertaining to the EDD's Work Sharing Program?

   a) Employers may reduce their employees' hours and wages, and the EDD supplements the wages with unemployment compensation
   b) To be eligible, the employer must have a minimum of five employees
   c) The reduced workweek must apply to a minimum of 20% of the workforce
   d) AB 1854 extends for one year the simplified, online application process

SOLUTIONS TO REVIEW QUESTIONS

9. What are among some of the California form changes for the 2023 filing season? **(Page 10-1)**

   a) Incorrect. This form is no longer available. The carryover should be claimed on Form FTB 3540, Credit Carryover and Recapture Summary.
   b) Incorrect. There are no penalties for failing to file these forms.
   c) Correct. This is because California is not providing premium assistance subsidies through 2025.
   d) Incorrect. Form 3835 pertains to the State Historic Rehabilitation Credit. Form FTB 3831 is for the Homeless Hiring Tax Credit.

10. What are among the details pertaining to the EDD's Work Sharing Program? **(Page 10-16)**

   a) Correct. The EDD provides unemployment compensation that the employee would be eligible for if they had been laid off.
   b) Incorrect. The employee minimum is two.
   c) Incorrect. The reduction must apply to at least 10% of the workforce but not more than 60%.
   d) Incorrect. The online application process and automatic one-year approval for employers who successfully apply for the program has been extended indefinitely.

 ©2022

Chapter 11

Practitioner Aids

PRACTITIONER AIDS

1040 ENGAGEMENT LETTER

This letter is provided for information purposes, only. Spidell Publishing, LLC® assumes no responsibility for its use. Consult with legal counsel. Engagement letters should always be modified to fit each engagement.

Dear [CLIENT NAME]:

Thank you for selecting [YOUR FIRM NAME] to assist you in preparing your personal income tax returns. This letter confirms the terms of our engagement and the nature, timing, and limitations of the services we will provide.

We will prepare your 2022 federal and state personal income tax returns from information you furnish us. We will not audit or otherwise verify the data you submit, although it may be necessary to request clarification and/or documentation of some of the information. Generally, we will rely on your representation that you have maintained the documentation required by law to support the information you provide, including expenses for meals, travel, gifts, vehicle use, charitable contributions, etc. If you are not clear regarding what documentation is needed for any given item of income or deduction, we'd be happy to discuss it with you. **You have the final responsibility for your tax returns and, therefore, you should carefully review them before you sign and file them.**

We have provided an organizer for your use. While we don't require its use, it may serve as a useful "tickler" to remind you of items to provide to us. Nonetheless, provide us with originals or copies of originals of all government tax documents including W-2s, 1099s, 1098s, and property tax statements.

We will use professional judgment in resolving issues when the tax law is unclear or when there is conflict among the authorities.

The filing deadline for the tax returns is April 18, 2023. In order to meet this filing deadline, we must receive your information in substantially complete form by April 1.

If an extension of time to file is required, we will use the information available to us at the time to prepare the extension. To prepare a valid, accurate extension, we need as much information as is available. We also need your express approval to file the extension on your behalf. **An extension, however, only provides you with an extension to file, not an extension to pay. Taxes paid after April 18 will result in late-payment penalties and interest.**

Under both federal and California law, we are required to electronically file your returns. You may opt out of electronic filing without explanation. If you would rather not e-file, please let us know and we will provide you with the government opt-out forms you must sign and return to us.

If a joint return is prepared, tax returns and copies of all supporting documentation will be made available to either spouse without the consent or notification of the other spouse.

You are responsible for reporting foreign activities. By signing this letter you acknowledge that you will inform us if you have income from foreign sources or if you have signatory authority over any foreign financial account. If you are unsure whether income or an account is foreign, we will review it. **Penalties for failure to report foreign activities are severe.**

Your tax returns may be selected for review by the taxing authorities. If the government selects your return for examination, we will be available to assist you. At our discretion, there may be additional fees for this service.

We generally retain, for seven years, the final work product generated for our clients. After the retention period, the documents are destroyed. We do not keep original documents — they are returned to you after completion of the returns. It is your responsibility to retain your records for possible future use, including possible examination by the taxing authorities.

Our fees for tax preparation services are based on the amount of time required at our standard billing rates plus out-of-pocket expenses. All invoices are due and payable upon presentation. Tax returns will not be filed electronically until fees are paid.

If the foregoing fairly sets forth your understanding, please sign the enclosed copy of this letter and return it to our office. Work cannot commence until a signed copy of this document is returned. If this is a joint return, both spouses must sign.

Yours truly,

[YOUR FIRM NAME]

Acknowledged:

Signature: ____________________________

Print name: ___________________________

Signature: ____________________________

Print name: ___________________________

Website
This client letter is also available at:
www.caltax.com/cl-letter1040

Additional engagement letters for Forms 1120, 1120S, and 1065 are also available at:

Website
Form 1120: www.caltax.com/cl-letter1120
Form 1120S: www.caltax.com/cl- letter1120s
Form 1065: www.caltax.com/cl-letter1065

 ©2022

CLIENT LETTER (MAY BE ORGANIZER LETTER)

Dear [CLIENT NAME]:

We hope that you and your family are doing well. Enclosed is your annual organizer for your 2022 taxes. It's been an interesting year with important tax changes that will impact you. Here are some of the changes and issues you need to know about.

Tax return due dates:

- Individuals must file returns by April 18, 2023, for the 2022 tax year;
- Partnerships must file returns by the 15th day of the third month following the close of the taxable year (March 15 for calendar-year taxpayers);
- C corporation returns are generally due by the 15th day of the fourth month following the close of the taxable year (April 15 for calendar-year taxpayers);
- S corporation returns will remain due by the 15th day of the third month of the taxable year (March 15 for calendar-year taxpayers); and
- W-2s and 1099s must be filed by January 31, 2023, for the 2022 tax year.

SECURE 2.0 Act: Passed in the closing days of 2022 as part of the annual year-end appropriations bill, the SECURE 2.0 Act, like its predecessor, the SECURE Act, which was passed in 2019, makes significant retirement changes, including increasing the age at which required distributions must be made, changing the catch-up contribution limits for older workers, and numerous Roth account changes, among many more.

Inflation Reduction Act: The Inflation Reduction Act was passed into law late last summer and contained numerous green energy credit provisions, including extended credits for clean energy vehicles (new and used) and energy-efficient home improvements. However, there are many more limitations for these credits, including income limitations and manufacturers suggested retail price (MSRP) limitations in the case of the Clean Vehicle Credit.

Be sure to consult our office before making any purchase where a salesperson asserts that you are eligible for a tax credit. It's very possible that your individual income tax situation, of which the salesperson has no knowledge, will limit your credit.

Please provide us with receipts and purchase contracts for energy efficient home improvements made during 2022, such as new windows, doors, and skylights. If you aren't sure if a home improvement you made qualifies for the credit, please ask.

Affordable Care Act: The IRS has issued new regulations that may allow more taxpayer to claim subsidies for purchasing health insurance through a state insurance exchange. These subsidies are also known as the Premium Tax Credit.

If you, as an employee, must pay any portion of your health insurance premiums or the health insurance premiums of your family members as payroll deductions, then we should discuss your options for purchasing health insurance through an exchange and whether you are eligible to claim the Premium Tax Credit for doing so.

Large inflation adjustments: Inflation was at its highest point in decades in 2022, which resulted in large inflation adjustments for the 2023 tax year for tax rate brackets, deductions, annual gift tax limitations, Social Security benefits, and retirement contribution limitations, just to name a few.

Be sure to provide your tax information to us as early as possible so that we can determine what effects these large inflation adjustments may have for you as we plan ahead for the remainder of 2023.

Property transactions: Did you sell any real estate this year? Be sure to provide copies of escrow statements, as well as the Loan Estimate form, the Closing Disclosure form, and California Form 593, Real Estate Withholding Tax Statement. We need these documents to properly prepare your return. If you can get them to us as early as possible, we can make sure we have everything we need, and make sure that any state withholding documentation is correct.

1099s and K-1s: If you received 1099s or K-1s from investments in 2022, we may extend your return in case these documents are corrected after the original filing deadline. We are seeing increasing numbers of corrected information returns, which require taxpayers to amend their original tax returns to reflect the corrected amounts. In some cases, the amounts are vastly different and can create additional costs in amending the tax returns and potential penalty problems.

1099-Ks: The filing threshold for 1099-Ks has dropped to $600 for 2023. If you receive income through a third-party settlement provider (such as a credit card company or even a mobile phone app like Venmo or Apple Pay, among many others) then you may receive a 1099-K for that income even if you haven't in the past.

The reduction of the filing threshold down to $600 was slated to take effect for 2022, but the IRS announced in late December 2022 that they will delay this requirement until the 2023 tax year.

Be sure to provide a copy of any 1099-Ks you receive and let's discuss the source of the income. In the case of mobile phone payment apps, if you designated your account as a business account, but receive payments for non-business items, then you may receive a 1099-K for income that should not be taxable to you. Do not ignore the 1099-K. The IRS will expect you to report the income. If the income was not receive in exchange for goods and services then we can report the 1099-K in a way that ensures you are not taxed on it.

Foreign accounts: We must report overseas assets owned by businesses as well as individuals. The reporting requirements are increasing and the penalties for failure to report continue to be harsh. Not all foreign holdings must be reported. If, for example, you hold stock in a foreign company through a U.S. broker, those holdings do not have to be separately reported. However, if you hold any other types of foreign assets, including bank accounts and securities accounts, please let us know. If you have any doubt as to whether any of your assets are foreign, please discuss those assets with us. Again, this year we will need information on a business' foreign holdings as well.

Please take extra care in preparing your organizer and documentation so we can do the best possible job to find new tax benefits that are hidden in the law and protect you from more aggressive audit programs and larger penalties.

Yours truly,

Your tax professional

Website

This client letter is also available at:
www.caltax.com/cl-organizerletter

 ©2022

OTHER CLIENT LETTERS AND RESOURCES

The following client letters and resources are available for you to customize to fit your needs.

Other Client Letters and Resources	
Client letters	
IRC §199A (business entity)	www.caltax.com/cl-199abusinessentity
IRC §199A (individual)	www.caltax.com/cl-199aindividual
AB 5	www.caltax.com/cl-ab5
Business interest	www.caltax.com/cl-businessinterest
CalSavers	www.caltax.com/cl-calsavers
Clients considering LLCs	www.caltax.com/cl-consideringllcs
Gig economy	www.caltax.com/cl-gigeconomy
California's individual health care mandate	www.caltax.com/cl-healthcareca
IRA-to-charity	www.caltax.com/cl-iracharity
IRA/UBI	www.caltax.com/cl-iraubi
Partner/shareholder notification	www.caltax.com/cl-k2k3notification
Partnership audit rules	www.caltax.com/cl-partnershipaudit
Passthrough entity elective tax	www.caltax.com/cl-peet
Passthrough entity elective tax refund	www.caltax.com/cl-peet-refund
Premium Tax Credit	www.caltax.com/cl-premiumtaxcredit
Qualified charitable distributions	www.caltax.com/cl-qcd
Solar	www.caltax.com/cl-solar
Virtual currency information	www.caltax.com/cl-virtualcurrency
Virtual currency reporting	www.caltax.com/cl-vcreporting
Resources	
Authorization to contact family of client with dementia	www.caltax.com/cl-contactfamily
Lender letter	www.caltax.com/cl-letterlender
Sample accountable plan	www.caltax.com/cl-sampleap
Sample data security plan (IRS)	www.irs.gov/pub/irs-pdf/p5708.pdf

EXPIRING TAX PROVISIONS

Many of the COVID-19–related tax provisions expired at the end of 2021 along with other provisions that either expired at the end of 2021 without extension or will expire at the end of 2022.

List of expiring tax provisions

Expired at the end of 2021

The following tax provisions expired at the end of 2021:

- Mortgage insurance premium deduction — expired 12/31/2021;
- COVID-19–related charitable contribution provisions, including those passed by the CARES Act and extended by the Taxpayer Certainty and Disaster Tax Relief Act (TCDTRA) expired at the end of 2021, including:
  - The 50% accuracy-related penalty imposed on any underpayment attributable to overstatements of the 2021 charitable contribution allowed on Form 1040, line 12b (TCDTRA §212; IRC §§6662(b)(9), 6751(b)(2)(A));
  - The increased charitable contribution limits for cash contributions applicable to individuals (100% of AGI) and corporations (25% of taxable income) and for donations of food inventory (25%) also apply for contributions made in 2021 (TCDTRA §213); and
  - The deduction for nonitemizers to claim a $300 deduction ($600 if married filing jointly) for cash contributions made to qualified organizations (excluding private foundations or donor advised funds) for 2021 (TCDTRA §212; IRC §§63(b), 170(p))
- The increased Child Tax Credit provisions from the American Rescue Plan Act, including the provision for advanced payments. See page 1-27 for a discussion of the Child Tax Credit provisions in effect for 2022;
- The enhanced Child and Dependent Care Credit provisions from the American Rescue Plan Act that were effective for the 2021 tax year only, including the increased eligible expenses and refundability provisions. See page 1-28 for a discussion of the Child and Dependent Care Credit provisions effective for 2022;
- The increased income exclusion for employer-provided dependent care assistance under the ARPA. See page 1-7 for a discussion of the dependent care assistance exclusion available for taxable years other than 2021;
- The enhanced Earned Income Credit provisions from the ARPA, including the easing of the age limitation and the increased credit limits, all of which were available for the 2021 tax year only. See page 1-31 for a discussion of the Earned Income Credit provisions for 2022.

Expiring at the end of 2022

The following tax provision will expire at the end of 2022:

- The flexible spending account carryover provisions in the ARPA expire at the end of 2022. See page 1-8 for a discussion of these rules.

 ©2022

CHARITABLE CONTRIBUTION SUBSTANTIATION

Charitable Contribution Substantiation Information Required

Amount	Documentation	Substantiation
Cash donations of less than $250	Bank record	Includes canceled check, bank, credit union, or credit card statement showing name and transaction posting date (credit card)
	Written communication from charity	Name of charity, date, and amount of contribution
	Payroll deduction	Pledge card and pay stub, W-2 wage statement, or other document furnished by employer, including total amount withheld for charity
Cash donations of $250 or more	Written acknowledgment from the charity for each donation	Name of charity, date, amount paid, description, and estimate of value of goods or services provided by the charity
Noncash contributions of less than $250	Receipt from donee or reliable records	
Property donations greater than $250 and not more than $500	Contemporaneous written acknowledgment	Name of charity, date, amount paid, and description (but not value) of goods or services provided by the charity
Property donations greater than $500 and not more than $5,000	Written acknowledgement	All of the above, plus: • How you got the property; • Date you got the property; and • Cost or other basis Must file Form 8283
Donations of $5,000 or more excluding stock, certain works of art, and autos	Qualified appraisal	Attach appraisal to return and complete page 2 of Form 8283
Donations of art valued at $20,000 or more	Signed appraisal and photograph	Attach signed appraisal to return and provide photograph of sufficient quality and size to fully show object if requested by the IRS
Stock of publicly traded corporation	No appraisal required if as of date of the contribution, market quotations are readily available on an established securities market	Attach Form 8283 to return
Nonpublicly traded stock	Contributions greater than $5,000 and less than or equal to $10,000	A partially completed appraisal summary; complete Form 8283, Part I
	Contributions greater than $10,000	Attach qualified appraisal to return
Vehicle, boat, and airplane with value of more than $500	Value is the lesser of the gross sales proceeds or the FMV of the vehicle if no "significant use or material improvement"	Taxpayer needs contemporaneous written acknowledgement from donee organization; donee organization must use Form 1098-C to report value of vehicle donations if vehicle is sold; this can be used to provide acknowledgement to the donor

Note: These rules apply to individuals making qualified contributions to IRC §501(c)(3) organizations. Additional rules apply when gifting a partial or restricted interest, gifts via trusts, and gifts with remainder interest.

TRANSPORTATION FRINGE BENEFITS

Comparison of Federal and California Qualified Transportation Benefit Excluded from Wages (Rev. Proc. 2021-45)		
	Federal subject and income tax wages and California subject wages	**California income tax wages (R&TC §17149)**
Vanpool	Vehicle that seats six or more adults (excluding the driver) and has at least 80% of its mileage for a year used for commuters, on trips during which the number of employees commuting is at least 50% of the adult seating capacity (excluding the driver) The excludable amount is $280 for 2022 and $300 for 2023.	Vehicle that seats seven to 15 adults (including the driver) used for commuters regularly and transports seven or more commuters daily. No maximum exclusion
Transit passes	Any pass, token, fare card, voucher, or similar item, including items exchangeable for fares, that entitles a person to transportation on mass transit facilities (presumably including ferries) or provided by a paid transportation business in a vehicle that can carry at least six adults (excluding the driver) The excludable amount is $280 for 2022 and $300 for 2023.	Any purchase of transit rides that entitles the holder to any number of transit rides to and from work used by an employee or his or her dependents, other than dependents who use transit passes for elementary and secondary school. No maximum exclusion
Parking	Either on or near the employer's premises (including parking on or near a work location at which the employee provides services for the employer) or on or near a location from which the employee commutes to work by mass transit, vanpool, carpool, or any other means. Parking on or near the employer's premises generally The excludable amount is $280 for 2022 and $300 for 2023.	Free or subsidized while participating in a ridesharing arrangement in California. No maximum exclusion
Bicycles	The TCJA suspends the exclusion of qualified bicycle commuting reimbursements from an employee's income from January 1, 2018 through December 31, 2025 (IRC §132(f)(8))	California has its own unlimited exclusion for an employee riding to and from work
Note: The TCJA generally repeals the business deduction for qualified transportation fringe benefits (vanpool, transit passes, and parking) provided to employees, except as necessary for ensuring the safety of an employee. (IRC §274) However, the employee's exclusion from income upon the receipt of transportation fringe benefits is retained. Interestingly, employers can continue to deduct qualified bicycle commuting reimbursements as a business expense, but the TCJA suspends the employee's exclusion for qualified bicycle commuting reimbursements		

FOREIGN ACTIVITY REPORTING FORMS

Forms Used to Report Foreign Activities			
Form	**Form name**	**Due date**	**Who must file**
114*	Report of Foreign Bank and Financial Accounts (FBAR)	Due date of individual income tax return, including extensions	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold
926	Return by a U.S. Transferor of Property to a Foreign Corporation	Due date of income tax return, including extensions, for the year that includes the date of the transfer	U.S. individuals, domestic corporations, domestic estates and trusts, to report certain direct and indirect transfers of cash or property to a foreign corporation
3520	Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts	Due date of income tax return, including extensions; in the case of a decedent, the due date coincides with Form 706, including extensions, even if 706 is not filed	U.S. persons to report certain transactions with foreign trusts, ownership of foreign grantor trusts, and receipt of certain large gifts or bequests from certain foreign persons
3520-A	Annual Information Return of Foreign Trust with a U.S. Owner	15th day of the third month after the end of the trust's tax year (March 15 for calendar year-end foreign trusts)	Foreign trusts with at least one U.S. owner
5471	Information Return of U.S. Persons with Respect to Certain Foreign Corporations	Due date of income tax return, including extensions	Certain U.S. persons, including owners and officers, of foreign corporations must report specific information regarding their ownership interest in a foreign corporation
5472	Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business	Due date of reporting corporation's income tax return, including extensions	A foreign corporation if it had specific reportable transactions with a foreign or U.S. related party
8865	Return of U.S. Persons with Respect to Certain Foreign Partnerships	Due date of reporting corporation's income tax return, including extensions	Certain U.S. persons, including owners and partners, of foreign partnerships must report specific information regarding their ownership interest in a foreign partnership
8938*	Statement of Specified Foreign Assets	Due date of income tax return, including extensions	Specified individuals, which includes U.S. citizens, resident aliens, and certain nonresident aliens that have an interest in specific foreign financial assets and meet the reporting threshold Domestic entities that are formed or utilized to hold specified foreign financial assets
* Also see Spidell's Comparison of Form 8938 and FBAR Requirements chart			

FATCA AND FBAR REQUIREMENTS

Comparison of Form 8938 and FBAR Requirements		
	Form 8938, Statement of Specified Foreign Financial Assets	**Form 114, Report of Foreign Bank and Financial Accounts (FBAR)**
Who must file?	Specified individuals, which include U.S. citizens, resident aliens, and certain nonresident aliens that have an interest in specified foreign financial assets and meet the reporting threshold Domestic entities that are formed or availed of to hold specified foreign financial assets	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold
Does the United States include U.S. territories?	No	Yes, resident aliens of U.S. territories and U.S. territory entities are subject to FBAR reporting
Reporting threshold (total value of assets)	$50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad)	$10,000 at any time during the calendar year (aggregate value of all foreign accounts)
When do you have an interest in an account or asset?	If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return	**Financial interest:** You are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title **Signature authority:** You have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account See instructions for further details
		(continued)

 ©2022

Comparison of Form 8938 and FBAR Requirements (continued)		
	Form 8938, Statement of Specified Foreign Financial Assets	**Form 114, Report of Foreign Bank and Financial Accounts (FBAR)**
What is reported?	Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign nonaccount investment assets	Maximum value of financial accounts maintained by a financial institution physically located in a foreign country
How are maximum account or asset values determined and reported?	Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars	Use periodic account statements to determine the maximum value in the currency of the account Convert to U.S. dollars using the end of the calendar year exchange rate, and report in U.S. dollars
When due?	By due date, including extension, if any, for income tax return	April 18, 2023, for 2022 tax year (with automatic six-month extension)
Where to file?	File with income tax return pursuant to instructions for filing the return	Must be e-filed through the BSA E-Filing System
Penalties	Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of nonfiling after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply	If nonwillful, up to $10,000; if willful, up to the greater of $100,000 or 50% of account balances; criminal penalties may also apply

CALIFORNIA NONRESIDENT WITHHOLDING CHART

Nonresident Withholding Chart			
	Domestic nonresidents (except partners, members, and shareholders)	**Nonresident S corporation shareholders, domestic partners/members, and beneficiaries of estates and trusts**	**Foreign partners and members**
Rate of withholding	7%	7%	Non-corporate: 12.3% Corporate: 8.84% Foreign banks: 10.84%
Withholding base	California-source payments in excess of $1,500 in one year	Distributions of current or prior year income of more than $1,500 to any one shareholder, partner/member or beneficiary during the year	Distributions of effectively connected taxable income from California sources
Date to remit withholding	Quarterly: April 15 June 15 September 15 January 15	Quarterly: April 15 June 15 September 15 January 15	15th day of the month following the 4th, 6th, 9th, and 12th months of the entity's tax year
Form used to remit withholding	592-V, Payment Voucher for Resident and Nonresident Withholding	Form 592-Q, Payment Voucher for Pass-Through Entity Withholding	592-A, Payment Voucher for Foreign Partner or Member Withholding
Annual/quarterly report to the FTB	592, Quarterly Resident and Nonresident Withholding Statement	Form 592-PTE, Pass-Through Entity Annual Withholding Return, by January 31 of the year following year of withholding	592-F, Foreign Partner or Member Annual Return, by 15th day of 3rd month following close of tax year
Annual report to recipient	592-B, Resident and Nonresident Withholding Tax Statement, by January 31 (February 15 for brokers) following close of calendar year	592-B, Resident and Nonresident Withholding Tax Statement, by January 31 (February 15 for brokers) following close of calendar year	592-B, Resident and Nonresident Withholding Tax Statement, by 15th day of 3rd month following close of tax year (15th day of the 6th month if all partners are foreign)
Exemption certificate	590, Withholding Exemption Certificate	590, Withholding Exemption Certificate	N/A
Waiver request	588, Nonresident Withholding Waiver Request	588, Nonresident Withholding Waiver Request	N/A
Reduced withholding request	589, Nonresident Reduced Withholding Request	589, Nonresident Reduced Withholding Request	589, Nonresident Reduced Withholding Request, with federal Form 8804-C, Certificate of Partner-Level Items to Reduce Section 1446 Withholding, attached

ROTH CONVERSION CHECKLIST

Roth Conversion Checklist		
☐	Does the taxpayer qualify?	Virtually all taxpayers qualify because Roth conversions do not have income limitations.
☐	Has the taxpayer decided to do a conversion?	The deadline is December 31 of the year of the conversion. The taxpayer does not get until April 15 of the following year, as is the case with contributions.
☐	Did the taxpayer take a distribution?	If so, the conversion must be completed within 60 days of the distribution by depositing the funds in a Roth account. The taxpayer gets 60 days regardless of the time of year. The conversion is deemed to take place on the day of distribution, not on the day the funds are deposited in the Roth.
☐	Does the taxpayer have RMD?	RMD must be taken first. If the taxpayer has an RMD requirement in the tax year, that amount cannot be converted. Essentially, the taxpayer must take RMD before doing the conversion or leave an amount in the traditional IRA sufficient to make his RMD.
☐	New beneficiary forms:	New Roth accounts need new beneficiary forms.
☐	60-day rollover:	If the taxpayer takes a distribution, the funds must be deposited in the Roth account within 60 days. Failure to do so results in the distribution being taxable. If possible, use a trustee-to-trustee transfer to avoid the possibility of failing the 60-day rule.
☐	Does the taxpayer have basis in his or her IRA?	The taxpayer should have a Form 8606 showing the basis and must determine the tax-free amount of the conversion at the end of the year of the conversion.
☐	Does the taxpayer understand the five-year rule?	Distributions from Roth IRAs are generally tax-free. However, the distributions of earnings from a Roth are taxable if distributed within five years of the taxpayer first establishing a Roth.
☐	Is the conversion coming from a SIMPLE IRA?	An amount distributed from a SIMPLE IRA during the two-year period that begins on the date that the individual first participated in a SIMPLE maintained by the individual's employer cannot be converted to a Roth.
☐	Is the taxpayer's income unusually low?	The taxpayer may want to consider a conversion to use excess deductions or, at the very least, to take IRA distribution into income at low tax brackets.
		(continued)

Roth Conversion Checklist (continued)		
☐	Does the taxpayer have an NOL carryover?	The taxpayer may want to do a conversion to offset the NOL.
☐	Does the taxpayer have a contributions carryover or wish to make sizable contributions during the year?	The taxpayer may want to do a conversion to offset the contributions or may want to make contributions during this year to offset a conversion.
☐	Does the taxpayer expect RMD to push him or her above the active participation threshold for passive losses?	The taxpayer may want to "take the hit" all at once and do a conversion in the current year. Without RMD, the taxpayer may be able to take up to a $25,000 deduction for active participation losses in future taxable years.
☐	Does the taxpayer expect RMD to push his or her income up to levels where Social Security becomes taxable?	The taxpayer may want to "take the hit" all at once and do a conversion in the current year. Without RMD, the taxpayer's Social Security may be tax-free.
☐	Does the taxpayer have cash outside of the IRA to pay tax?	A conversion is not feasible if the taxpayer can't pay taxes caused by the conversion.
☐	Can income past 2022 be predicted with any reasonable certainty?	If the taxpayer is going to be in lower tax brackets in future years, it might not make sense to do a conversion now (in higher brackets).
☐	Does the taxpayer trust Congress not to change the law on Roth distributions in the future?	For a long time, it was commonly believed that Social Security benefits would never be taxable. Is it possible Congress might someday make Roth distributions taxable at least to the extent of earnings?

Website
To download a copy of this checklist, go to:
www.caltax.com/files/2022/rothconversion.pdf

SPIDELL'S CALIFORNIA REFUND GRABBER CHECKLIST

"I do a thorough review of the federal return and my tax program makes the California adjustments for me." How often have we said this? But we all know the computer does what we tell it to do. So, if someone doesn't tell the computer there is a California difference, it goes unnoticed and the taxpayer usually pays more tax. Or, sometimes we think we told the computer something and we actually didn't. Here is a list of common errors made on tax returns where you might find lost money for your clients.

Spidell's Refund Grabber Checklist		
☐	Railroad retirement — May be included in pension income	California does not tax railroad retirement. For federal purposes, Part A is treated as Social Security and Part B is fully taxable and reported on the pension line of the federal return. Be sure both are excluded for California purposes.
☐	IRA, Keogh, and SEP distributions — Basis	Taxpayers who contributed to these accounts between 1982 and 1986 probably have a California basis, as do taxpayers who contributed to IRAs after 2019 when they were age 70½ and older. Contributions in 1987–1995 may have a higher California basis if income was different. Verify that the basis has been excluded from income.
☐	HSA — Basis	California does not conform to any of the HSA provisions. Since the taxpayer does not get a California deduction for contributions and must report earnings currently, the taxpayer gets basis for California purposes. Be sure to track California basis. The expenses paid with HSA funds are a deductible medical expense on the California return.
☐	Depreciation — Basis differences from IRC §179 and bonus	California has had different depreciation methods and different §179 expensing amounts for many years. Be sure that the basis and method are correct for California purposes. For an older asset, the California depreciation may be greater because of a longer life or higher basis.
☐	Passthrough entity income	Is the taxpayer an owner of a partnership, S corporation, or LLC taxed as a partnership or S corporation? If so, does the taxpayer want to consent to have the partnership, S corporation, or LLC elect to pay tax on the taxpayer's income from the entity so the income will not be subject to the $10,000 state and local tax deduction limitation on the taxpayer's return? The taxpayer will be able to claim up to a 100% nonrefundable credit on the return for the amount of tax paid.
☐	Suspended passive losses — Did they carry over?	Make sure that suspended passive losses were not accidentally dropped in a prior year.
		(continued)

Spidell's Refund Grabber Checklist (continued)		
☐	Excess business losses	Does the taxpayer have any excess business losses carried over from prior years? If so, these carryovers may increase the amount of excess business losses claimed on the California return.
☐	AMT passive losses — Were suspended losses carried over?	Suspended passive losses for AMT purposes are often different. Also, when inputting client information into a new computer program, you must make separate entries for AMT items and regular tax items.
☐	AMT — Check depreciation	Make sure that AMT depreciation has been carried forward properly, otherwise, when the asset is sold, the AMT gain may be too high.
☐	AMT Credit — Don't forget	If the taxpayer suffers or has ever suffered from AMT, see if there is a credit for prior-year AMT and carry it forward to reduce current-year regular tax.
☐	AMT NOL — Correctly computed?	If the taxpayer has California AMT, make sure that any California AMT NOL is correctly computed so it carries over to next year.
☐	Capital loss carryover for new clients, including AMT	Particularly when setting up a new client, make sure to enter capital loss carryforwards, including the AMT capital loss carryover, even if the same as for regular tax. Most software requires both entries.
☐	Mortgage Interest Credit — Larger itemized deduction	If the taxpayer has a federal mortgage interest credit, the Schedule A interest expense is reduced. For California purposes, the taxpayer may deduct up to $1.1 million in acquisition debt because California does not conform to the Tax Cuts and Jobs Act limits on mortgage interest deductions.
☐	Carryover credits — Don't lose them	Most of California's credits can be carried over for many years or indefinitely. Make sure that any carryover credits were not accidentally lost from one year to the next.
☐	Federal credits — Larger deductions and basis	If the taxpayer claimed federal business credits, there is often a basis or expense deduction lost on the federal return. Be sure that the basis is increased or the deduction increased for California purposes (e.g., taxpayers who claimed the Employee Retention Credit on the federal return can claim the full wage expense on the California return).
☐	Credit for taxes paid to another state — Calculate it properly	If the taxpayer has income taxed by both California and another state, be sure there is a credit on the California or the other state return. Make sure it is on the correct state return.
		(continued)

Spidell's Refund Grabber Checklist (continued)		
☐	Interest income: Nonresident — May not be California-source	A nonresident is not taxed on interest income from California sources unless the income has a situs in California. Generally, interest on the note collateralizing the sale of property or business assets in California is not taxable unless the note is used as collateral on another California business or property.
☐	Renter's Credit — Don't forget it	For the 2022 tax year, single renters with California AGI of $49,220 or less may qualify for a $60 credit. The Renter's Credit is $120 for MFJ and head of household renters with California AGI of $98,440 or less.
☐	Excess SDI — More than one employer	If a taxpayer had two or more jobs during the taxable year, make sure the return gives credit for any excess SDI. Include voluntary plan disability insurance (VPDI) in this calculation
☐	Mental health surtax — File MFS when taxable income exceeds $1 million	The California surtax applies to taxable income in excess of $1 million, regardless of filing status. So, married taxpayers benefit from filing separate, saving up to $10,000 in tax. **Caution:** If you file separate for California, you must generally also file separate for federal purposes.
☐	Credits on S corporation return	When an S corporation is entitled to a tax credit, the S corporation is allowed one-third of the credit and the shareholders are entitled to 100% of the same credit. Be sure the credit was computed for both the entity and the shareholders.
☐	State tax paid on group return	When a member/partner/shareholder is a nonresident included on the entity's group return, include tax paid as state tax deduction on federal Schedule A. Verify that California's Schedule S was included to claim the credit for tax paid to the other state.
☐	State tax withheld	Check 1099s and partnership, LLC, or S corporation K-1s (or FTB Form 592, Resident and Nonresident Withholding Statement, attachment or separate letter) for state tax withheld. Also, check for withholding on real property reported on the closing statement or FTB Form 593, Withholding on the Sale of California Real Estate.
☐	California nonconformity to the Tax Cuts and Jobs Act (TCJA)	The TCJA made many changes that California does not conform to, including the $10,000 limit on state and local tax deductions, the elimination of miscellaneous itemized deductions subject to the 2% floor, repeal of the alimony deduction, and reduced mortgage interest limitation.

Website

To download a copy of this checklist, go to:
www.caltax.com/files/2022/refundgrabber.pdf

CHECKLIST FOR A TROUBLE-FREE TAX RETURN

For trouble-free processing of your client's California scannable or e-filed return, we suggest you incorporate the following items into your normal processing procedures.

e-file	Scannable	
☐	☐	Is the client's name, address, and Social Security number correct?
☐	☐	If the client had an estimated tax or balance due payment of more than $20,000, or a tax liability of more than $80,000 for the first time in the 2022 taxable year, did you advise the client of the mandatory EFT payment requirement?
☐	☐	Ask the client if he or she would like to pay electronically or schedule quarterly payments electronically.
☐	☐	If using a different filing status from federal, is the box checked? (**Note:** Different filing statuses may be used only in very limited circumstances.)
☐	☐	If claiming the Child and Dependent Care Expenses Credit on Form FTB 3506, did you enter the child's year of birth and the child care provider's address, telephone number, and Social Security number?
☐	☐	If the client is using the Head of Household filing status, have you verified that the client qualifies for 2022, and that the Form 3532, Head of Household Filing Status Schedule is completed?
☐	☐	Is the Direct Deposit of Refund bank account information correct? The routing number must have nine digits (starting with 01-12 or 21-32), and verify the account number. (See FTB Publication 1095D)
☐	☐	Did you verify estimated payments claimed? (You can do this using MyFTB.)
☐	☐	Is your client entitled to a refund of excess SDI? Did the taxpayer (or spouse) work for more than one California employer in 2022 and have more than $145,600 in wages?
☐	☐	If claiming a credit for withholding on real property, did the escrow company use the taxpayer's correct Social Security number?
☐	☐	Have you included withholding from K-1s, real estate withholding, back-up withholding and nonresident withholding?
☐	☐	Is the third-party designee box checked? Checking this box allows a preparer to discuss with the FTB information needed to process the return, inquire about the status of a refund or payments made, and respond to FTB notices about math errors, offsets and return preparation.
☐	☐	Is the client's address properly designated as a new address or the same address?
		(continued)

Checklist for a Trouble-Free Tax Return (continued)		
e-file	**Scannable**	
☐	☐	If the client has a private mailbox, enter PMB next to the box number (e.g., 1200 Hollow Way, PMB 123).
	☐	Mailing envelopes to the FTB should be white and use sans serif fonts, and contain the correct address including ZIP + 4 extension.
	☐	Is the federal return attached? Do not attach a federal return unless the client is filing Form 540 with any federal schedules other than Schedule A or Schedule B, Form 540NR, or a return for an RDP couple. **Note:** For e-file, your software should transmit the federal return, when it is required, with the state return.
	☐	Do not staple anything to the scannable forms, including the check or W-2s, and do not staple page 1 to the rest of the return.
	☐	Is Schedule W-2, Wage and Withholding Summary, attached directly behind Side 5 of the return? If your software does not populate Schedule W-2, include the "state" copy of federal Form(s) W-2, W-2G, and any Form(s) 592-B, 593, and federal Form(s) 1099 showing California tax withheld to it.
	☐	Did you sign the return as preparer and enter your PTIN? Remember, you and your clients only need to sign the California return itself. You do not need to sign copies of any attached federal returns or other forms or schedules requesting signatures.
	☐	If a Form FTB 5805 is required, did you check the box indicating it is attached, and is it attached to the back of the return?
	☐	Is the mailing envelope addressed to the correct FTB address?
☐	☐	Did you give your client the option to include use tax paid on the return (unless the client is a qualified purchaser)?
☐	☐	If filing a joint RDP return, is the California RDP Adjustments Worksheet attached or are copies of the federal single returns attached?
☐	☐	Did the taxpayer and everyone in the taxpayer's household have health insurance coverage for the full year. If not attach Form 3853 to the return.
☐	☐	For taxpayers who filed Form 8938, is a copy of the form attached to the California return?
☐	☐	For any credits, be certain to include the appropriate form(s). For example, when filing a return that claims the Other State Tax Credit, be certain to include a Schedule S for each state.

Website

To download a copy of this checklist, go to:
www.caltax.com/files/2022/troublefree.pdf

ITEMS YOUR CLIENT SHOULD BRING TO A TAX INTERVIEW

1. 1099-Ks for merchant charges. Reconcile amounts on 1099s to amounts reported by the client for Schedules C, E, or F (or business entity return).
2. 1099-Bs for sales of stock or securities. Reconcile amounts on 1099s to amounts shown on client reports, if any.
3. Property tax statements: Look at property tax bills and estimate of value of real property in California to verify that the county has properly computed tax based on reduced property values.
4. Property tax statements: Look for items that are not deductible as property taxes, such as HERO or PACE payments.
5. Review government documents (W-2s, 1099s) for federal/California differences. Also be sure to review government documents for accurate taxpayer identification numbers.
6. Paycheck stubs to review withholding and to provide to the FTB if withholding amount is reduced.
7. Statements and instructions from mutual fund companies breaking down U.S. government and state tax-exempt income information.
8. All tax information broken out separately for both members of a registered domestic partnership.
9. Notices, bills, etc., from the IRS or California.
10. New clients should bring the past four years' returns.
11. For the Child and Dependent Care Expenses Credit:
    - Nontaxable funds received, including child support and public assistance;
    - Percentage of time the qualifying dependent lives in the California home of the taxpayer;
    - Address, telephone number, and Social Security number or Employer Identification Number of the care providers;
    - Expenses paid to California providers; and
    - Nonresident military spouse's military income.
12. California K-1 and accompanying correspondence (check for California differences and possible state tax paid by S corporation, partnership, trust, or LLC).
13. Withholding paid through escrow on sales of property reported on FTB Form 593-B and closing statements. Keep a copy of the escrow closing statement and Form 593-B.
14. Withholding for residents and nonresidents reported on FTB Form 592-B.
15. Invoices from purchases made over the Internet, by mail, or by phone order where no California sales or use tax was paid (or, if the use tax table amount is used, only individual purchases of more than $1,000).
16. Any activity pertaining to a Health Savings Account, including contributions to, earnings or losses from, distributions from, and rollovers to that account.
17. Rollover or distribution amounts from Medical Savings Accounts, FSAs, HRAs, and Roth IRA conversions.
18. Did the taxpayer form a business entity this year, does the taxpayer own an inactive business, or does he or she plan to terminate a business this year?
19. Change of ownership of business entity.
20. Title change information for property that changed hands due to gift or death of an owner.
21. For employers with no more than 25 full-time equivalent employees, review for possible federal Health Insurance Credit. If credit is taken, there will be a federal/California difference in the expense amount for employee health insurance.

 ©2022

22. For Schedule C and other business returns, alert the taxpayer of the requirement for a city business license.
23. Identity Protection PIN (IP PIN): If you received a CP101A Notice from the IRS in January, your IP PIN is located in the left column. Please provide a copy of this letter.
24. For all documents, please provide a scan, photocopy, or fax. Do not send photos taken with a cell phone.
25. Proof of health insurance coverage, including 1095 Forms.

Website
To download a copy of this list, go to:
www.caltax.com/files/2022/taxinterview.pdf

TIPS TO PREPARE YOURSELF AND YOUR OFFICE FOR TAX SEASON

In addition to worrying about our clients, here are a few things you can do to prepare for the upcoming tax season.

Tips to Prepare Yourself and Your Office for Tax Season	
☐	Practice management: Raise prices every year. Your costs rise every year and so should the rates you charge.
☐	Fire troublesome clients. Consider: a. Those who constantly complain about the fees, pay late, and don’t appreciate the value of your work; b. Those who get their numbers from your ceiling or want to push the envelope past where you feel comfortable will immediately throw you under the bus when they’re audited and lose; and c. Those who wait until the last minute to meet with you or bring in their disorganized tax information bumping up to the deadline and expect miracles.
☐	Check your tax software and equipment needs: a. Install; b. Check proforma’d clients if converting from another software company. Update client information that has changed (i.e., addresses and phone numbers). Be sure to verify that California carryover amounts are correct. Often the federal amounts are carried over but not the California amounts, or the federal numbers are repeated for California purposes; c. Verify software security; and d. Test not only the software but that your equipment and internet can handle the workload. It may be time to upgrade before busy season begins.
☐	Complete CPE: a. For CPAs and attorneys, if your license renewal will happen during tax season; and b. For Enrolled Agents, hours, including ethics must be completed prior to December 31.
	(continued)

Tips to Prepare Yourself and Your Office for Tax Season (continued)	
☐	Renew your PTIN. The 2023 application/renewal fee is $30.75.
☐	Perform MyFTB maintenance: a. You must renew the password for your MyFTB account every 12 months; b. You must renew your clients in your MyFTB account 13 months from completing the process last year; c. Set up clients you may want to access (to check estimated tax payments or for other reasons) into your MyFTB account now so you won't be delayed during filing season while the FTB sends the 10-business day notification; and d. Refresh tax preparer clients in your account prior to the 13-month period so you don't need to start over or wait for another 10-business-day hold during the filing season.
☐	Obtain powers of attorney from clients in preparation for the upcoming filing season. Some practitioners get POAs on all clients, some get them only on clients who make estimated tax payments, and some don't obtain POAs unless needed for a specific purpose. Revoke POAs that are no longer needed.
☐	Alert payroll clients that due dates to send W-2s and 1099s to the IRS is February 1, 2023.
☐	Write your client letters including engagement letters, and prepare to send organizers, appointment cards/e-mails, etc.
☐	Get copies of escrow statements for sales of property, and check to see if the real estate withholding has been credited to the taxpayer's account.
☐	Train office staff. Hire them if you haven't already.
☐	Order supplies.
☐	Organize your office.
☐	Review tax return processing procedures.

Website

To download a copy of this checklist, go to:
www.caltax.com/files/2022/tipstoprepare.pdf

 ©2022

IDENTITY THEFT VICTIM CHECKLIST

<table>
<tr><th colspan="2">Identity Theft Victim Checklist</th></tr>
<tr><td>☐</td><td>Report the fraud to the three major credit bureaus, and review your credit report thoroughly.
• Equifax: (800) 525-6285 / www.equifax.com/CreditReportAssistance/
• Experian: (888) 397-3742 / www.experian.com/fraud/center.html
• TransUnion: (800) 680-7289 / www.transunion.com/fraud-victim-resource/place-fraud-alert
Use the Federal Trade Commission's ID Theft Affidavit when reporting the theft to creditors and credit bureaus. The form is available on the FTC's website.</td></tr>
<tr><td>☐</td><td>California victims of identity theft are allowed free credit reports monthly for 12 months following the date of the police report. (Cal. Civ. Code §1785.15.3(b)) The method of requesting these varies depending on the credit agency.</td></tr>
<tr><td>☐</td><td>Report the fraud to the police, and save the police report to use when reporting the fraud elsewhere.</td></tr>
<tr><td>☐</td><td>For identity theft related to tax returns and employment, call the IRS Identity Protection Specialized Unit at (800) 908-4490 to have the IRS put an account marker on your Social Security number. This will allow any IRS employee who deals with the file to be aware of the ID theft. File Form 14039, IRS Identity Theft Affidavit.</td></tr>
<tr><td>☐</td><td>Contact the Franchise Tax Board Theft Resolution Coordinator at (916) 845-3669. File Form FTB 3552, Identity Theft Affidavit, and supporting documents.</td></tr>
<tr><td>☐</td><td>If your credit or debit card account has unauthorized charges, contact your bank or account issuer to report the transactions. Close the accounts. If checks were stolen, contact major check verification companies and ask that they not accept checks on the closed account.
• TeleCheck: (800) 710-9898
• Certegy: (800) 437-5120
To find out if the identity thief has passed bad checks in your name, call SCAN at (800) 262-7771.</td></tr>
<tr><td>☐</td><td>Follow up with the credit bureaus via mail, and include copies of the police report and ID Theft Affidavit.
• Equifax, P.O. Box 740241, Atlanta, GA 30374
• Experian, P.O. Box 9532, Allen, TX 75013
• TransUnion, P.O. Box 2000, Chester, PA 19016-2000</td></tr>
<tr><td colspan="2" align="right">(continued)</td></tr>
</table>

	Identity Theft Victim Checklist (continued)
☐	Report the fraud to creditors if the thief opened accounts in your name. Ask for the security or fraud department. Report the fraud via telephone and regular mail.
☐	Consider a credit freeze. This means that your credit file cannot be shared with potential creditors, insurers, employers, or residential landlords without your permission.
☐	If you are contacted by debt collectors, explain that you are not responsible for the debt, and follow up in writing.
☐	If your driver's license was stolen, call your local DMV office, and report the theft and ask them to put a fraud alert on your license. Contact the DMV ID Theft Hotline at (866) 658-5758.
☐	If your mail was stolen or if someone filled out a change of address request in your name, contact the Postal Inspector to report the theft at (800) 275-8777 or file a complaint at https://postalinspectors.uspis.gov/
☐	If your Social Security number was used to claim unemployment benefits, contact the EDD's Fraud Hotline at (800) 229-6297 or use the EDD's Fraud Reporting Form at https://askedd.edd.ca.gov/ReportFraud.aspx
☐	If your Social Security number was used to claim Social Security benefits, call the Social Security Administration's Fraud Hotline at (800) 269-0271. You can also report fraud on the SSA's website.
☐	If your Social Security number was used to claim Medicare, Medi-Cal, or other social services, call the Department of Health and Human Services Office of the Inspector General at (800) 447-8477 (for Medicare fraud). Call the California Department of Health Care Services Medical Fraud Reporting Hotline at (800) 822-6222 (for Medi-Cal fraud). Call the California Department of Social Services Welfare Fraud Referral Hotline at (800) 344-8477 or by e-mail at FraudHotline@dss.ca.gov (for other social services–related fraud).
Taken from "Identity Theft Victim Checklist" California Office of the Attorney General. Available at: www.oag.ca.gov/idtheft/facts/victim-checklist. Checklist also contains sample letters for reporting fraudulent accounts	

Website

To download a copy of this checklist, go to:
www.caltax.com/files/2022/identitytheft.pdf

CHECKLIST TO HELP DETERMINE CALIFORNIA RESIDENCY/NONRESIDENCY

Listed below are some questions that are commonly asked by the FTB to help determine whether a taxpayer is a resident or nonresident of California. These questions have various weights, depending on the facts and circumstances in the case.

To the best of our knowledge, only the very first question in the chart below positively determines nonresidency. (R&TC §17014) However, registering to vote in California and taking the homeowner's property tax exemption on a California residence have been found to make taxpayers residents of California regardless of any other factors (except for nonresident military personnel). (***Appeal of Pierre and Nicole Salinger*** (June 30, 1980) 80-SBE-089; ***Appeal of Frank J. Milos*** (February 24, 1984) 84-SBE-042) However, the converse is not true: Registering to vote in or taking the homeowner's property tax exemption on a residence in another state does not automatically make the taxpayer a nonresident as far as California is concerned.

As a general rule, the state or country in which the taxpayer (and spouse) has the closest business and social contacts is the state of residency.

Website
To download a copy of this checklist, go to:
www.caltax.com/files/2022/determineresidency.pdf

T = Taxpayer S = Spouse

	Resident		Nonresident	
	T	**S**	**T**	**S**
Are you employed under a contract that requires you to be absent from California for at least 546 days with not more than 45 days per year spent in California for any purpose?	☐ No	☐ No	☐ Yes	☐ Yes
If the answer to the question above is "Yes," did you have more than $200,000 in income from stocks, bonds, notes, or other intangible personal property in any taxable year in which the employment-related contract was in effect? If the answer to this question is yes, you do not qualify under this test.	☐ Yes	☐ Yes	☐ No	☐ No

	California		Elsewhere	
	T	**S**	**T**	**S**
During the year, how many months did you live in:	___	___	___	___
How much of your income was from sources in:	___	___	___	___
Where are you registered to vote?	___	___	___	___
Do you own a house in:	___	___	___	___
Where do you take your homeowner's exemption?	___	___	___	___
Where is your driver's license issued?	___	___	___	___
Where is your attorney located?	___	___	___	___
Where is your stockbroker located?	___	___	___	___

(continued)

	California		**Elsewhere**	
	T	**S**	**T**	**S**
Where do you attend regular services?				
Where do you make regular religious contributions?				
Where is your tax professional located?				
Where are your closest social contacts?				
Where are your closest business contacts?				
Where are your vehicles registered?				
Where do your children attend school?				
Did you pay nonresident tuition in:				
Where are your social clubs located?				
Where is your union/professional association located?				
Where is your bank located?				
If working outside California:				
• Where will you move to when your assignment is completed?				
• Where is your personal property stored?				
• Where do(es) your spouse (and minor children) live?				
• When you take vacation or time off, where do you visit?				
• Where is your permanent mailing address?				
• Do you own a house in:				
o Is it:				
Rented	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No
Leased	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No
o Does a related party live there?	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No
If working in California or elsewhere on a temporary basis:				
• Where did you list your residence on the employment application?				
• Where is your permanent telephone number?				
• Do you cook your meals or eat out?	☐ Cook	☐ Cook	☐ Eat Out	☐ Eat Out
• Did you deduct a moving expense?	☐ Yes	☐ Yes	☐ No	☐ No
• Are you on an expense account or being paid per diem?	☐ Yes	☐ Yes	☐ No	☐ No
• Are you: ☐ Living in a hotel or motel	☐ Renting month-to-month		☐ Leasing	
• Did you file a tax return in another state?	☐ Yes	☐ Yes	☐ No	☐ No
o If so, did you file as a resident or nonresident?	☐ Nonres.	☐ Nonres.	☐ Resident	☐ Resident
Where did you have:				
• Your hair and nails done?				
• Your clothes cleaned?				
• Your pet(s) groomed?				

CALIFORNIA TAXATION OF NONRESIDENT INCOME

California Taxation of Nonresident Income	
Type of Income	**Taxability**
Income from business activities conducted solely in CA	Taxable
Income from business activities conducted outside CA by a CA business	Apportionable[1]
Income from business activities conducted both in and outside CA	Apportionable[1]
Real property located in CA	Taxable
Real property located outside CA	Not taxable
Income from tangible personal property located in CA	Taxable
Income from tangible personal property located outside CA	Not taxable
Gain on the sale of real property or tangible personal property located in CA	Taxable
Gain on the sale of real property outside of CA if the property has CA deferred gain from a like-kind exchange of CA property for property located outside of CA	Taxable[6]
Interest and dividends	Not taxable[2]
Wages for services performed in CA	Taxable
Wages for services performed outside CA for a CA business, trade, or profession	Not taxable
Sole proprietor's receipts for services performed for CA businesses	Apportionable[3]
Pensions accrued during CA residency from services performed in CA	Not Taxable
Income from a stock option exercised after taxpayer becomes a nonresident but where services between grant date and exercise date were performed while taxpayer was a resident	Taxable[4]
CA-source income from CA S corporation or partnership	Taxable
Gain on sale of partnership interest or closely held stock in a CA corporation	Not taxable[5]
Income from royalties and for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, etc., that have a business situs in CA	Taxable
Payments on installment sale of intangibles sold while a resident	Taxable

[1] If the income is an integral part of a unitary business, it would be taxable, and you would need to use California's single-sale apportionment formula and market-based sourcing rules to determine the portion allocable to California (18 Cal. Code Regs. §17951-4(c))

[2] Interest and dividend income would not be taxable unless it had a business or taxable situs in California (R&TC §17952) or unless the intangible income is from an installment sale that occurred while the taxpayer was a resident

[3] ***Appeal of Bindley***, 2019-OTA-179P

[4] 18 Cal. Code Regs. §17952

[5] ***Appeal of Amyas Ames, et al.*** (June 17, 1987) 87-SBE-042; however, see FTB Legal Ruling 2022-02 and ***The 2009 Metropoulos Family Trust v. FTB*** (May 27, 2022) Cal.Ct.App. 4th Dist., Case No. D078790

[6] Taxable to the extent of California deferred gain

Website
To download a copy of this chart, go to:
www.caltax.com/files/2022/nonresidentincome.pdf

WALKING AWAY FROM A CORPORATION/LLC QUALIFIER

Use this checklist to see if the FTB can hold the shareholder or LLC member liable for unpaid income and franchise taxes.

PART I

1. Compensation taken from corporation/LLC:
   - A. Cash .... $________
   - B. Fair market value of tangible personal property .... ________
   - C. Fair market value of real estate .... ________
   - D. Fair market value of inventory .... ________
   - E. Fair market value of accounts/notes payable .... ________
   - F. Face value of loans to shareholder/member .... ________
   - G. Fair market value of goodwill .... ________
   - H. Fair market value of other intangibles .... ________
   - I. Other compensation taken .... ________
   - J. Total compensation received by shareholder/member (Add lines A – I) $________
2. Consideration given by shareholder/member:
   - A. Wages or other compensation paid .... $________
   - B. Loans from shareholder/member to corporation/LLC .... ________
   - C. Liabilities assumed by shareholder/member .... ________
   - D. Corporate/LLC expenses paid by shareholder/member .... ________
   - E. Other consideration .... ________
   - F. Capital stock at shareholder's cost (corporation) .... ________
   - G. Member contributions (LLC) .... ________
   - H. Total consideration given by shareholder/member (Add lines A – G) $________

PART II

If the answers to ALL of the following questions are YES, the FTB may hold the shareholder/member liable for income or franchise taxes:

		Yes	No
1.	Is the total on Part I, line 1J greater than the amount in Part I, line 2G?	☐	☐
2.	At the time of the transfer and at the time the shareholder/member liability was asserted, was the corporation/LLC liable for the tax?	☐	☐
3.	Was the transfer made after liability for the tax was accrued, whether or not the tax was actually assessed at the time of the transfer?	☐	☐
4.	Was the corporation/LLC insolvent at the time of the transfer or did the transfer leave the corporation/LLC insolvent?	☐	☐
5.	Had the FTB exhausted all reasonable remedies against the corporation/LLC?	☐	☐

Website

To download a copy of this worksheet, go to:
www.caltax.com/files/2022/walkingaway.pdf

 ©2022

AUDIT-PROOFING DISASTER/CASUALTY LOSSES

☐	Include the loss on the original tax return. When filing the tax return for the year of the loss, try to include the loss, or an estimate, on the originally filed return. Filing an amended tax return with a large refund due to the loss could result in an audit. If the taxpayer cannot determine the exact amount of the loss in time to include it in the tax return, file the return with an estimate of the amount of the loss, insurance proceeds, and deductible loss. When all the insurance proceeds are received and the replacement property is acquired, file an amended return to account for the exact gain or loss on the casualty/disaster.
☐	If the taxpayer will have a gain from the casualty/disaster, do not file an extension without paying at least as much, if not more, of the expected tax liability. California has an automatic extension of time to file tax returns. If the taxpayer takes advantage of the automatic extension, he or she will have late-payment penalties and interest due when the return is filed. If the return is filed and the gain is reported on the extended tax return, the taxpayer will be assessed interest and late-payment penalties. If the taxpayer files the return and underestimates the amount of tax due on the gain for the extension and later files an amended return paying the full amount of tax on the recognized gain, there will be interest due, but no late-payment penalties.
☐	Have the property appraised immediately after the event. If local appraisers are busy, use a real estate broker to do a curbside appraisal for your estimate. Later, have a licensed appraiser prepare an appraisal. If this amount differs from the broker's values, amend the tax return to adjust the difference. Because the loss is based on the decline in FMV, the taxpayer must have an appraisal done to show the FMV immediately before and immediately after the disaster. An appraisal done at the time of the audit (years after the event) will hurt your taxpayer's case during the audit.
☐	The taxpayer does not need to reduce the cost of real property by the land value when the property was the taxpayer's principal residence. (Treas. Regs. §1.165-2(b)(2)(ii))
☐	Have the taxpayer take photographs or videos of the damage. Keep a copy in their file of tax records.
☐	Gather photos taken prior to the casualty to establish the pre-disaster condition of the property.
☐	Get testimony of neighbors as to the condition of the property prior to and immediately after the disaster.
☐	Keep copies of newspaper clippings showing the extent of the disaster.
☐	Make a complete, written inventory of items damaged or destroyed. Include, if available, brand names, year of purchase, any available receipts of purchase, and estimated values from thrift shops, second-hand stores, or catalogs.
☐	File an insurance claim. Taxpayers should still file a claim with their homeowner's insurance company even if they do not have the appropriate insurance (e.g., earthquake insurance). Keep the denial of the claim with the tax files. This document will be required during the audit.
☐	If the taxpayer has received an SBA loan, include the following information on SBA's policy. According to the SBA Standard Operating Procedures, loan proceeds must be used to "repair," "replace," and "repaint," not for improvement of the home. Although not conclusive, a copy of the SBA report can be helpful in determining the loss.
Note: Personal casualty losses are suspended for federal income taxes through the 2025 taxable year unless they were the result of a Presidentially-declared disaster.	

Website

To download a copy of this checklist, go to:
www.caltax.com/files/2022/disastercasualty.pdf

CALIFORNIA ITEMIZED DEDUCTIONS CONFORMITY WORKSHEET

> **Practice Pointer**
>
> Use this worksheet to ensure that your clients give you information on items that are no longer deductible federal return, but are still deductible for California purposes.

State and local taxes (over $10,000 TCJA limitation)

- DMV fees (cars, boats, motorcycles, and recreational vehicles) $ ____________
- Property taxes (for principal residence, second home, and other real property) $ ____________

Mortgage interest

- Interest paid on home equity debt $ ____________

Charitable contributions

- Contributions to institutions of higher education for which the taxpayer receives the right to purchase tickets for seating at an athletic event $ ____________

Casualty and theft losses

- Losses from disasters declared by the Governor, but not the President $ ____________
- Losses from storms, floods, fires, or earthquakes that are not declared by the Governor, nor the President $ ____________
- Losses resulting from a theft $ ____________

Unreimbursed employee business expenses

- Auto expenses $ ____________
- Travel $ ____________
- Entertainment $ ____________
- Supplies and equipment $ ____________
- Computers, printers, etc. $ ____________
- Telephone and cell phone $ ____________
- Job-related education $ ____________
- Dues and subscriptions $ ____________
- Other employee business expenses $ ____________
- Tax preparation fees $ ____________

(continued)

Other miscellaneous itemized deductions

- Investment advisor fees or other asset management fees $ ____________________
- Home office for employees $ ____________________
- Union dues $ ____________________
- Uniforms and safety equipment $ ____________________
- Hobby expenses $ ____________________
- Expenses related to nonbusiness income $ ____________________
- Attorney fees $ ____________________
- Repayment of amounts under a claim of right if $3,000 or less $ ____________________
- Unrecovered investment in pension or annuity (on decedent's final return) $ ____________________
- Other miscellaneous itemized deductions $ ____________________

Website
To download a copy of this worksheet, go to:
www.caltax.com/files/2022/tcjaitemized.pdf

OTHER PRACTITIONER AIDS

The following is a list of other practitioner aids that can be found throughout this book.

Other Practitioner Aids

Description	Page
Qualifying Child Flowchart	1-2
Head of Household Flowchart	1-3
Filing Requirements for Dependents	1-5
Individual Long-Term Capital Gains Rates	1-9
Inflation-Adjusted Limitations for HSAs	1-15
Standard Deductions	1-16
Long-Term Care Premium Deduction Limits	1-19
IRC §199A Phaseout Range	1-24
AMT Exemption Amounts and Phaseout Threshold	1-24
Net Investment Income Tax Threshold Amounts	1-27
Child and Dependent Care Credit Applicable Percentages	1-29
Earned Income Credit Plateau Amounts and Phaseout Ranges	1-31
Comparison of Education Tax Benefits	1-32
Saver's Credit Rate Chart	1-34
Inflation Reduction Act Energy Incentives for Individuals	1-35
Clean Vehicle Credit: Which Rules Apply When?	1-40
Qualifications for Energy Efficient Home Improvements and Residential Energy Property	1-45
Maximum Income Contribution Percentage by Household Income for PTC	1-50
2022 Federal Applicable Percentage Per Income Range for ACA Subsidies	1-51
Limitation of Payback of Excess Advance Credits for 2022 and 2023	1-51
§529 Distributions	1-55
2022 AGI Phaseouts	1-61
AGI Phaseout Ranges for Taxpayers Active in Employer-Sponsored Plans	2-1
AGI Phaseout Ranges for Nonactive Participant Individual with Active Spouse	2-2
RMD Distribution Timetable	2-17
Roth IRA AGI Limits	2-24
Maximum Deductible Contributions to IRAs, Keogh Plans, and SEPs	2-30

(continued)

 ©2022

Other Practitioner Aids (continued)	
Description	**Page**
Comparison Chart of Allowable Rollovers	2-31
Maximum Contributions to Retirement Plans	2-32
FICA and Self-Employment Tax Update	2-33
Medicare Parts B and D Premium Surcharge	2-35
IRC §179 Expensing Limitation and Phaseout Threshold	3-32
Bonus Depreciation Rates	3-33
Federal Mileage Rates	3-38
2022 Maximum Depreciation Amounts	3-39
Per Diem Rates	3-42
Meals and Entertainment Expenses	3-43
Federal/California Comparison of NOL Treatment by Year Generated	3-44
Excess Business Loss Threshold	3-45
Cost of Electing to Be Excepted from Business Interest Limitation Rules	3-50
Real Estate Professional Flowchart	4-12
Comparison of DST and TIC 1031s	4-19
Checklist of Who Must File Schedules K-2 and K-3	5-11
Entity Changes Requiring New EIN	5-23
Name Control Examples	5-27
IRS Transaction Codes	5-34
Planning Checklist	5-43
Tax Bills Enacted in 2022	6-1
November 2022 Tax-related Ballot Initiatives	6-7
SDI Withholding Rate	6-18
Quick Guide to California Nonconformity for Taxable Year 2022	7-11
Tax Refunds Under California AB 192/SB 192	8-1
Differences Between Federal and California First-Time Penalty Abatement Program	8-5
Other State Tax Credit — Where to Take It	8-13
Nonresident Sole Proprietor Checklist	9-39
CalSavers Requirements	9-42

2022 California Tax Rates, Exemptions, and Credits

The rate of inflation in California, for the period from June 1, 2021, through June 30, 2022, was 8.3%. The 2022 personal income tax brackets are indexed by this amount.

Exemption credits

- Married/RDP filing joint, and surviving spouse..........$280
- Single, married/RDP filing separate, and HOH...........$140
- Dependent..........$433
- Blind..........$140
- Age 65 or older..........$140

Phaseout of exemption credits

Higher-income taxpayers' exemption credits are reduced as follows:

	Reduce each credit by:	For each:	Federal AGI exceeds:
Single	$6	$2,500	$229,908
Married/RDP filing separate	$6	$1,250	$229,908
Head of household	$6	$2,500	$344,867
Married filing joint	$12	$2,500	$459,821
Surviving spouse	$12	$2,500	$459,821

When applying the phaseout amount, apply the $6/$12 amount to each exemption credit, but do not reduce the credit below zero.

If a personal exemption credit is less than the phaseout amount, do not apply the excess against a dependent exemption credit.

Example of exemption credit phaseout

Joe is a single taxpayer with one dependent. His federal AGI is $250,000. He must phase out each of his exemptions by $54. That is, ($250,000 – $229,908) ÷ $2,500 = 9 (always round up); 9 × $6 = $54. His exemption credit for 2022 is $465, calculated as follows:

Joe's personal exemption credit is ....$ 140
Less phaseout amount .... ($ 54)
Personal exemption credit allowed is .$ 86
Joe's dependent credit exemption is ...$ 433
Less phaseout amount .... ($ 54)
Total dependent credit allowed is ....$ 379
Total exemption credits allowed is......$ 465

Reduction in itemized deductions

Itemized deductions must be reduced by the lesser of 6% of the excess of the taxpayer's federal AGI over the threshold amount or 80% of the amount of itemized deductions otherwise allowed for the taxable year.

- Single and married/RDP filing separate $229,908
- Head of household..........$344,867
- Married/RDP filing joint and surviving spouse....$459,821

Standard deductions

- Single and married/RDP filing separate................$5,202
- Married/RDP filing joint, head of
- household, and surviving spouse..........$10,404
- Minimum standard deduction for dependents $1,150

Miscellaneous credits

- Qualified Senior Head of Household Credit is 2% of California taxable income, with a maximum California AGI of $89,931, and a maximum credit of $1,695
- Joint Custody Head of Household Credit and Dependent Parent Credit are each 30% of net tax, with a maximum credit of $556

Nonrefundable Renter's Credit

This nonrefundable, noncarryover credit for renters is available for:

- Single and married/RDP filing separate with a California AGI of $49,220 or less....................... $60 credit
- Married/RDP filing joint, head of household, and surviving spouse with a California AGI of $98,440 or less .... $120 credit

Individual tax rates

- The maximum rate for individuals is...................... 12.3%
- The AMT rate for individuals is.......................... 7%

The Mental Health Services Tax Rate is 1% for taxable income in excess of $1,000,000.

AMT exemption

- Married/RDP filing joint, and surviving spouse...$112,734
- Single and head of household..........$84,550
- Married/RDP filing separate, estates, and trusts.....$56,364

AMT exemption phaseout

- Married/RDP filing joint, and surviving spouse...$422,750
- Single and head of household..........$317,062
- Married/RDP filing separate, estates, and trusts...$211,371

FTB cost recovery fees

- Bank and corporation filing enforcement fee............$100
- Bank and corporation collection fee $334
- Personal income tax filing enforcement fee.................$81
- Personal income tax collection fee $307

The personal income tax fees apply to individuals and partnerships, as well as limited liability companies that are classified as partnerships. The bank and corporation fees apply to banks and corporations, as well as limited liability companies that are classified as corporations. Interest does not accrue on these cost recovery fees.

Corporate tax rates

- Corporations other than banks and financials....... 8.84%
- Banks and financials.......... 10.84%
- AMT rate.......... 6.65%
- S corporation rate 1.5%
- S corporation bank and financial rate........................ 3.5%

 ©2022

2022 California Tax Rate Schedules

Single or Married/RDP Filing Separate

If the taxable income is…

Over	But not over	Tax is...			Of amount over...
$0	$10,099	$0	plus	1.00%	$0
$10,099	$23,942	$100.99	plus	2.00%	$10,099
$23,942	$37,788	$377.85	plus	4.00%	$23,942
$37,788	$52,455	$931.69	plus	6.00%	$37,788
$52,455	$66,295	$1,811.71	plus	8.00%	$52,455
$66,295	$338,639	$2,918.91	plus	9.30%	$66,295
$338,639	$406,364	$28,246.90	plus	10.30%	$338,639
$406,364	$677,275	$35,222.58	plus	11.30%	$406,364
$677,275	and over	$65,835.52	plus	12.30%	$677,275

Married Filing Joint or Qualifying Widow(er) with Dependent Child

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$20,198	$0	plus	1.00%	$0
$20,198	$47,884	$201.98	plus	2.00%	$20,198
$47,884	$75,576	$755.70	plus	4.00%	$47,884
$75,576	$104,910	$1,863.38	plus	6.00%	$75,576
$104,910	$132,590	$3,623.42	plus	8.00%	$104,910
$132,590	$677,278	$5,837.82	plus	9.30%	$132,590
$677,278	$812,728	$56,493.80	plus	10.30%	$677,278
$812,728	$1,354,550	$70,445.15	plus	11.30%	$812,728
$1,354,550	and over	$131,671.04	plus	12.30%	$1,354,550

Head of Household

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$20,212	$0	plus	1.00%	$0
$20,212	$47,887	$202.12	plus	2.00%	$20,212
$47,887	$61,730	$755.62	plus	4.00%	$47,887
$61,730	$76,397	$1,309.34	plus	6.00%	$61,730
$76,397	$90,240	$2,189.36	plus	8.00%	$76,397
$90,240	$460,547	$3,296.80	plus	9.30%	$90,240
$460,547	$552,658	$37,735.35	plus	10.30%	$460,547
$552,658	$921,095	$47,222.78	plus	11.30%	$552,658
$921,095	and over	$88,856.16	plus	12.30%	$921,095

Individual Filing Requirements

Filing Status	Age as of December 31, 2022*	California Gross Income			California Adjusted Gross Income		
		Dependents			Dependents		
		0	1	2 or more	0	1	2 or more
Single or head of household	Under 65 65 or older	$20,913 $27,913	$35,346 $38,738	$46,171 $47,398	$16,730 $23,730	$31,163 $34,555	$41,988 $43,215
Married filing joint, RDP, or separate	Under 65 (both spouses/RDPs) 65 or older (one spouse) 65 or older (both spouses/RDPs)	$41,830 $48,830 $55,830	$56,263 $59,655 $66,655	$67,088 $68,315 $75,315	$33,466 $40,466 $47,466	$47,899 $51,291 $58,291	$58,724 $59,951 $66,951
Surviving spouse	Under 65 65 or older		$35,346 $38,738	$46,171 $47,398		$31,163 $34,555	$41,988 $43,215
Dependent of another person — Any filing status	Under 65 65 or older	More than your standard deduction More than your standard deduction					

*If you turn 65 on January 1, 2023, you are considered to be age 65 at the end of 2022.

©2022 Spidell Publishing, LLC®

2022 Federal Tax Rate Schedules

Schedule 1 — Single

If the taxable income is…

Over	But not over	Tax is...			Of amount over...
$0	$10,275	$0.00	plus	10%	$0
$10,275	$41,775	$1,027.50	plus	12%	$10,275
$41,775	$89,075	$4,807.50	plus	22%	$41,775
$89,075	$170,050	$15,213.50	plus	24%	$89,075
$170,050	$215,950	$34,647.50	plus	32%	$170,050
$215,950	$539,900	$49,335.50	plus	35%	$215,950
$539,900	and over	$162,718.00	plus	37%	$539,900

Schedule 2 — Married Filing Separate

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$10,275	$0.00	plus	10%	$0
$10,275	$41,775	$1,027.50	plus	12%	$10,275
$41,775	$89,075	$4,807.50	plus	22%	$41,775
$89,075	$170,050	$15,213.50	plus	24%	$89,075
$170,050	$215,950	$34,647.50	plus	32%	$170,050
$215,950	$323,925	$49,335.50	plus	35%	$215,950
$323,925	and over	$87,126.75	plus	37%	$323,925

Schedule 3 — Married Filing Joint and Surviving Spouse

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$20,550	$0.00	plus	10%	$0
$20,550	$83,550	$2,055.00	plus	12%	$20,550
$83,550	$178,150	$9,615.00	plus	22%	$83,550
$178,150	$340,100	$30,427.00	plus	24%	$178,150
$340,100	$431,900	$69,295.00	plus	32%	$340,100
$431,900	$647,850	$98,671.00	plus	35%	$431,900
$647,850	and over	$174,253.50	plus	37%	$647,850

Schedule 4 — Head of Household

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$14,650	$0.00	plus	10%	$0
$14,650	$55,900	$1,465.00	plus	12%	$14,650
$55,900	$89,050	$6,415.00	plus	22%	$55,900
$89,050	$170,050	$13,708.00	plus	24%	$89,050
$170,050	$215,950	$33,148.00	plus	32%	$170,050
$215,950	$539,900	$47,836.00	plus	35%	$215,950
$539,900	and over	$161,218.50	plus	37%	$539,900

 ©2022

2023 Federal Tax Rate Schedules

Note: These tax rates are for the 2023 tax year (for filing in 2024), and are provided here for tax planning purposes.

Schedule 1 — Single

If the taxable income is…

Over	But not over	Tax is...			Of amount over...
$0	$11,000	$0.00	plus	10%	$0
$11,000	$44,725	$1,100	plus	12%	$11,000
$44,725	$95,375	$5,147	plus	22%	$44,725
$95,375	$182,100	$16,290	plus	24%	$95,375
$182,100	$231,250	$37,104	plus	32%	$182,100
$231,250	$578,125	$52,832	plus	35%	$231,250
$578,125	and over	$174,238.25	plus	37%	$578,125

Schedule 2 — Married Filing Separate

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$11,000	$0.00	plus	10%	$0
$11,000	$44,725	$1,100	plus	12%	$11,000
$44,725	$95,375	$5,147	plus	22%	$44,725
$95,375	$182,100	$16,290	plus	24%	$95,375
$182,100	$231,250	$37,104	plus	32%	$182,100
$231,250	$346,875	$52,832	plus	35%	$231,250
$346,875	and over	$93,300.75	plus	37%	$346,875

Schedule 3 — Married Filing Joint and Surviving Spouse

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$22,000	$0.00	plus	10%	$0
$22,000	$89,450	$2,200	plus	12%	$22,000
$89,450	$190,750	$10,294	plus	22%	$89,450
$190,750	$364,200	$32,580	plus	24%	$190,750
$364,200	$462,500	$74,208	plus	32%	$364,200
$462,500	$693,750	$105,664	plus	35%	$462,500
$693,750	and over	$186,601.50	plus	37%	$693,750

Schedule 4 — Head of Household

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$15,700	$0.00	plus	10%	$0
$15,700	$59,850	$1,570	plus	12%	$15,700
$59,850	$95,350	$6,868	plus	22%	$59,850
$95,350	$182,100	$14,678	plus	24%	$95,350
$182,100	$231,250	$35,498	plus	32%	$182,100
$231,250	$578,100	$51,226	plus	35%	$231,250
$578,100	and over	$172,623.50	plus	37%	$578,100

This page intentionally left blank.

 ©2022

Glossary

GLOSSARY — Part I

Administrative adjustment request (AAR): a mechanism under IRC §6227 by which a partnership can correct errors on a partnership return for a prior year

ABLE account: an account that provides a tax-advantaged savings plan for disabled individuals. They are closely modeled on §529 Qualified Tuition Plans. Contributions are not deductible, but earnings are tax-free

Age of majority: the age of legal adulthood. The proposed SECURE Act regulations create a hard definition of age of majority to mean a person's 21st birthday

Accountable plan: employer plans that meet certain requirements whereby employees receive reimbursements from their employer for their business expenses, and these reimbursements are excludable from the employee's gross income

Accumulated earnings tax: a tax on accumulated taxable income that exceeds the reasonable needs of a business. It applies to every corporation formed or availed of for the purpose of tax avoidance. An S corporation is not subject to the tax

Accumulation trust: a trust that holds the distributions for later disbursement to the beneficiary

Active participation: described in the Tax Code as a negative, active participation does *not* include participation in an activity in which the taxpayer holds a less than 10% interest, or participation as a limited partner (unless the limited partner is also a general partner). Active participation is the standard used to determine if a taxpayer qualifies for the allowable passive losses of up to $25,000 per year

Airdrop: a procedure for distributing tokens at one time by awarding them to existing holders of a particular blockchain currency. The practice has raised questions about tax liabilities and whether it amounts to income or capital gains

Alternative depreciation system (ADS): required by the IRS to be used in certain circumstances to calculate depreciation on depreciable business assets. ADS typically will increase the number of years for property depreciation, which will decrease the annual deduction. The longer recovery period usually better reflects the asset's income streams

American Opportunity Tax Credit (AOTC): a credit for education expenditures paid for a qualified student for the first four years of their higher education. The maximum annual credit per student is $2,500. Available for four tax years per eligible student

Beneficial owner: an individual who directly or indirectly through any contract arrangement, understanding, relationship, or otherwise exercises substantial control over an entity or owns or controls not less than 25% of the ownership interests in the entity

Blockchain: a continuously growing list of records, called blocks, which are linked and secured using cryptography. Each block typically has a cryptographic hash of the previous block, a timestamp, and transaction data

Bonus depreciation: for assets whose original use commences with the taxpayer, an added amount of depreciation that can be deducted, always in the first year that the depreciable item is placed in service

Brownfield site: specified contaminated real property

Cancellation of debt (COD): occurs when a creditor cancels, forgives, or discharges a debt. The amount forgiven is considered income to the debtor and must be reported and taxed as ordinary income unless an exclusion or exception applies

Centralized partnership audit rules (CPAR): repeals TEFRA rules governing partnership audits and replaces them with a new centralized partnership audit regime that assesses and collects taxes at the partnership level. Applies to all partnerships with partnership taxable years beginning after December 31, 2017

Charitable remainder trust (CRT): a trust in which the noncharitable beneficiaries are the current beneficiaries, and the remainder interest goes to charity

Child and Dependent Care Tax Credit: available to taxpayers that paid expenses for the care of a qualifying individual to enable the taxpayer and spouse, if filing jointly, to work, actively look for work, or attend school full time. Married taxpayers must file an MFJ return unless they are legally separated or married and living apart, with other specified qualifications

Child Tax Credit: under the American Rescue Plan Act (ARPA), the Child Tax Credit was increased from $2,00 per child to $3,000 per child ($3,600 for a child under age 6) for certain households and made fully refundable. The requirement that taxpayers must have earned income of at least $2,500 to qualify for the credit was repealed. As of December 31, 2021, ARPA's Child Tax Credit provisions have expired

Claim of right doctrine: a doctrine holding that if a taxpayer receives property without restriction as to its use, then the taxpayer has received income that must be included in gross income in the year of receipt

Clean Vehicle Credit: formerly known as the Qualified Plug-In Electric Drive Motor Vehicle Credit, which was amended by the Inflation Reduction Act of 2022. Provides a credit for electric vehicles including passenger vehicles and light trucks, although multiple factors apply

College Access Tax Credit: enables taxpayers to claim up to 50% of cash contributions made to the College Access Tax Credit Fund. The fund provides support for the CalGrants program to provide educational financial aid to low and middle income students

Conduit trust: a trust in which the plan distributions are automatically paid out by the trust to the beneficiary

Consent dividends: hypothetical distributions made by a corporation to a shareholder owning consent stock on the last day of the corporation's tax year whereby the consent dividend is treated as if it were actually distributed by the corporation to the shareholder and then contributed to the capital of the corporation by the shareholder on the same day

Constructive dividend: arises when a corporation confers an economic benefit upon a shareholder without expectation of repayment, and the corporation on the date of the deemed distribution had current or accumulated earnings and profits. The shareholder need not receive the dividend directly and must include payments the corporation made on the shareholder's behalf in gross income

©2022

Controlled foreign corporation (CFC): a foreign corporation that is owned by U.S. shareholders by more than 50% by vote or by total value or such corporation's stock

Cost segregation study: segregates the components of real property into its shorter depreciable-life components

Cryptocurrency: a form of digital currency designed to work as a medium of exchange. Uses cryptography to secure its transactions, control the creation of additional units, and to verify asset transfer. Also uses decentralized control outside of central banking systems

Cryptocurrency address: an identifier of 26-35 alphanumeric characters beginning with the number 1 or 3 that represents a possible destination for a bitcoin payment

Deceased spouse unused exclusion (DSUE): the amount of the first deceased spouse's unused estate tax exclusion that is used to compute the exclusion amount for the surviving spouse who has elected portability

DeFi: decentralized finance; uses emerging technology similar to that used by cryptocurrencies that is based on secure distributed ledgers. Takes banks and financial companies, and their associated fees, out of the transaction

Defined benefit plan: an employer-sponsored retirement plan whereby benefits are based on a formula using such factors as salary history, employment duration, etc.

Defined contribution plan: an employer-sponsored retirement plan whereby a specific amount of money is allocated to an individual's account for a plan year ending with or within the tax year. The employee must meet certain conditions before an allocation is made to their account, and if the conditions are not met, the individual is not an active participant in the plan

Digital asset: any digital representation of value that is recorded on a cryptographically secured distributed ledger or any similar technology, which includes most cryptocurrencies and potentially some nonfungible tokens

Digital currency exchanges (DCE): businesses that allow customers to trade cryptocurrencies for other assets such as fiat money or to exchange cryptocurrencies

Digital wallet: an electronic device that allows an individual to make electronic transactions. A cryptocurrency wallet is a digital wallet where private keys are stored for cryptocurrencies

Disabled Veterans' Property Tax Exemption: reduces the property tax liability on the principal place of residence of qualified veterans who, due to a service-connected injury or disease, have been rated 100% disabled or are being compensated at the 100% rate due to unemployability. An unmarried surviving spouse of a qualified veteran may also claim the exemption

Donor advised fund: allows donors to make a charitable contribution to a public charity and receive an immediate tax benefit while retaining advisory privileges. However, the sponsoring organization receives and retains exclusive ownership and legal control over investment returns and the amounts contributed

Delaware statutory trust (DST): a legally recognized trust set up as a private governing agreement under which property is held and managed or for-profit business activities are carried on by one or more trustees for the benefit of the trustor. The trust is not necessarily established in the state of Delaware. Also referred to as an unincorporated business organization trust (UBOT)

Depreciation: an annual allowance that reflects the reduction in the value of an asset due to wear and tear, deterioration, or obsolescence, resulting in an income tax deduction in order to recover the costs or other basis of specific property

Earned Income Tax Credit (EITC): a tax credit for low-income workers depending on the taxpayer's income and whether the taxpayer has one, more than one, or no qualifying children. Was not available for married individuals filing separate returns, but the American Rescue Plan Act expanded the credit to allow MFS filers to claim it if they have a qualifying child who lived with them for half of the tax year and if the taxpayer meets the spousal separation requirements

Energy Star certified: a government-backed designation signifying energy efficiency

Energy usage intensity (EUI): expresses a building's energy use based on its size or other characteristics

Employee Retention Credit (ERC): a program that provided employers with refundable tax credits against their quarterly payroll taxes. Employers that qualified for, and claimed, the ERC are required to reduce their deduction for wage expenses on their income tax return for the year that the wages were paid that generated the ERC by the amount of the ERC claimed. The ERC can only be claimed for wages paid from March 12, 2020, through December 31, 2021

Excise tax: a legislated tax on specific goods or services. May be imposed on the manufacturer, retailer, or consumer depending on the tax

Excess business loss limitation: limits the amount of business losses a taxpayer can utilize in offsetting other income in the year the loss is generated. Under the TCJA, for taxable years beginning after December 31, 2017, and before January 1, 2026, excess business losses of noncorporate taxpayers were disallowed, and the amount disallowed is treated as an NOL in the following year. California treats any unused business loss as a "carryover excess business loss," not an NOL carryover

Foreign Account Tax Compliance Act (FATCA): part of the HIRE Act, which requires financial institutions and certain other nonfinancial foreign entities to report on foreign assets held by U.S. account holders. Under the act, U.S. persons must also report their foreign assets if above the reporting threshold

FBAR: the Report of Foreign Bank and Financial Accounts, which must be filed with the IRS if a taxpayer has a financial interest or signatory authority over a foreign financial account over specific thresholds

FICA: Federal Insurance Contributions Act tax imposed on employers and employees in order to fund Social Security and Medicare

FIFO: first in, first out; a valuation method whereby the assets acquired first are sold first

FinCEN: a bureau of the Department of Treasury – Financial Crimes Enforcement Network – whose mission it is to safeguard the U.S. financial system from "illicit use" and to promote national security through the collection and analysis of financial intelligence

 ©2022

FUTA: Federal Unemployment Tax Act, along with state unemployment systems, provides for payments of unemployment compensation to individuals who have lost their jobs

Goodwill: an intangible asset, the value of which is considered as a consequence of a buyer's acquisition of an existing business. Goodwill is represented by the value of such things as a business entity's brand name, its corporate image, its customer base and customer relations, and its good employee relations

Hard fork: occurs when a blockchain splits into two separate chains as a consequence of two incompatible sets of rules trying to govern the system. One fork records transactions using the new updated technology on a new distributed ledger, and the other fork records transactions using the pre-updated technology in the old, distributed ledger (aka the legacy distributed ledger)

Home Owner Managing Energy Savings (HOMES): a congressional act of 2019 providing incentives for homeowners to invest in energy efficiency improvements

Incentive stock option (ISO): a type of employee stock option that is usually only offered to key employees and top management. When incentive stock options are exercised, typically the employee buys the stock at a preestablished price that may be well below market value. The taxpayer is not required to report income when receiving or exercising the stock option

Income in respect of a decedent (IRD): taxable income which a deceased person was entitled to but did not receive prior to their death

Initial coin offering (ICO): a means of crowdfunding for a cryptocurrency, which can be a source of capital for startup companies. A quantity of the crowdfunded cryptocurrency is preallocated to investors in the form of tokens in exchange for legal tender or other cryptocurrencies. The tokens theoretically become functional units of currency if or when the ICO's funding goal is met and the project launches

IRA: individual retirement account that allows a person to save for retirement on a tax-deferred basis. With a traditional IRA, permissible contributions may be deducted on an individual tax return, and earnings grow tax-deferred until they are withdrawn. With a Roth IRA, after-tax contributions are made that may be withdrawn at retirement tax-free

IRC §179 depreciation deduction: allows a taxpayer to elect to deduct the cost of certain types of property as an expense on their tax return rather than being required to capitalize and depreciate the property cost

IRC §199A deduction: a small business tax deduction under the TCJA. With respect to a trade or business, it is the actual deduction after subjecting the combined tentative deduction to the taxable income limitation and adding in any deductible amount with respect to co-ops, REITs, and PTPs

IRC §481(a) adjustment: computed as of the beginning of the taxable year of accounting method change. The adjustment reflects the cumulative difference between the present and the proposed methods and is used to prevent amounts of income or expense from being duplicated or omitted when the change is made. All IRC §481(a) adjustments are aggregated in the year of change

IRC §951 income: tax code section wherein global intangible low-taxed income for each person who is a U.S. shareholder of any controlled foreign corporation is included in gross income

IRC §1031 exchange: provides an exception to taxation on gain upon the sale of business or investment property, allowing taxpayers to postpone paying taxes if the proceeds of the sale are reinvested in similar property in a qualifying like-kind exchange

Kiddie tax: a special tax on a person under age 17 who has earned income above an annually determined threshold. Income above the threshold is taxed at the parent's or guardian's rate. The tax deters shifting income to children in hopes of paying tax at the child's lower tax rate

Lifetime Learning Credit: for qualified tuition and related expenses for eligible students enrolled in an eligible institution. The nonrefundable credit is 20% of the first $10,000 of qualified education expenses, or a maximum of $2,000 per return; available for an unlimited number of years

Like-kind exchange: a transaction or series of transactions that allows for the reciprocal transfer of property without generating a current tax liability when the first asset is sold

MACRS: the Modified Accelerated Cost Recovery System, a method of depreciation whereby taxpayers can recover basis in tangible property over an identified life through annual tax deductions, allowing for larger deductions in the early years of an asset's life and lower deductions in later years. MACRS replaced the accelerated cost recovery system (ACRS) for property placed in service post 1986

Marketplace facilitator: a taxpayer, including electronic and physical marketplaces, catalogues, television and radio broadcasts, or dedicated software applications, who contracts with a marketplace seller for consideration for the sale of the seller's tangible personal property by engaging in bringing the buyer and seller together and facilitating the sale

Material participation: participation on a regular, continuous, and substantial basis (IRC §469(c)(7)(B)). The key is to establish the continuity of the activity

Mining: a validation of transactions in cryptocurrency networks. Successful miners obtain new cryptocurrency as a reward

Mobilia sequuntur personam: movable property follows the person

Nanny tax: a federal tax that is required to be paid by individuals who hire household workers (maid, babysitter, gardener, etc.) and pay them, in total, above a threshold amount for the tax year. It is not applicable for services performed by the taxpayer's parent, spouse, or if a babysitter is under age 18 and not primarily working in household employment

National Research Program: an IRS program that conducts a variety of studies, for example, audits of a random sample of tax returns, to gather data on voluntary compliance and key areas of noncompliance

Net investment income tax (NIIT): a 3.8% Medicare surtax on certain net investment income of individuals, estates, and trusts that have income above a statutory threshold amount. A child's income is included in the parent's computation of NIIT

Net operating loss (NOL): a period when a company's allowable tax deductions are more than the company's taxable income with negative taxable income as a result

 ©2022

NIL income: income derived from an individual's name, image, or likeness that allows them to earn money from endorsements, sponsorships, social media, etc. NIL income of $600 or more for the tax year will generate a 1099-NEC as well as self-employment taxes

Nonaccountable plan: any business expense reimbursement paid by an employer that does not meet the requirements of an accountable plan

Nonfungible token (NFT): cryptographic assets on the blockchain with unique codes for identification that distinguish them from each other. They cannot be exchanged or traded like cryptocurrencies

OASDI: Old Age, Survivors, and Disability Insurance. The OASDI tax provides funding for Social Security in the U.S., providing comprehensive federal benefits to retired persons and those who are disabled, as well as their spouses, children, and survivors. Employees pay 6.2% of their wages, with employers matching 6.2%, for a total of 12.4%

Other State Tax Credit (OSTC): a credit allowed to individuals, estates, or trusts for net income taxes imposed and paid to another state only on income that has a source within the other state and is taxed by both California and the other state

Paycheck Protection Program (PPP): a program that allowed qualifying businesses to receive special loans through the SBA that were eligible for loan forgiveness up to 100% of the loan if the loan proceeds were spent on eligible expenses within a specified period of time. If certain requirements were met, taxpayers could have received a second PPP loan that was also forgivable up to 100% of the loan proceeds. Forgiven PPP loans are treated as tax-exempt income to the business, and the business is allowed to deduct all expenses paid with their PPP loan. The PPP program ended on May 31, 2021

Pell Grant: awarded by the federal government usually to undergraduate students with exceptional financial need, who have not earned a bachelor's, graduate, or professional degree. Pell Grants do not have to be repaid

Portability: allows the deceased spouse's unused exclusion amount ((DSUE) to be transferred to the surviving spouse. This is accomplished by an election by the executor on Form 706 within nine months of the decedent's date of death, unless an extension is requested, which would give the executor an additional six months

Premium Tax Credit: a refundable credit that is advanced to eligible individuals of low or moderate income to assist them in purchasing health care through a health care exchange, also known as the Marketplace. IRA '22 extends and expands the Premium Tax Credit provisions that were enacted by the American Rescue Plan Act (ARPA) through 2025

Proof of stake: a concept that states that a person can mine and/or validate blockchain transactions based on the amount of coins they hold. Created as an alternative to proof of work (POW) – the original consensus algorithm in blockchain technology used to confirm transactions. However, POW requires vast amounts of energy, with miners being required to sell their coins in order to complete a valid transaction

Qualified business income (QBI): as pertains to IRC §199A, the net amount of qualified items of income, gain, deduction, and loss for a taxpayer's qualified trade or business

Qualified longevity annuity contract (QLAC): a deferred annuity that is funded from a qualified retirement plan or IRA and is exempt from required minimum distributions

Qualified improvement property: any improvement to the interior portion of a building that is nonresidential real property if such improvement is placed in service after the date the building was first placed in service. Under the TCJA, the separate definitions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property have been eliminated and put under the single umbrella of qualified improvement property. The CARES Act provides a technical correction to the TCJA, whereby qualified improvement property is now classified as eligible for a 15-year recovery period, allowing for the bonus depreciation deduction to be claimed, retroactive as if it were always included in the TCJA at the time of enactment

Qualified small business stock (QSBS): generally stock in any C corporation whose assets do not exceed $50 million and which was originally issued after the enactment of the Revenue Reconciliation Act of 1993, and was acquired by the taxpayer at its original issue in exchange for money or as compensation for services. A qualified small business must have at least 80% of its assets utilized in the active conduct of a qualified trade or business

Real estate mortgage investment conduit (REMIC): a passthrough entity holding mortgages secured by any type of real property, which can issue multiple classes (tranches) of ownership interests to investors in the form of certificates, bonds, etc.

Real estate investment trust (REIT): a company that invests in income-producing real estate through property or mortgages and may trade on a major exchange like stock or through nonlisted, private REITs. They are modeled after mutual funds

Residential Clean Energy Credit: previously known as the Residential Energy Efficient Property (REEP) Credit. Has been extended for an additional 11 years under the IRA '22

Restaurant Revitalization Fund: set up for grants to be issued by the SBA of up to $25 billion in restaurant revitalization grants to restaurants that experienced pandemic-related revenue losses

Research and Development (R&D) Credit: provides incentives for companies to invest in research and development by providing credits for qualified research expenditures

Roth IRA: a special retirement account where taxes are paid on money going into the account, but all future withdrawals are tax-free

RMD: required minimum distribution, which is the minimum amount a taxpayer must withdraw from their retirement account every year by April 1 following the year they reach age 70½. This includes withdrawals from an IRA, SEP IRA, SIMPLE IRA, or retirement plan account. Roth IRAs do not require withdrawals until after the owner dies. Penalties apply if RMD is not taken. The SECURE Act increases the age at which taxpayer must take RMDs to age 72

Shared responsibility payment: a nondeductible excise tax assessed to individuals and employers for not having or offering a health insurance policy with minimum essential coverage

State Disability Insurance (SDI): part of a state program that provides short-term disability insurance and Paid Family Leave to eligible workers who require time off, which may be related to non-work-related illness or injury, pregnancy, or childbirth

 ©2022

See-through trust: a trust where the beneficiaries are considered designated beneficiaries of the grantor's retirement plan rather that the trust being considered the beneficiary

Series I savings bond: a security issued by the U.S. Treasury that earns interest based on both a fixed rate and a rate that is set twice a year based on inflation

SEP IRA: Simplified Employee Pension Plan, which allows self-employed individuals and small employers to contribute to retirement plans on behalf of themselves and their employees without the complexities of a qualified plan. All contributions are funded by the employer. Withdrawals are taxed as ordinary income

Shuttered Venue Operators Grant: authorized under the ARPA and issued by the SBA beginning April 8, 2021. The grants provide emergency assistance for eligible venues that have been affected by the COVID-19 pandemic

SIMPLE IRA: Savings Incentive Match Plan for Employees, a savings incentive match plan that allows employees and small employers to contribute to a traditional IRA

Stablecoins: cryptocurrencies that attempt to peg their market value to an external reference such as the U.S. dollar or gold. They are designed to reduce volatility relative to unpegged cryptocurrencies such as Bitcoin

Standard 90.1: with respect to any property, the most recent Standard 90.1 published by the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America

Statutory employee: an independent contractor who by law is treated as an employee for specific employment tax purposes

Superseding tax return: replaces a previously filed original tax return and is treated as an original return. It is filed subsequent to the original return but still within the filing period including extensions

Supplemental Security Income (SSI): a program to help aged, blind, and disabled individuals with little or no income, which provides cash to assist in meeting basic needs. The program is funded by general tax revenues, not by Social Security taxes

Tenancy in common (TIC): shared ownership of property by two or more persons in which each individual owns a share that may be unequal in size to shares owned by other tenants-in-common (or cotenants), unlike joint tenancy. All owners have the right to occupy and use all of the property. The shares may be transferred to other owners during life or through a will

Zero Energy Ready Home: a program under the U.S. Department of Energy to recognize homes that achieve exceptional levels of energy savings

401(k) plan: a defined contribution plan whereby retirement savings contributions are deducted from an employee's paycheck before taxation (and sometimes matched by the employer), deferring taxes until funds are withdrawn after retirement or as permitted by law

403(b) plan: a retirement plan for certain employees of public schools, certain tax-exempt organizations, and certain ministers. Also known as a tax-sheltered annuity (TSA) plan

457(b) plan: a nonqualified, defined contribution retirement plan for state and local public employees and certain nonprofits

§529 plan: aka a qualified tuition program or QTP; a tax-advantaged vehicle for education savings held in an account for a designated beneficiary

 ©2022

GLOSSARY — Part II

ABC test: a test based on the ***Dynamex*** decision to determine if a worker should be treated as an independent contractor for purposes of the wage orders. The worker must be free from the control and direction of the hiring entity for work performed, the worker performs work outside of the usual course of the hiring entity's business, and the worker is customarily engaged in an independent trade or occupation performing the same nature of the work performed

ADU: accessory dwelling unit

Apportionment: the method used by multistate businesses to determine how much of their business income is taxed in each state in which they have taxable nexus

CalABLE: a California public benefit with accounts for individuals with a disability that occurred prior to reaching age 26

California Competes Tax Credit: a nonrefundable credit against corporate franchise and personal income taxes that is available to new and growing California businesses or businesses that are considering terminating or leaving California. The credit may reduce the regular tax below the tentative minimum tax

California method: California's method of taxation whereby tax is calculated by multiplying the California-source taxable income of a nonresident or part-year resident by a rate equal to the tax computed on worldwide income as if the person were a resident

CalKIDS: California Kids Investment and Development Savings; a program providing newborns and eligible low-income public school children in California an initial deposit plus other financial incentives to help them save for higher education

CalSavers: previously known as California Secure Choice Retirement Program; a state-sponsored retirement program for private-sector employees, which will require private employers with five or more employees who don't offer a retirement plan to enroll their employees in a CalSavers account unless the employee opts out

Cannabis Equity Tax Credit: available for the 2023-2027 tax years, cannabis equity licensees (those who qualify for the California Department of Cannabis Control's license fee and deferral waiver program) may claim a credit against the personal income or corporation franchise and income tax equal to $10,000

Convenience of the Employer Test: as pertains to payroll taxes, wages are sourced to the employer's location unless the employee can prove that they are teleworking due to the employer's necessity

Disabled Veterans' Property Tax Exemption: reduces the property tax liability on the principal place of residence of qualified veterans who, due to a service-connected injury or disease, have been rated 100% disabled or are being compensated at the 100% rate due to unemployability. An unmarried surviving spouse of a qualified veteran may also claim the exemption

Earned Income Tax Credit (EITC): a tax credit for low-income workers depending on the taxpayer's income and whether the taxpayer has one, more than one, or no qualifying children. Was not available for married individuals filing separate returns, but the American Rescue Plan Act expanded the credit to allow MFS filers to claim it if they have a qualifying child who lived with them for half of the tax year and if the taxpayer meets the spousal separation requirements

Economic injury disaster loan (EIDL): offered by the Small Business Administration to small businesses, which may request an emergency advance grant against the loan for up to $1,000 per employee up to a maximum of $10,000. The advance does not need to be repaid under any circumstances. The grant is not included in taxable income on the federal return, but expenses paid with the grant can be fully deducted. On the California return, the grant is not included in taxable income, and expenses are deductible. The ARPA authorized another $15 billion for targeted EIDL grants

Equity Licensee Excise Tax Credit: available for the 2023-2025 tax years, a "vendor compensation" for approved equity cannabis licensee retailers equal to 20% of the cannabis excise tax due

Foster Youth Tax Credit: a new refundable California tax credit equal to $1,000 (adjusted for inflation to $1,083 for 2022) multiplied by the Earned Income Tax Credit adjustment factor (85% for 2022). Qualified taxpayers must be allowed a California Earned Income Tax Credit for the taxable year, be 18-25 years old, inclusive, as of the last day of the year, and was in foster care while age 13 or older in county or tribal-approved placement

FUTA: Federal Unemployment Tax Act, along with state unemployment systems, provides for payments of unemployment compensation to individuals who have lost their jobs

GO-Biz: the Governor's Office of Business and Economic Development, which was created to function as California's single point of contact for economic development and job creation

Grantor trust: a trust where the grantor effectively retains control over the assets in the trust, which will cause the existence of the trust to be ignored for income tax purposes. Also known as a living trust

High Road Cannabis Tax Credit: available for the 2023-2027 tax years, a credit of up to 25% of qualified expenditures in the tax year, up to a $250,000 maximum, is available to qualified cannabis businesses (a state-licensed commercial cannabis business that is a licensed retail or microbusiness licensee)

Homeless Hiring Tax Credit: authorized under AB 150, a new credit for qualified taxpayers that hire individuals who are currently or were recently homeless. The credit is capped at $30,000 per taxpayer per taxable year

IRC §1031 exchange: provides an exception to taxation on gain upon the sale of business or investment property, allowing taxpayers to postpone paying taxes if the proceeds of the sale are reinvested in similar property in a qualifying like-kind exchange

Joint tenancy: shared ownership of property by two or more persons with the right of survivorship, where each owner has an equal and undivided interest in the property. When a joint tenant dies, the other tenants automatically absorb the deceased person's interest

Main Street Small Business Hiring Credit: a small business hiring credit claimed against a taxpayer's personal income tax or corporation franchise and income taxes, or at the election of the taxpayer, against state and local sales and use taxes. The credit was only available during the 2021 tax year

 ©2022

Market-based sourcing: California's approach to sourcing whereby the sales of intangibles and services are sourced to the state where the customer receives the benefit

Net operating loss (NOL): a period when a company's allowable tax deductions are more than the company's taxable income with negative taxable income as a result

Other State Tax Credit (OSTC): a credit allowed to individuals, estates, or trusts for net income taxes imposed and paid to another state only on income that has a source within the other state and is taxed by both California and the other state

Passthrough entity elective tax: enacted in California in July 2021, provisions allow qualified entities to elect to pay California income tax on behalf of certain partners/shareholders/members that consent to have the tax paid on their behalf. Shareholders/partners/members that consent will receive a California tax credit equal to 100% of the state tax paid by the passthrough entity, subject to limitations

Paycheck Protection Program (PPP): a program that allowed qualifying businesses to receive special loans through the SBA that were eligible for loan forgiveness up to 100% of the loan if the loan proceeds were spent on eligible expenses within a specified period of time. If certain requirements were met, taxpayers could have received a second PPP loan that was also forgivable up to 100% of the loan proceeds. Forgiven PPP loans are treated as tax-exempt income to the business, and the business is allowed to deduct all expenses paid with their PPP loan. The PPP program ended on May 31, 2021

Public Law 86-272: federal law that provides state tax immunity to sellers of tangible personal property by prohibiting a state from imposing an income tax on income derived within that state from interstate commerce if the only business activity within the state is the solicitation of orders. In 2021, the Multistate Tax Commission adopted a more restrictive interpretation of P.L. 86-272 immunity, and California has followed their lead, meaning more activities by an out-of-state business selling tangible personal property to a California customer are unprotected by P.L. 86-272

Restaurant Revitalization Fund: set up for grants to be issued by the SBA of up to $25 billion in restaurant revitalization grants to restaurants that experienced pandemic-related revenue losses

ScholarShare 529: California's college savings plan

Shuttered Venue Operators Grant: authorized under the ARPA and issued by the SBA beginning April 8, 2021. The grants provide emergency assistance for eligible venues that have been affected by the COVID-19 pandemic

State Disability Insurance (SDI): part of a state program that provides short-term disability insurance and Paid Family Leave to eligible workers who require time off, which may be related to non-work-related illness or injury, pregnancy, or childbirth

Throwback rule: when a taxpayer sells tangible personal property into a state where the taxpayer is not subject to tax, if the state has adopted a throwback rule, the revenues from these sales are thrown back and included in the numerator of the state from where the property was shipped

Tenancy in common (TIC): shared ownership of property by two or more persons in which each individual owns a share that may be unequal in size to shares owned by other tenants-in-common (or cotenants), unlike joint tenancy. All owners have the right to occupy and use all of the property. The shares may be transferred to other owners during life or through a will

Unitary business principle: if the operation of a part of a specific business performed within the state adds to the operation of the business outside the state, the operations are considered unitary. Under the unitary method, all of the elements comprising a single trade or business are viewed as a whole, or a unit. Applies to multistate entities, nonresident individual partners, S corporation shareholders, LLC members, and sole proprietors

Work Sharing Program: a program under the Employment Development Department that allows workers to work part-time for an employer and still collect unemployment benefits. The program provides an alternative to employers laying off their employees by allowing employers to reduce their employees' hours and wages and having the EDD supplement the employee's reduced wages by paying part of the unemployment compensation benefits that the worker would be entitled to had they been laid off

§529 plan: aka a qualified tuition program or QTP; a tax-advantaged vehicle for education savings held in an account for a designated beneficiary

 ©2022

Index

Index

§1031 ... 4-17
§121 ... 4-1
§163(j) ... 3-46
§179 expensing ... 3-32, 3-34
§199A ... 1-23
§280E ... 3-54
§529 accounts ... 1-79
§529 distributions ... 1-55
§754 election ... 3-65
1099-K reporting ... 5-1
1099-NEC reporting ... 5-3
AB 150 ... 1-20, 9-1
ABC test ... 10-13
ABLE account contributions ... 6-12
Accountable plans ... 3-39
Accumulated earnings tax ... 3-59
Active participation ... 4-13
Affordable Care Act ... 1-49
Alimony ... 1-14
Alternative Fuel Vehicle Refueling
  Property Credit ... 3-10
Alternative minimum tax ... 1-24
AMT credit ... 1-26
Anti-clawback rule (gift and estate tax) ... 1-76
Appeal of Faries ... 8-11
Apportionment formula ... 8-9
Apprenticeship requirement ... 3-4, 3-5, 3-16
Apprenticeship requirements ... 3-13
Audits ... 3-59, 5-28, 5-33
  Reasonable compensation ... 5-29
Automobile expenses ... 3-38
Average rental period ... 4-14
Backdoor Roth conversions ... 2-29
Ballot initiatives ... 6-7
Base-year value transfers ... 10-8
Beneficial owners ... 5-6
Beneficiaries ... 10-4
  Application of SECURE Act ... 2-19
  Classifications (SECURE Act) ... 2-16
  Designated beneficiaries ... 2-21
  Disregarded ... 2-23
Bittner v. U.S. ... 5-38
Bonus depreciation ... 3-32
Business credit limitation ... 9-24
Business expenses ... 3-41
Business interest expense limitation ... 3-46
Business start-up expenses ... 3-52
Business vs. nonbusiness income ... 8-9
Business-to-business exemption ... 10-13
California first-time penalty abatement ... 8-4
California individual health care mandate ... 8-5
California method ... 8-12
California tax basis ... 6-8
CalKIDS college savings program ... 10-22
CalSavers ... 1-33, 9-42
Cannabis excise taxes ... 9-24
Capital gain (real estate sale) ... 4-5
Capital gains ... 1-8, 9-6
Capital losses ... 1-9
Casualty and theft losses ... 1-20
Centralized partnership audit regime ... 3-61
Certificate of mailing ... 10-7
Change in accounting method ... 3-25, 3-36
Charitable contributions ... 1-22
Clean electricity property ... 3-18
Clean vehicle ... 3-7
Clean Vehicle Credit ... 1-35
COD exclusion ... 1-12
Collection fees ... 10-7
College savings ... 1-55
College savings program ... 10-22
Commercial fisher exemption ... 10-14
Consent dividends ... 3-61
Consenting owners ... 9-4
Constructive dividends ... 3-56
Coronavirus-related IRA distributions ... 2-13
Corporate conversions ... 10-21
Corporate minimum tax ... 3-22
Corporate Transparency Act ... 5-4
Covered California ... 8-6
COVID-19 paid supplemental sick leave ... 6-14
CPAR ... 3-61
Credit card payments (1099-NEC) ... 5-3
Credit ordering rules ... 9-19
Credits
  Adoption Credit ... 1-30
  Alternative Fuel Vehicle Refueling
    Property Credit ... 3-10
  Business solar credit ... 3-14
  California Competes Tax Credit ... 6-15

California Earned Income Tax Credit 10-1
California Historic Rehabilitation Tax Credit ... 6-16
Cannabis Equity Tax Credit ... 9-26
Child and Dependent Care Credit... 1-28
Child Tax Credit... 1-27
Clean Electricity Production Credit ... 3-17
Clean Vehicle Credit... 1-35
College Access Tax Credit ... 6-13
Domestic content bonus credit... 3-16
Earned Income Credit ... 1-31
Earned Income Tax Credit... 1-32
Education credits ... 1-32
Energy Efficient Home Improvement Credit... 1-43
Energy Investment Tax Credit... 3-12
Equity Licensee Excise Tax Credit... 9-25
Foreign Tax Credit... 5-38
Foster Youth Tax Credit... 8-16
High Road Cannabis Tax Credit... 9-25
Homeless Hiring Tax Credit ...6-15, 10-1
Inflation Reduction Act energy credits ... 1-34
Main Street Small Business Credit...6-14, 10-1
New Energy Efficient Home Credit ... 3-11
Nonbusiness Energy Credit... 1-43
Other State Tax Credit...8-12, 9-20
Passthrough Entity Elective Tax Credit...9-1, 9-16, 9-20
Previously Owned Clean Vehicle Credit ... 1-41
Qualified Commercial Clean Vehicle Credit... 3-6
Renewable Electricity Production Tax Credit... 3-14
Research Credit... 3-28
Residential Clean Energy Credit ... 1-47
Saver's Credit ... 1-33
Selling credits ... 3-18
State Historic Rehabilitation Credit... 10-1
Tentative minimum tax credit limitation... 9-17
Workers' Tax Credit ... 6-16
Young Child Tax Credit... 8-15
Cryptocurrency ... 1-64
1040 question... 1-70
401(k) investment... 1-71
Accounting methods ... 1-70
FBAR regulations... 5-37
Nonfungible tokens... 1-66
Paying employees... 1-67
Payments... 1-66
Reporting guidance... 1-65, 1-72
Staking (cases)...1-71
Underreporting...1-74
Wash sale rules ...1-69
DeFi ...*See* Cryptocurrency
Delaware statutory trusts ...4-16
Delivery app drivers ...10-14
Dependent care assistance...1-7
Dependents... 1-1, 1-4
Depreciation ...3-47
Depreciation errors...3-35
Depreciation recapture (home sale) ...4-3
Disability (SECURE Act) ...2-21
Disabled Veterans' Exemption ...10-12
Disaster relief ...5-43
Dishonored payment penalty ...10-5
Disproportionate distributions...3-55
Doing business... 9-33, 9-35
Domestic content bonus credit ...3-16
Drug manufacturers...3-23
DSTs ...*See* Delaware statutory trusts
DSUE ...1-78
Education gifting ...1-80
Educator expenses...1-13
E-file rejections... 5-25, 6-17
Employee business losses...1-21
Employee Retention Credit... 3-1, 3-2
Employer Identification Numbers ...5-22
Employment tax... 9-29, 10-13
Energy community...3-17
Energy efficient commercial buildings deduction...3-8
Energy Efficient Home Improvement Credit... 1-43, 1-45
Energy Investment Tax Credit...3-12
E-signatures...5-21
Estate taxes ...1-74
Estimated tax payments ...9-18
Excess business losses...3-45, 7-7, 7-9
Excess sales tax reimbursements...10-18
Excise tax on drug manufacturers...3-23
Excise tax on stock buybacks ...3-21
Exclusions from income...1-12
Expiring tax provisions...1-56
Extended returns ...9-8
Fabrication labor...10-20
FATCA ...5-37
FBAR ...5-37
Federal deduction, passthrough entity tax....9-7

Federal worker classification rules 10-15
Filing enforcement fees 10-7
Filing extensions.. 10-7
Filing requirements.. 1-4
FinCEN identifier... 5-9
First-time penalty abatement 8-4
Foreign reporting 5-37
Foreign sourcing rules.................................. 5-39
Foreign Tax Credit regulations 5-38
Foreign treaties 5-40
Foreign withholding requirements 5-36
Foreign-earned income exclusion............... 5-36
Form changes.. 10-1
Forms
  1099 9-33
  1099-K 5-1
  1099-NEC 5-2
  1116 (exemption exception) 5-14
  3115 3-36
  3804 .... 9-8, 9-17
  3804-CR 9-17
  3893 9-13
  4709 10-2
  4709 ENS 10-2
  5498 2-2
  8300 1-73
  8978 3-62
  8986 3-61
  FBAR... 5-37
  FinCEN 114 5-37
  Schedule 1 4-15
  Schedule E.. 4-13
  Schedules K-2/K-3..................................... 5-11
FTB outreach campaigns.............................. 10-2
FUTA increase 9-40
Gift tax exclusion 1-79
Gift taxes... 1-74
Gross income adjustments........................... 1-13
Gross income items... 1-6
Guaranteed payments 9-5
Head of household flowchart........................ 1-3
Health care mandate....................................... 8-5
Health savings accounts............................... 1-15
Hemp businesses... 3-54
Hobby activities 1-10
Home mortgage interest 1-21
Home office.. 4-7
Home sale exclusion 4-1
HOMES retrofit rebates................................ 1-57
Household employers..................................1-54
I bonds..1-62
Incentive stock options 1-25
Inflation Reduction Act ....
  .... 1-34, 1-57, 2-36, 3-3, 3-21
Information Returns Intake System 5-3
Inherited residence 4-4
Intergenerational transfer changes.............10-8
Interstate commerce 9-35
Investment income 9-6
Investments 1-62, 4-17
IRA
  Allowable rollovers..................................2-31
  Contribution amounts 2-1
  Coronavirus-related distributions...........2-13
  Distributions..2-4
  Early withdrawal penalty.........................2-13
  Employer-sponsored plans 2-1
  Excess contributions...................................2-2
  Form 5498 2-2
  Inherited 2-6, 2-15
  Maximum deductible contributions 2-30
  Missed RMDs 2-6
  Plan limitation amounts 2-32
  Qualified charitable distributions 2-10
  Roth 2-24
IRS funding...5-32
IRS refund tool 5-35
IRS transcript codes......................................5-33
Itemized deduction phaseout 1-17
June 15 payment 9-10, 9-12
Jurisdictional nexus......................................5-38
Kiddie tax 1-5
Legal Ruling 2022-01 9-30
Like-kind exchanges.....................................4-17
Litigation settlements...................................10-7
LLC fee protective refund claims 10-4
LLC gross receipts fee 9-40
Loan forgiveness............................1-12, 7-1, 7-2
Long-term care insurance.............................1-19
Low-income taxpayers.................................8-15
Mandatory e-pay 9-14
Market-based sourcing rules........................9-30
Material participation 4-10
Meals and entertainment..............................3-41
Medical exemption (sales tax)....................10-20
Medical expenses...1-17
Medicare 2-34
  Inflation Reduction Act provisions.........2-36

Metropoulos Family Trust v. FTB 8-11
Middle Class Tax Refunds 8-1
Minimum wage increases 10-21
Miscellaneous itemized deductions 1-23
Mismatched withholding 10-3
Mortgage insurance premiums 1-22
Multistate entities (excess business loss) ... 7-10
Multistate Tax Commission 9-36
Multistate taxpayers (PPP loans) 7-5
Musselwhite v. Comm. 4-5
MyFTB account 10-6
MyFTB password expiration 10-6
Name control matching 5-25
Name, image, likeness income 1-6
Nanny tax 1-54
National Research Program audits 5-28
Net investment income tax 1-26
Net operating loss suspension 9-23
Net operating losses 3-43
New Energy Efficient Home Credit 3-11
Nexus 9-27
NFTs .... *See* Cryptocurrency
Nonfungible tokens 1-66
Nonqualified use (of residence) 4-1
Nonresident partners 8-7
Nonresident S corporation shareholders 8-8
Nonresident sole proprietors 9-37
Nonresident withholding 9-22
Offer-in-compromise 10-18
Ordinary income (real estate sale) 4-5
Out-of-state entities 9-33
P.L. 86-272 9-35
Parent/subsidiary 10-19
Partial property transfers 10-10
Partner notification (K-2/K-3) 5-13
Partnership interest sale 8-7
Partnership tax adjustments 3-63
Passive activity 4-10, 4-15
Passthrough entity tax 1-20, 3-50, 9-1, 9-7
  50% requirement 9-10
  Client letter 9-23
  Consenting owners 9-4
  Credit 9-16
  Credit and OSTC 9-20
  Credit ordering rules 9-19
  Debt-financed distributions 9-7
  Election 9-8
  Estimated tax payments 9-18
  Expense allocation 9-5
  Extended returns 9-8
  Federal deduction 9-7
  Fiscal-year taxpayers 9-11
  Guaranteed payments 9-5
  June 15 payment 9-10, 9-12
  Mandatory e-pay 9-14
  Multiple payments 9-13
  MyFTB 9-14
  New entities 9-11
  Nonresident withholding 9-22
  Overpayment 9-8, 9-9
  Paid in or paid for 9-11
  Payments 9-9, 9-13
  Qualified entity 9-2
  Qualified net income 9-4
  Qualified taxpayer 9-3
  Single-member LLCs 9-2, 9-4
  Sourcing income 9-6
  Superseding returns 9-8
  Trusts 9-4, 9-17
  Underpayment 9-9
Payroll taxes 9-27, 9-40
Penalties
  FBAR 5-37
  Schedule K-2/K-3 5-21
Per diem reimbursements 3-40
Per-owner penalties 9-34
Personal exemption deduction 1-1
Personal property rentals 4-14
Portability election 1-78
PPP loan forgiveness 7-2, 7-5
PPP loans (taxability) 3-2
Premium Tax Credit 1-49
  Affordability exemption 1-52
Previously Owned Clean Vehicle Credit ... 1-41
Private letter ruling 3-54
Property tax 10-7
Proposition 19 10-8
PTIN renewal 5-1
Qualified business income deduction 1-23
Qualified Commercial Clean Vehicle Credit 3-6
Qualified longevity annuity contracts 2-8
Qualified taxpayers (passthrough entity tax) ... 9-16
Qualifying child flowchart 1-2
Quick guide to California nonconformity 7-11
R&D credits 3-28
Real estate dealer versus investor 9-40
Real estate professional flowchart 4-12
Real estate professionals 4-9

Real estate sales 9-40
Real estate withholding 10-3
Reasonable compensation 3-56
Reasonable compensation audits 5-29
Remote workers 9-27
Renewable Electricity Production Tax Credit 3-14
Rental property reporting 4-13
Required minimum distributions 2-4, 2-6
  Proposd regulations 2-15
Research and experimental expenditures 3-23
Research Credit 3-28, 3-30
Research expenses 3-23, 3-47
Residential Clean Energy Credit 1-47
Residential energy property 1-45
Restaurant Revitalization Fund grants 7-6
Retirement plan limitation amounts 2-32
Retrofit property 3-9
Roth IRAs 2-24
S corporation asset sale 8-8
S corporation terminations 3-54
Sale of partnership interest 8-7
Sale of residence 4-1
Sales tax 10-17
SALT workaround 3-50
SB 113 9-1
Schedule 1 reporting 4-15
Schedule C PPP borrowers 7-5
Schedule CA 10-1
Schedule E reporting issues 4-13
Schedule K-3 requests 5-14
Schedule P 10-1
Schedules K-2/K-3 5-11
  Domestic filing exception 5-12
Secretary of State 10-21
SECURE Act 2-15
Self-employment tax 1-26
Selling credits 3-18
Series I Treasury bonds 1-62
Sezonov v. Comm. 4-9
Shareholder notification (K-2/K-3) 5-13
Shuttered Venue Operator Grants 7-6
Single-activity election 4-11
Social Security 2-33
Social Security deferral 1-26
Solar property 3-14, 10-7
SOS entity numbers 10-21
SOS filing fees 10-21
Spouses working in different states 8-11
Standard deduction 1-16
Standard mileage rate 3-38
Start-up expenses 3-52
State and local income taxes 1-19, 3-50
State of emergency extensions 10-17
Stock buybacks 3-21
Student loan forgiveness exclusion 1-12, 7-1
Student loan interest 1-14
Student loan payments 1-14
Subcontractor services 9-31
Superseding returns 5-31, 9-8
TAM 2022-01 9-36
Tax basis capital account reporting 6-8
Tax planning checklist 5-43
Tax Pro Account 5-35
Tenants in common like-kind exchange 4-18
Thrift store 10-17
Traditional IRAs 2-1
Transcript codes 5-33
Trucking industry 10-13
Trust taxes 1-74
Trusts 9-4, 9-17
  Designated beneficiary (SECURE Act) 2-21
  See-through trust 2-22
Turf replacement 6-12, 10-2
Uber/Lyft 10-14
Unclaimed property 6-9
Unified exclusion amount 1-74
Use tax overpayment 10-20
Used car dealers 10-18
Utility payment exclusion 6-12
Virtual currency .... *See* Cryptocurrency
Voluntary Disclosure Program 6-10
Voter registration checkboxes 6-18
Wage and apprenticeship requirements 3-4, 3-16
Wage exclusion (excess business loss) 7-9
Wages (cryptocurrency) 1-67
Wages subject to employment tax 9-29
Water and utility payments 6-12
Wayfair 9-35
Wildfire filing deadlines 10-7
Wildfire settlement exclusions 10-2
Wildfire settlements 6-11
Withholding credit 10-16
Work Sharing Program 10-15
Worker classification updates 10-13
Working in different states 8-11
Zeroing-out profits 3-58

©2022

This page intentionally left blank.

2022/2023 FEDERAL AND CALIFORNIA TAX UPDATE
PART I — CHAPTERS 1-5
Course description and study guide

Course objectives: Be prepared for the upcoming 2022-2023 filing season with this comprehensive review and critical analysis of essential issues in federal tax law and practice that have come up during the past year. Topics discussed include: filing requirements; name, image, likeness (NIL) income; student loan forgiveness exclusion; alternative minimum tax and credits; individual tax credits; Inflation Reduction Act energy incentives for individuals and businesses; Affordable Care Act; HOMES retrofit rebates; Treasury bonds; taxation of cryptocurrency; estate, trust, and gift taxes; traditional IRAs; inherited IRAs and proposed RMD regulations; Roth IRAs; Social Security and Medicare; proposed SECURE Act 2.0 legislation; Paycheck Protection Program and Employee Retention Credit lingering issues; research and development; IRC §179 and depreciation; business interest expense limitation; SALT workaround; business start-up expenses; centralized partnership audit regime (CPAR); sale of real estate; real estate professionals; Schedule E reporting issues; Delaware statutory trusts; new domestic filing exception to Schedules K-2/K-3; IRS audits; foreign tax issues; and much more.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

Recommended CPE Hours: CPAs — 6 Tax
EAs — 6 Federal Update
CRTPs — 6 Federal Update

Level: Update

Prerequisite: General tax preparation knowledge is required.

Advance Preparation: None

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, LLC® (Registry ID: 104931)

Expiration Date: December 2023*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

- Individuals
- Business
- Retirement
- Real Estate
- Practice and Procedures

Learning Objectives:

After completing this course, you will be able to:

- Recall the transition relief for the Clean Vehicle Credit for taxpayers who purchased a car before the Inflation Reduction Act was enacted
- Identify the types of property that qualify for the Residential Clean Energy Credit
- Recall how taxpayers should make repayments of deferred Social Security taxes
- Determine the calculation of required minimum distributions when the taxpayer owns multiple IRA accounts
- Recall the effect on the distribution ordering rules when a taxpayer makes a qualified charitable distribution
- Identify the wage and apprenticeship requirements applicable to the Energy Efficient Commercial Building deduction
- Identify what needs to be included in a valid R&D Credit refund claim
- Determine periods of nonqualified use for purposes of claiming the IRC §121 exclusion
- Recall differences between a Delaware statutory trust and a TIC 1031
- Identify directives under the new beneficial ownership reporting requirement enacted by the Corporate Transparency Act of 2019

After studying the materials, please answer exam questions 1-30.

2022/2023 FEDERAL AND CALIFORNIA TAX UPDATE
PART II — CHAPTERS 6-10
Course description and study guide

Course objectives: Be ready for the upcoming 2022-2023 filing season with this exhaustive review and analysis of important issues in California tax law and practice that have come up during the past year. Topics discussed include: middle class tax refunds; first-time penalty abatement; California's individual health care mandate; calculating the Other State Tax Credit (OSTC); California's PPP loan forgiveness partial conformity; student loan forgiveness; nonconformity issues; passthrough entity elective tax and credit; interplay between the OSTC and the Passthrough Entity Elective Tax Credit; net operating losses; cannabis businesses; remote workers; market-based sourcing rules; Public Law 86-272; CalSavers; tax basis capital account reporting; reporting unclaimed property on California tax returns; California like-kind exchanges; property tax; worker classification updates; CalKIDS college savings program; and much more.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

Recommended CPE Hours: CPAs — CPAs — 2 Tax
CRTPs — 2 CA Tax

Level: Update

Prerequisite: General tax preparation knowledge is required.

Advance Preparation: None

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, LLC® (Registry ID: 104931)

Expiration Date: December 2023*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

- California Legislation and Filing Issues
- California Conformity
- California Individuals
- California Business
- California Miscellaneous

Learning Objectives:

After completing this course, you will be able to:

- Identify differences between the federal and California first-time penalty abatement programs
- Determine taxable wages when one spouse lives in California and the other spouse lives in another state
- Recall where adjustments are made on the California return for taxpayers who don't meet the 25% gross receipts reduction threshold for PPP loans
- Recall how payment of the passthrough entity tax may effect mandatory e-pay requirements
- Identify the new reporting requirements for cannabis businesses
- Choose who must file an unclaimed property report

After studying the materials, please answer exam questions 1-10.

Course Evaluation for Spidell Publishing, LLC®

Program title: **2022/23 Federal and California Tax Update — Part I**

If applicable, program instructor: ____________________________

Program date: ______________ Participant name (optional): _____________________

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest rating.

1. Were the stated learning objectives met? ______________
2. If applicable, were prerequisite requirements appropriate and sufficient? ______________
3. Were the program materials accurate? ______________
4. Were program materials relevant, and did they contribute to the achievement of the learning objectives? ______________
5. Was the time allotted to the learning activity appropriate? ______________
6. If applicable, were the individual instructors knowledgeable and effective? _____________
7. Were the facilities and/or technological equipment appropriate? ______________
8. Were the handout and/or advanced preparation materials satisfactory? ______________
9. Were the audio and visual materials effective? ______________
10. Additional comments:
    ____
    ____
    ____

IRS Course Number (if applicable): CRA7E-U-00612-22-S

TTP (CTEC) Course Number (if applicable): 1019-CE-1204

Date course completed: ______________

Number of hours it took to complete the course: ______________

Course Evaluation for Spidell Publishing, LLC®

Program title: **2022/23 Federal and California Tax Update — Part II**

If applicable, program instructor: ____________________________

Program date: ______________ Participant name (optional): _____________________

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest rating.

1. Were the stated learning objectives met? ______________

2. If applicable, were prerequisite requirements appropriate and sufficient? ______________

3. Were the program materials accurate? ______________

4. Were program materials relevant, and did they contribute to the achievement of the learning objectives? ______________

5. Was the time allotted to the learning activity appropriate? ______________

6. If applicable, were the individual instructors knowledgeable and effective? _____________

7. Were the facilities and/or technological equipment appropriate? ______________

8. Were the handout and/or advanced preparation materials satisfactory? ______________

9. Were the audio and visual materials effective? ______________

10. Additional comments:
____
____
____

IRS Course Number (if applicable): N/A

TTP (CTEC) Course Number (if applicable): 1019-CE-1205

Date course completed: ______________

Number of hours it took to complete the course: ______________

P. O. Box 61044 • Anaheim, California 92803-6144 • *e-Mail:* cpe@spidell.com
***Phone:* (800) 277-2257 • *Fax:* (714) 776-9906 • *Web site:* http://www.spidell.com**

December 2022

Dear Customer:

Thank you for purchasing Spidell's 2022/2023 Federal and California Tax Update self-study or on-demand webinar. This course contains two exams that may be completed for continuing education credit: Part I (Chapters 1-5) qualifies for six hours of Federal Tax Update credit and Part II (Chapters 6-10) qualifies for two hours of California tax credit.

If you are an EA, you may only receive credit for completing Part I of the materials (six hours of Federal Tax Update credit). You may not receive credit for completing Part II of the materials (two hours of California tax credit) because the IRS does not recognize continuing education that is related to state taxes.

If you are a CRTP (CTEC), you may receive credit for completing both Part I and Part II of the materials. You will receive a certificate for each exam you complete, but you must complete both exams in order to receive the full eight hours of credit.

If you are a CPA, you may also receive credit for completing both Part I and Part II of the materials, but you must complete both exams in order to receive the full eight hours of tax credit.

You have one year from the date of purchase to complete the two exams for credit. If you are taking this course for information only and do not wish to receive credit then you may disregard this letter.

If you have any questions, please do not hesitate to call or e-mail our office using the contact information below.

Regards,

Melissa Vandenburg
Customer Service Manager
Spidell Publishing, LLC
P.O. Box 61044 | Anaheim, CA 92803
ph: 800-277-2257 | fax: 714-776-9906
Melissa@Spidell.com | https://cpe.spidell.com

Examination for Spidell's 2022/23 Federal and California Tax Update — Part I

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (21 of 30) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. Even if a taxpayer's gross income is not greater than their standard deduction, they must file a return if:
   - **a)** They had income tax withholding
   - **b)** They made estimated tax payments for the year
   - **c)** The taxpayer had net earnings from self-employment of at least $400
   - **d)** The taxpayer qualifies for the Earned Income Credit
2. For 2022, the Child Tax Credit is:
   - **a)** $2,000 per child
   - **b)** $3,000 per child
   - **c)** $3,600 for children under the age of six
   - **d)** $1,000 for a qualifying child who does not have a Social Security number
3. Details of the Clean Vehicle Credit include:
   - **a)** For purchases after August 16, 2022, the credit will apply, but the vehicle's final assembly point must be in North America
   - **b)** Applies to vehicles that are acquired for lease or resale
   - **c)** For vehicles placed in service after 2022, the battery must have a capacity of not less than four kilowatt hours
   - **d)** Vehicles must have a gross weight rating of less than 16,000 pounds
4. What are among the details of the Energy Efficient Home Improvement Credit?
   - **a)** It is a solar credit
   - **b)** The percentage of the credit for the installation of qualified energy efficient improvements has been increased from 10% to 25% of the total cost
   - **c)** The credit cap has been increased from a $500 lifetime cap to $1,000 annually
   - **d)** All items placed in service after 2024 for which the credit is claimed need a qualified product identification number that must appear on the taxpayer's return
5. Which of the following applies to the Residential Clean Energy Credit?
   - **a)** Unused credits can be carried over indefinitely
   - **b)** It is the Solar Energy Credit and only applies to solar property
   - **c)** The credit is limited by the taxpayer's AGI
   - **d)** It is refundable
6. A(n) ________ is an electronic device that enables an individual to make electronic transactions.
   - **a)** Hard fork
   - **b)** Digital wallet
   - **c)** Exchange
   - **d)** Blockchain

7. The IRS has proposed new regulations regarding the anti-clawback rule for the gift and estate tax basic exclusion when it goes back down to the $5 million inflation-adjusted amount in 2026 or sooner. Which of the following is not included in the IRS's list of exceptions to the anti-clawback rule?

   a) Transfers made by a promissory note, to the extent they remain unsatisfied upon the death of the decedent
   b) Gifts where the taxable amount is 5% of the total amount of the transfer, valued as of the date of such transfer
   c) Transfers made within three years of the decedent's death
   d) Life insurance policies on the decedent's life where the decedent retained specific incidents of ownership

8. Qualified longevity annuity contracts may be purchased with funds from any of the following except:

   a) Defined contribution plans
   b) Traditional IRAs
   c) 403(b) plans
   d) Inherited IRAs

9. Which choice represents an accurate rule for qualified charitable distributions?

   a) The distribution ordering rules are ignored for taxpayers making a QCD, and basis is distributed last
   b) QCDs are not considered distributions for purposes of required minimum distributions
   c) A charitable contribution deduction is allowed for QCDs
   d) The age at which taxpayers may make QCDs was increased from age 70½ to age 72 under the SECURE Act

10. Based on the SECURE Act, which choice reflects the correct distribution period in which an inherited IRA must be dispersed?

    a) If the account holder did not have a designated beneficiary: Life expectancy of the nondesignated beneficiary
    b) If the retirement account is a defined benefit plan: five years
    c) If the account holder died after December 31, 2019, and had an eligible designated beneficiary: 10 years
    d) If the account holder died before January 1, 2020, and had a designated beneficiary under pre-SECURE Act rules: 5 years

11. Under the proposed regulations modifying the SECURE Act, which of the following applies?

    a) The IRS has stated that the 10-year requirement for annual RMDs to designated beneficiaries of an inherited IRA won't apply until the 2023 distribution year
    b) The proposed regulations define "age of majority" to mean a person's 18th birthday
    c) Any defined benefit plan that used a prior permitted definition of "age of majority" can no longer apply that definition
    d) The proposed regulations provide that with a defined contribution plan, if an employee has a designated beneficiary who is considered an eligible designated beneficiary, the 10-year rule applies

12. What is true about Roth conversions?

    a) A conversion will not result in the assessment of tax
    b) Conversions and rollovers are the same because IRA funds are moved from one account to another
    c) Converting to a Roth IRA will not avoid having income in respect of a decedent upon the owner's death
    d) If a taxpayer converts only part of a traditional IRA to a Roth IRA, the distribution ordering rules will come into play

13. The cost of living adjustment for 2023 for Social Security and Supplemental Security Income beneficiaries is:

    a) 5.9%
    b) 6.5%
    c) 7.9%
    d) 8.7%

14. Which statement correctly describes some of the health care relief provided under the Inflation Reduction Act?

    a) Premium and co-pay assistance on prescription drugs has been expanded for low-income persons by providing full subsidies to seniors earning 135% to 150% of the federal poverty level for post-2022 plan years
    b) Out-of-pocket costs for prescription drugs is capped at $2,500 for individuals on Medicare
    c) Seniors covered by Medicare are provided with free vaccines 2023-2025
    d) Annual increases of Part D premiums for Medicare recipients are limited to 5% per year from 2024 through 2029

15. Beginning with the 2023 tax year, the energy efficient commercial building property (EECBP) deduction cap is:

    a) Five years
    b) Three years
    c) 10 years
    d) Lifetime

16. What are among the details of the Alternative Fuel Vehicle Refueling Property Credit?

    a) For 2022 and thereafter, any taxpayer that installs electric charging stations in their business or home are able to claim the credit
    b) For property placed in service after 2022, the 30% credit amount for depreciable property is reduced to 6% unless the taxpayer meets the wage and apprenticeship hour requirements
    c) The Inflation Reduction Act extended this credit through 2035
    d) The $30,000 per-location limit for depreciable property has been increased to $50,000

17. The New Clean Electricity Production Credit:

    a) Is equal to 1.3 cents per kilowatt hour
    b) Is subject to phase out beginning in 2026
    c) Will only apply to U.S. facilities for which the greenhouse gas emissions rate is less than zero
    d) May be claimed along with the IRC §48 Energy Investment Tax Credit

18. For tax years beginning after December 31, 2022, there is an increase in the available IRC §41 Research Credit that a small business can apply against their employer share of payroll taxes. For taxable years beginning after December 31, 2022, these businesses are also able to apply an additional ________ against their share of Medicare taxes.

    a) $500,000
    b) $250,000
    c) $150,000
    d) $100,000

19. What is considered qualified improvement property under the CARES Act?

    a) Building enlargement
    b) Internal structural framework of a building
    c) Improvements made by the taxpayer to the interior of a nonresidential building if the improvements are placed in service after the building is first placed in service
    d) Improvements to residential rental property

20. When comparing accountable and nonaccountable plans for business expense reimbursement, which of the following applies?

    a) Accountable plans must be written
    b) If a partner receives payment under a nonaccountable plan, the payment is classified as a guaranteed payment to the partner subject to self-employment tax
    c) When an employee is reimbursed under either plan, that amount paid is taxable compensation reported on the employee's W-2
    d) Accountable plans have just two requirements: the expense paid by the employee must have a business connection, and the employee must substantiate the expenses

21. Based on the year generated, which of the following applies to net operating loss treatment?
    - **a)** For post-2020 taxable years, there is an 80% taxable income limitation
    - **b)** For pre-2018 taxable years, carryforwards are indefinite
    - **c)** For 2018-2020, there is a two-year carryback period
    - **d)** For 2018-2020 taxable years, carryforwards are for 20 years
22. In the application of these deferral provisions, which is applied last?
    - **a)** Passive activity rules under IRC §469
    - **b)** At-risk rules under IRC §465
    - **c)** Excess business loss rules under IRC §461
    - **d)** Basis rules for S corporations and partnerships
23. Corporations are subject to a ________ accumulated earnings tax unless they can shows that there is a legitimate business reason for holding on to earnings in excess of their required operating expenses.
    - **a)** 10%
    - **b)** 12%
    - **c)** 15%
    - **d)** 20%
24. Which of the following correctly highlights a rule that applies to the home sale exclusion under IRC §121?
    - **a)** The home sale exclusion cannot be claimed if the taxpayer previously claimed it on a qualifying sale within three years from the date of the current sale
    - **b)** For married taxpayers, both spouses must meet the use test
    - **c)** The taxpayer's residence must be actual real estate
    - **d)** The exclusion applies per residence, not per taxpayer
25. As it pertains to the real estate professional test and the material participation test, what are among the details of making a single-activity election?
    - **a)** The election is made annually
    - **b)** The election is made by reporting the aggregated losses of various rental activities on the income tax return
    - **c)** The election makes it easier to meet the material participation test
    - **d)** All of the above
26. What are the pertinent factors pertaining to the use of a Delaware statutory trust (DST) as an investment vehicle?
    - **a)** With a Delaware trust, beneficiary-investors purchase an interest in the trust and hold title to property
    - **b)** DST investors have voting rights
    - **c)** DST investors must have a net worth exceeding $1 million
    - **d)** DST investors must be accredited
27. Under the Corporate Transparency Act's entity ownership reporting requirements, a beneficial owner is an individual who either exercises substantial control over the reporting company or who owns or controls at least ________ of the reporting company's ownership interests.
    - **a)** 10%
    - **b)** 25%
    - **c)** 40%
    - **d)** 50%
28. There is a Form 1116, Foreign Tax Credit, filing exemption if an individual partner or shareholder has less than ________ in foreign taxes paid on qualified income and claims the credit on Form 1040 instead.
    - **a)** $600
    - **b)** $500
    - **c)** $300
    - **d)** $200

29. What is included among the general rules for name control matching?

   a) On a joint return, if the taxpayers use different last names, the name control from the primary taxpayer's last name is used
   b) For taxpayer names that include "Van" or "Von" or "El" or "Al," for example, these are not considered part of the individual's name control
   c) The name control must include an apostrophe if the apostrophe is part of the taxpayer's name
   d) The name control generally consists of the first three characters of the individual's name

30. Which of the following is true about superseding returns?

   a) The date a superseding return is filed starts the running of the statute of limitation period
   b) Both business and 1040 superseding tax returns can be filed electronically
   c) They are not treated as original returns
   d) They cannot change an irrevocable election

Answer Sheet for Spidell's 2022/23 Federal and California Tax Update — Part I

Name: ______________________________ Signature: ____________________________

Company: ____

Address: ____

City/State/ZIP: ____

Phone: _____________________________ Fax: ________________________________

E-mail: ____

License/Registration No.: ____________ ☐ CPA ☐ EA ☐ CRTP (CTEC) ☐ Atty

PTIN: ___________

If you are an EA or CRTP (CTEC), we must have your PTIN in order to report your hours to the IRS.

Deadline to Complete the Course: *In accordance with NASBA and IRS requirements, you have one year from the date of purchase to complete the examination and submit it to our office for grading.*

This examination is designed to test your knowledge on the content of **Spidell's 2022/23 Federal and California Tax Update — Part I**. We will grade the answer sheet, and if you answer 70% or more of the questions correctly you will be sent a certificate of completion. Passing CPAs will be recommended for six hours of continuing education credit, and passing EAs and CRTPs will be recommended for six federal update tax hours of continuing education.

* Attorneys will be recommended for 5 hours of General MCLE/Tax Specialization credit.

To complete your exam: Go to https://cpe.spidell.com/ and login with your e-mail address and license number to complete your exam. Click on "view courses to be completed" then "start exam". When you are finished click "submit".

Or, fax your answer sheet to (714) 776-9906.

Final Exam Questions

1. ☐ **a)** They had income tax withholding
   ☐ **b)** They made estimated tax payments for the year
   ☐ **c)** The taxpayer had net earnings from self-employment of at least $400
   ☐ **d)** The taxpayer qualifies for the Earned Income Credit

2. ☐ **a)** $2,000 per child
   ☐ **b)** $3,000 per child
   ☐ **c)** $3,600 for children under the age of six
   ☐ **d)** $1,000 for a qualifying child who does not have a Social Security number

3. ☐ **a)** For purchases after August 16, 2022, the credit will apply, but the vehicle's final assembly point must be in North America
   ☐ **b)** Applies to vehicles that are acquired for lease or resale
   ☐ **c)** For vehicles placed in service after 2022, the battery must have a capacity of not less than four kilowatt hours
   ☐ **d)** Vehicles must have a gross weight rating of less than 16,000 pounds

4. ☐ **a)** It is a solar credit
   ☐ **b)** The percentage of the credit for the installation of qualified energy efficient improvements has been increased from 10% to 25% of the total cost
   ☐ **c)** The credit cap has been increased from a $500 lifetime cap to $1,000 annually
   ☐ **d)** All items placed in service after 2024 for which the credit is claimed need a qualified product identification number that must appear on the taxpayer's return

5. ☐ **a)** Unused credits can be carried over indefinitely
   ☐ **b)** It is the Solar Energy Credit and only applies to solar property
   ☐ **c)** The credit is limited by the taxpayer's AGI
   ☐ **d)** It is refundable

6. ☐ **a)** Hard fork
   ☐ **b)** Digital wallet
   ☐ **c)** Exchange
   ☐ **d)** Blockchain

7. ☐ **a)** Transfers made by a promissory note, to the extent they remain unsatisfied upon the death of the decedent
   ☐ **b)** Gifts where the taxable amount is 5% of the total amount of the transfer, valued as of the date of such transfer
   ☐ **c)** Transfers made within three years of the decedent's death
   ☐ **d)** Life insurance policies on the decedent's life where the decedent retained specific incidents of ownership

8. ☐ **a)** Defined contribution plans
   ☐ **b)** Traditional IRAs
   ☐ **c)** 403(b) plans
   ☐ **d)** Inherited IRAs

9. ☐ **a)** The distribution ordering rules are ignored for taxpayers making a QCD, and basis is distributed last
   ☐ **b)** QCDs are not considered distributions for purposes of required minimum distributions
   ☐ **c)** A charitable contribution deduction is allowed for QCDs
   ☐ **d)** The age at which taxpayers may make QCDs was increased from age 70½ to age 72 under the SECURE Act

10. ☐ **a)** If the account holder did not have a designated beneficiary: Life expectancy of the nondesignated beneficiary
    ☐ **b)** If the retirement account is a defined benefit plan: five years
    ☐ **c)** If the account holder died after December 31, 2019, and had an eligible designated beneficiary: 10 years
    ☐ **d)** If the account holder died before January 1, 2020, and had a designated beneficiary under pre-SECURE Act rules: 5 years

11. ☐ **a)** The IRS has stated that the 10-year requirement for annual RMDs to designated beneficiaries of an inherited IRA won't apply until the 2023 distribution year
☐ **b)** The proposed regulations define "age of majority" to mean a person's 18th birthday
☐ **c)** Any defined benefit plan that used a prior permitted definition of "age of majority" can no longer apply that definition
☐ **d)** The proposed regulations provide that with a defined contribution plan, if an employee has a designated beneficiary who is considered an eligible designated beneficiary, the 10-year rule applies

12. ☐ **a)** A conversion will not result in the assessment of tax
☐ **b)** Conversions and rollovers are the same because IRA funds are moved from one account to another
☐ **c)** Converting to a Roth IRA will not avoid having income in respect of a decedent upon the owner's death
☐ **d)** If a taxpayer converts only part of a traditional IRA to a Roth IRA, the distribution ordering rules will come into play

13. ☐ **a)** 5.9%
☐ **b)** 6.5%
☐ **c)** 7.9%
☐ **d)** 8.7%

14. ☐ **a)** Premium and co-pay assistance on prescription drugs has been expanded for low-income persons by providing full subsidies to seniors earning 135% to 150% of the federal poverty level for post-2022 plan years
☐ **b)** Out-of-pocket costs for prescription drugs is capped at $2,500 for individuals on Medicare
☐ **c)** Seniors covered by Medicare are provided with free vaccines 2023-2025
☐ **d)** Annual increases of Part D premiums for Medicare recipients are limited to 5% per year from 2024 through 2029

15. ☐ **a)** Five years
☐ **b)** Three years
☐ **c)** 10 years
☐ **d)** Lifetime

16. ☐ **a)** For 2022 and thereafter, any taxpayer that installs electric charging stations in their business or home are able to claim the credit
☐ **b)** For property placed in service after 2022, the 30% credit amount for depreciable property is reduced to 6% unless the taxpayer meets the wage and apprenticeship hour requirements
☐ **c)** The Inflation Reduction Act extended this credit through 2035
☐ **d)** The $30,000 per-location limit for depreciable property has been increased to $50,000

17. ☐ **a)** Is equal to 1.3 cents per kilowatt hour
☐ **b)** Is subject to phase out beginning in 2026
☐ **c)** Will only apply to U.S. facilities for which the greenhouse gas emissions rate is less than zero
☐ **d)** May be claimed along with the IRC §48 Energy Investment Tax Credit

18. ☐ **a)** $500,000
☐ **b)** $250,000
☐ **c)** $150,000
☐ **d)** $100,000

19. ☐ **a)** Building enlargement
☐ **b)** Internal structural framework of a building
☐ **c)** Improvements made by the taxpayer to the interior of a nonresidential building if the improvements are placed in service after the building is first placed in service
☐ **d)** Improvements to residential rental property

20. ☐ **a)** Accountable plans must be written
☐ **b)** If a partner receives payment under a nonaccountable plan, the payment is classified as a guaranteed payment to the partner subject to self-employment tax
☐ **c)** When an employee is reimbursed under either plan, that amount paid is taxable compensation reported on the employee's W-2
☐ **d)** Accountable plans have just two requirements: the expense paid by the employee must have a business connection, and the employee must substantiate the expenses

21. ☐ **a)** For post-2020 taxable years, there is an 80% taxable income limitation
☐ **b)** For pre-2018 taxable years, carryforwards are indefinite
☐ **c)** For 2018-2020, there is a two-year carryback period
☐ **d)** For 2018-2020 taxable years, carryforwards are for 20 years

22. ☐ **a)** Passive activity rules under IRC §469
☐ **b)** At-risk rules under IRC §465
☐ **c)** Excess business loss rules under IRC §461
☐ **d)** Basis rules for S corporations and partnerships

23. ☐ **a)** 10%
☐ **b)** 12%
☐ **c)** 15%
☐ **d)** 20%

24. ☐ **a)** The home sale exclusion cannot be claimed if the taxpayer previously claimed it on a qualifying sale within three years from the date of the current sale
☐ **b)** For married taxpayers, both spouses must meet the use test
☐ **c)** The taxpayer's residence must be actual real estate
☐ **d)** The exclusion applies per residence, not per taxpayer

25. ☐ **a)** The election is made annually
☐ **b)** The election is made by reporting the aggregated losses of various rental activities on the income tax return
☐ **c)** The election makes it easier to meet the material participation test
☐ **d)** All of the above

26. ☐ **a)** With a Delaware trust, beneficiary-investors purchase an interest in the trust and hold title to property
☐ **b)** DST investors have voting rights
☐ **c)** DST investors must have a net worth exceeding $1 million
☐ **d)** DST investors must be accredited

27. ☐ **a)** 10%
☐ **b)** 25%
☐ **c)** 40%
☐ **d)** 50%

28. ☐ **a)** $600
☐ **b)** $500
☐ **c)** $300
☐ **d)** $200

29. ☐ **a)** On a joint return, if the taxpayers use different last names, the name control from the primary taxpayer's last name is used
☐ **b)** For taxpayer names that include "Van" or "Von" or "El" or "Al," for example, these are not considered part of the individual's name control
☐ **c)** The name control must include an apostrophe if the apostrophe is part of the taxpayer's name
☐ **d)** The name control generally consists of the first three characters of the individual's name

30. ☐ **a)** The date a superseding return is filed starts the running of the statute of limitation period
☐ **b)** Both business and 1040 superseding tax returns can be filed electronically
☐ **c)** They are not treated as original returns
☐ **d)** They cannot change an irrevocable election

Examination for Spidell's 2022/23 Federal and California Tax Update — Part II

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (7 of 10) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. Which choice correctly pertains to tax basis capital account reporting?
   - **a)** The requirement to provide the partners' and members' capital account using California tax basis does not apply to small partnerships, which among other conditions, must have less than $250,000 in gross revenue for the tax year
   - **b)** For California purposes, taxpayers may not use the federal tax basis figure reported on their federal return
   - **c)** California does not recognize the safe harbors the IRS allows for partnerships to recreate tax basis on their federal return
   - **d)** The issue of PPP loan forgiveness does not impact California tax basis when comparing it to federal tax basis
2. Which of these is a condition that still allows for participation in the Unclaimed Property Voluntary Disclosure Program?
   - **a)** The business must have been notified of an unclaimed property audit
   - **b)** The business may be involved in a civil prosecution related to the unclaimed property
   - **c)** The business has an unpaid interest assessment from a notice issued within the last five years
   - **d)** The business has had no interest assessment waived within the last five years
3. For Restaurant Revitalization Fund grants, which of the following is false?
   - **a)** California fully conforms to federal treatment of these grants
   - **b)** There is a 25% gross reduction threshold to qualify to fully deduct expenses paid with these grants
   - **c)** Funds from these grants are excludable from gross income
   - **d)** Expenses paid with the grants are fully deductible
4. What are among the differences/similarities between federal and California first-time penalty abatement?
   - **a)** California's program is only available for one tax year
   - **b)** Both programs apply to individuals and businesses
   - **c)** Requests may not be made orally for both the federal and California programs
   - **d)** California's program applies to late-filing and failure-to-file penalties

5. When apportioning business income, the apportionment formula's sales factor measures the activity of a business in a state (the numerator) in relation to its activities throughout all states in which it operates (the denominator). A business must include all of its gross receipts in the calculation except for an "occasional" sale that generates "substantial" receipts. A sale is "substantial" if excluding the gross receipts results in at least a ________ decrease in the sales factor denominator.

   a) 20%
   b) 15%
   c) 10%
   d) 5%

6. Which choice is true based on this example of making the passthrough entity tax election?

   Pickle Paddles, Inc. is a California S corporation with qualified net income of $420,000. Jill and Jon each hold a 50% interest, and they qualify and make the passthrough entity tax election.

   a) Jon and Jill each make a payment to the FTB of $19,530
   b) The California returns filed by each partner will report $380,940 of net income from Pickle Paddles
   c) Pickle Paddles makes a payment to the FTB of $39,060, and deducts that amount on their federal return
   d) Each shareholder's net income reported on their Schedule K-1 is $210,000

7. Under California law, credits are taken in a specific order, with which of these credits coming last as of the beginning of the 2022 taxable year?

   a) The minimum tax credit
   b) Passthrough Entity Elective Tax Credit
   c) New Employment Credit
   d) Credits that contain refundable provisions but no carryover provisions

8. Under AB 195, all of the following are provided for cannabis tax relief except:

   a) There is a new income tax credit for qualified cannabis business taxpayers
   b) The CDTFA is prohibited from increasing the cannabis excise tax rate for two years
   c) The cannabis cultivation tax is repealed effective July 1, 2022
   d) A new Cannabis Equity Tax Credit is enacted against personal income and corporation franchise and income taxes

9. The Board of Equalization has adopted emergency rules to clarify intergenerational property transfer changes. Which statement correctly clarifies what is among these changes?

   a) A parent-child/grandparent-grandchild transferee is eligible for a refund of overpaid taxes if they file a claim for the exclusion and filed the homeowners' exemption within two years of the transfer of the family home
   b) A qualifying principal residence includes property owned by a decedent's estate, held either directly or through a trust, if the residence was the decedent's primary residence immediately prior to their death
   c) If a transfer involves a parcel of land that contains both a principal residence and a family farm, there is only one exclusion that applies
   d) If after a parent-child transfer, the child uses the home as their primary residence but fails to file the homeowners' exemption, they will still qualify for a refund of any increased taxes paid without limitation

10. In this example, what is the new base-year value of the replacement primary residence?

    The base-year value of Charlie's original primary residence is $500,000. Charlie sells this residence for $800,000 on July 1, 2021. He purchases a replacement property for $900,000 on September 1, 2021.

    a) $900,000
    b) $840,000
    c) $560,000
    d) $500,000

Answer Sheet for Spidell's 2022/23 Federal and California Tax Update — Part II

Name: ______________________________ Signature: ____________________________

Company: ____

Address: ____

City/State/ZIP: ____

Phone: _____________________________ Fax: ________________________________

E-mail: ____

License/Registration No.: ____________ ☐ CPA ☐ CRTP (CTEC) ☐ Atty

Deadline to Complete the Course: *In accordance with NASBA requirements, you have one year from the date of purchase to complete the examination and submit it to our office for grading.*

This examination is designed to test your knowledge on the content of **Spidell's 2022/23 Federal and California Tax Update — Part II**. We will grade the answer sheet, and if you answer 70% or more of the questions correctly you will be sent a certificate of completion. Passing CPAs will be recommended for two hours of continuing education credit, and passing CRTPs will be recommended for two California hours of continuing education.

* Attorneys will be recommended for 1.75 hours of general MCLE credit.

To complete your exam: Go to https://cpe.spidell.com/ and login with your e-mail address and license number to complete your exam. Click on "view courses to be completed" then "start exam". When you are finished click "submit".

Or, fax your answer sheet to (714) 776-9906.

Final Exam Questions

1. ☐ **a)** The requirement to provide the partners' and members' capital account using California tax basis does not apply to small partnerships, which among other conditions, must have less than $250,000 in gross revenue for the tax year
   ☐ **b)** For California purposes, taxpayers may not use the federal tax basis figure reported on their federal return
   ☐ **c)** California does not recognize the safe harbors the IRS allows for partnerships to recreate tax basis on their federal return
   ☐ **d)** The issue of PPP loan forgiveness does not impact California tax basis when comparing it to federal tax basis

2. ☐ **a)** The business must have been notified of an unclaimed property audit
   ☐ **b)** The business may be involved in a civil prosecution related to the unclaimed property
   ☐ **c)** The business has an unpaid interest assessment from a notice issued within the last five years
   ☐ **d)** The business has had no interest assessment waived within the last five years

3. ☐ **a)** California fully conforms to federal treatment of these grants
   ☐ **b)** There is a 25% gross reduction threshold to qualify to fully deduct expenses paid with these grants
   ☐ **c)** Funds from these grants are excludable from gross income
   ☐ **d)** Expenses paid with the grants are fully deductible

4. ☐ **a)** California's program is only available for one tax year
   ☐ **b)** Both programs apply to individuals and businesses
   ☐ **c)** Requests may not be made orally for both the federal and California programs
   ☐ **d)** California's program applies to late-filing and failure-to-file penalties

5. ☐ **a)** 20%
   ☐ **b)** 15%
   ☐ **c)** 10%
   ☐ **d)** 5%

6. ☐ **a)** Jon and Jill each make a payment to the FTB of $19,530
   ☐ **b)** The California returns filed by each partner will report $380,940 of net income from Pickle Paddles
   ☐ **c)** Pickle Paddles makes a payment to the FTB of $39,060, and deducts that amount on their federal return
   ☐ **d)** Each shareholder's net income reported on their Schedule K-1 is $210,000

7. ☐ **a)** The minimum tax credit
   ☐ **b)** Passthrough Entity Elective Tax Credit
   ☐ **c)** New Employment Credit
   ☐ **d)** Credits that contain refundable provisions but no carryover provisions

8. ☐ **a)** There is a new income tax credit for qualified cannabis business taxpayers
   ☐ **b)** The CDTFA is prohibited from increasing the cannabis excise tax rate for two years
   ☐ **c)** The cannabis cultivation tax is repealed effective July 1, 2022
   ☐ **d)** A new Cannabis Equity Tax Credit is enacted against personal income and corporation franchise and income taxes

9. ☐ **a)** A parent-child/grandparent-grandchild transferee is eligible for a refund of overpaid taxes if they file a claim for the exclusion and filed the homeowners' exemption within two years of the transfer of the family home
   ☐ **b)** A qualifying principal residence includes property owned by a decedent's estate, held either directly or through a trust, if the residence was the decedent's primary residence immediately prior to their death
   ☐ **c)** If a transfer involves a parcel of land that contains both a principal residence and a family farm, there is only one exclusion that applies
   ☐ **d)** If after a parent-child transfer, the child uses the home as their primary residence but fails to file the homeowners' exemption, they will still qualify for a refund of any increased taxes paid without limitation

10. ☐ **a)** $900,000
    ☐ **b)** $840,000
    ☐ **c)** $560,000
    ☐ **d)** $500,000