2020/21 Federal and California Tax Update

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2020/2021 FEDERAL AND CALIFORNIA TAX UPDATE
PART I — CHAPTERS 1-6

Course objectives: This update provides a thorough review and analysis of essential issues in federal tax law and practice that have developed during the past year and prepares tax professionals for the upcoming 2020-2021 filing season. Topics addressed include: economic impact payments; charitable contributions; unemployment compensation; kiddie tax rules; business vs. nonbusiness bad debts; virtual currency transactions; alimony; student loan interest; individual tax credits; maximizing qualified business income on the 1040; Families First Coronavirus Response Act (FFCRA); employment benefits related to COVID-19; mandatory paid sick leave and paid family leave; Employee Retention Credit; payroll tax credits and deferral; net operating losses; CARES Act; excess business losses; IRC §179 and depreciation; IRC §199A; partner capital accounts; business interest limitation; SECURE Act; qualifying coronavirus-related distributions from retirement accounts; IRA-to-charity rules; required minimum distributions; estate, trust, and gift taxes; like-kind exchanges; Qualified Opportunity Funds; foreign tax issues; forms and filing updates; and much more.

After completing this course, you will be able to:

- Recall who is ineligible for an economic impact payment
- Identify the order in which debt is considered repaid under the rules for home mortgages
- Choose expenses that are eligible for §529 distributions
- Recall the employer's responsibility when an employee requests a Social Security tax deferral
- Determine how employer payroll credits work under the FFCRA
- Recall what is included in wages for purposes of the Employee Retention Credit
- Identify the two safe harbors for determining tax basis capital accounts for partnerships
- Choose the retirement accounts from which a penalty-free coronavirus-related distribution may be made
- Recall how the CARES Act affects inherited retirement accounts
- Determine whether a long-time, part-time employee is eligible to participate in an employer-sponsored 401(k) plan
- Identify deductible administrative costs for estates and trusts
- Recall IRS-provided relief for Qualified Opportunity Funds and their investors

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 2021

2020/2021 FEDERAL AND CALIFORNIA TAX UPDATE
PART II — CHAPTERS 7-11

Course objectives: This course provides a comprehensive review and analysis of key issues in California tax law and regulations that developed during the past year and will prepare tax professionals for the upcoming California 2020-2021 filing season. Topics include: individual health care mandate; residency issues, including changing California residency/domicile; Earned Income Tax Credit; electric vehicle rebates; calculating S corporation shareholder basis; dissolving with the SOS; administrative dissolutions; CalSavers; excess business loss limitation; multistate business issues; "doing business" in California; cannabis businesses; net operating losses; AB 5; revocable transfer on death deeds; COVID-19 conformity; SECURE Act; Quick Guide to California Nonconformity for Taxable Year 2020; property taxes; disaster victims; and much more.

After completing this course, you will be able to:

- Determine the individual share responsibility penalty for a family of four that remains uninsured for the entire year
- Recall who is exempt from the requirement to have health care coverage
- Identify whether a California domiciliary is out of the state for a temporary or transitory purpose
- Recall how to deal with passthrough losses in excess of a shareholder's basis
- Identify the three conditions under which the FTB will not assess the $800 minimum franchise tax
- Identify the entities that are eligible for administrative dissolution
- Recall how the FTB treats workers telecommuting due to COVID-19
- Determine how to file tax returns for taxpayers who are independent contractors for federal purposes and employees for California purposes

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 2021

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Table of Contents

List of Chapters

Chapter 1 — Individuals

Chapter 2 — Practice and Procedures

Chapter 3 — Paycheck Protection Program

Chapter 4 — Business

Chapter 5 — Retirement

Chapter 6 — Miscellaneous

Chapter 7 — California Legislation and Filing Issues

Chapter 8 — California Conformity

Chapter 9 — California Individuals

Chapter 10 — California Business

Chapter 11 — California Miscellaneous

Chapter 12 — Practitioner Aids

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Chapter 1

Individuals

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INDIVIDUALS

NEW LEGISLATION

ECONOMIC IMPACT PAYMENTS (CARES ACT)

Under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the IRS automatically sent out economic impact payments (also called "EIPs" or "stimulus checks") to taxpayers starting in April 2020. (CARES Act §2201; IRC §6428(f)(3)) If the IRS had the taxpayer's direct deposit information on file, then the payments were directly deposited into the taxpayer's bank account.

Payments not subject to tax

Economic impact payments are treated as an advance against a 2020 federal tax credit. Therefore, they are not taxable for federal or state purposes.

Payment amounts

The base credit amount is:

- $1,200 per qualifying individual ($2,400 for married taxpayers filing jointly); plus
- $500 per qualifying child (defined under IRC §152(c)) under the age of 17. (CARES Act §2201; IRC §6428)

The amount of the credit is phased out (but not below zero) by 5% of every dollar by which the taxpayer's AGI exceeds the AGI thresholds (or $5 for every $100 over the AGI threshold) in the following chart. (CARES Act §2201; IRC §6428(a) and (c))

Economic Impact Payment AGI and Phaseout Levels		
Filing status	**Phaseout begins at AGI of …**	**Credit phased out at …**
Married filing joint	$150,000	$198,000 if no children (add $10,000 for each qualified child)
Head of household	$112,500	$146,500 if one child (add $10,000 for each additional qualified child)
Single and MFS	$75,000	$99,000

AGI based on 2019 or 2018 returns

The AGI amounts are based on a taxpayer's 2019 income tax return. If the taxpayer's 2019 income tax return had not yet been filed at the time the payment was made by the IRS, then the taxpayer's 2018 AGI was used. (CARES Act §2201; IRC §6428(f)(5))

Credit reconciliation on 2020 return

Taxpayers must reconcile the amount of the advanced credit received with the amount the taxpayer is due, based on the taxpayer's 2020 income. This is similar to the premium tax credit reconciliation. However, unlike the premium tax credit reconciliation, no repayment is necessary. (CARES Act §2201; IRC §6248(e)) This means taxpayers will not be required to repay any credit, even if their 2020 income was higher than 2018 or 2019.

Example #1 of credit reconciliation

Daniel is single and has no children. In April 2020, he received an economic impact payment of $1,200 based on his 2019 AGI, which was $70,000. Daniel's 2020 AGI is $105,000. Because Daniel's 2020 AGI is over the top of the phaseout range ($99,000 for a single filer), his actual credit amount is zero. Under the CARES Act, he is not required to repay any of the $1,200 advanced credit.

However, assume Daniel's AGI went the other direction, where his AGI was over the top of the phaseout range in 2018 or 2019 (whichever one the IRS used to calculate his payment out in April 2020), then his 2020 AGI was below the phaseout threshold. In this scenario, Daniel can claim the $1,200 credit on his 2020 income tax return.

Example #2 of credit reconciliation

Craig is single and has no children. In April 2020, he received an economic impact payment of $700 based on his 2019 AGI, which was $85,000. Craig's 2020 AGI is $60,000. Because Craig's 2020 AGI is below the phaseout threshold ($75,000 for a single filer), his actual credit amount is $1,200. Under the CARES Act, he will receive an additional credit of $500 when he files his 2020 income tax return.

Example #3 of credit reconciliation

Ben and Naomie are married and at the time they received their economic impact payment in May 2020, they had no children. They received the full economic impact payment of $2,400 based on their 2019 AGI of $120,000.

On December 29, 2020, Naomie gave birth to twins. Ben and Naomie's 2020 AGI is still under the phaseout threshold for 2020, so they are entitled to an additional economic impact payment of $1,000 ($500 for each of their two children) when they file their 2020 income tax return.

Joint filers

If a married couple filed a joint return in 2019 (or 2018), then each spouse is treated as having received half the credit for reconciliation purposes. If they file a married filing separate return or a single return in 2020 due to a divorce or separation, they would each be treated as receiving 50% of the credit prepayment.

☑ Planning Pointer

Taxpayers who did not receive a full economic stimulus payment in 2020 should consider reducing income in 2020 to increase the payment. For example, they should consider making IRA or pension payments that will reduce income while contributing to retirement. Additionally, married taxpayers should review the effect that filing a joint return can have on their economic impact payment credit on their 2020 income tax return.

Example of married filing separate or married filing joint

Alexei and Marla are married and typically file separately. Neither Alexei nor Marla received an economic impact payment in 2020 because they each had AGI over the top of the phaseout range for 2018 and 2019.

In 2020, Alexei's AGI is $60,000 (below the phaseout threshold) and Marla's AGI is $85,000 (within the phaseout threshold). Using the threshold for married taxpayers filing separately, Alexei will get an economic impact payment of $1,200 when he files his 2020 income tax return. Marla will receive $700 ($1,200 − ($85,000 − $75,000) × 0.05).

However, if they file a joint return for 2020, their combined AGI will be $145,000 and they will receive the full economic impact payment of $2,400. In this scenario, married filing joint will provide them with an additional economic impact payment of $500 over married filing separate.

Erroneous payments

The IRS has stated that taxpayers who received economic impact payments erroneously must return them; however, they have not released any official guidance on this subject. Informal FAQs posted to the IRS website provided that payments made to a taxpayer who died before receipt of the payment should be returned to the IRS. The FAQ provided that the entire payment must be returned unless it was made to joint filers and one spouse had not died before receipt of the payment. If one spouse was still living, then the surviving spouse was only required to return the portion of the payment attributable to the deceased spouse ($1,200).

As of publication, it is still unclear whether the IRS has the legal authority to demand repayment of erroneous economic impact payments, especially where the payment was made to a taxpayer who would have qualified for the payment based on their 2018 or 2019 income tax return.

Example #1 of erroneous payment

Omar is single and claims his 80-year-old mother as a dependent on his 2019 and 2020 returns. His AGI is $70,000. His mother lives in a nursing home, and she had $11,000 of Social Security benefit income in 2019. She most likely would have received a $1,200 payment.

Omar doesn't receive an economic impact payment for claiming his mother as a dependent because she's older than age 17. Taxpayers without a filing requirement receive their economic impact payment based on their current Form 1099-SSA or Form 1099-RRB. But Omar's mother is not eligible to receive an economic impact payment because she is Omar's dependent.

Unanswered question: If Omar's mother erroneously received an economic impact payment, will she be required to return it?

Example #2 of erroneous payment

Luka is 72 years old and single. Her adjusted gross income, including Social Security benefits and other income, would be over the top of the economic impact payment phaseout range ($99,000), but she did not file her 2018 or 2019 income tax returns.

But, because she receives Social Security, she should have automatically received a $1,200 payment, even though she doesn't qualify.

Unanswered question: Will Luka be required to repay the $1,200?

Notice informing taxpayers of their economic impact payment

The IRS should have sent a Notice 1444, Your Economic Impact Payment, to the taxpayer's last known address within 15 days of distributing an economic impact payment. The notice stated how the payment was made (electronic funds transfer or check), the amount of the payment, and a phone number to call at the IRS if the payment wasn't received.

✐ Practice Pointer

Ask your clients for a copy of the Notice 1444 they received regarding their economic impact payments. Tax professionals must know the amount of the payment received by their clients in order to accurately reconcile the credit on the client's 2020 income tax return.

Social Security numbers required

The credit, including the advance credit, is only available to taxpayers with Social Security numbers (the act references IRC §24(h)(7), which states ITINs are not sufficient). For taxpayers filing a joint return and/or claiming a dependent qualifying child, the return must also include the spouse's Social Security number and any qualifying child's Social Security number if they are included on the 2019 (or 2018) return. The only exceptions are:

- If one spouse is a member of the Armed Forces, then a Social Security number need only be provided for one of the spouses; and
- If the credit is taken for a qualifying child who is adopted or placed for adoption, the adoption taxpayer identification number should be used.
(CARES Act §2201; IRC §6428(g))

Ineligible taxpayers

The credit is not available to:

- Nonresident aliens (however, a U.S. citizen working abroad qualifies);
- Individuals who may be claimed as a dependent on another person's tax return (even if they are not actually claimed);
- Estates or trusts; and
- Business entities.

Offsets and reductions prohibited

Any credit or refund of the rebate is not subject to reduction or offset for:

- Debts owed to other federal agencies, including student loan interest;
- State income tax deficiencies;
- Unemployment compensation overpayments; or
- Federal taxes that would otherwise be subject to levy or collection. (CARES Act §2201(d))

> ***Comment***
>
> The only administrative offset that will be enforced applies to those who have past due child support payments that the states have reported to the Treasury Department.

> ***Responses to common questions about these payments***
>
> **Q: What if my client's AGI for 2019 was below the AGI limits and they received a payment, but their AGI for 2020 was above the AGI limit? Will they be required to pay back the amount they received with their 2020 return?**
>
> A: No, excess payments will not have to be refunded.
>
> **Q: My client's 2019 return was filed and accepted, but they received a payment based on the AGI reported on the 2018 return. Why did this happen?**
>
> A: It is unclear what date the IRS used as a cutoff for processing these payments, and with workforce shortages, facility closures, and other issues slowing down processing, it is not surprising that this happened to a number of taxpayers. Regardless of what year's AGI was used to issue the payment, the amount will be reconciled on the 2020 return based on the 2020 AGI (although nothing will have to be paid back).
>
> **Q: What should dependents over age 17 do? Do they not qualify for any payments?**
>
> A: There is nothing they can do. Only the parents of children under age 17 who are dependents get the $500 dependent credit. Older dependents do not qualify if they were dependents of their parents and claimed on the tax return. However, a taxpayer who was a dependent of another taxpayer in 2018 or 2019 but is no longer a dependent in 2020 will still be able to claim the credit on their 2020 income tax return.
>
> **Q: My client received an additional $500 payment in 2020 for a qualifying child. However, the child just turned age 17. Will the client be required to pay back the $500 next year when I prepare their 2020 tax return?**
>
> A: No, there is no provision in the law requiring repayment of a payment. Taxpayers won't be required to repay any payment when filing their 2020 tax return even if their qualifying child turns age 17 in 2020.
>
> **Q: My ex-spouse and I claim our child as a dependent in alternating years. My ex-spouse received a $500 economic impact payment for our child in April 2020 based on her 2019 tax return. Can I also claim a $500 economic impact payment credit for the same child when I file my 2020 income tax return because our child will be my dependent in 2020?**
>
> A: Yes, even though this results in two $500 credits for the same child (one to each parent). (IRS FAQs, question J3, www.irs.gov/newsroom/economic-impact-payment-information-center-reconciling-on-your-2020-tax-return#collapseCollapsible1600269038995)

Economic impact payments and nursing homes

The IRS has provided notice to nursing homes and other care facilities that economic impact payments generally belong to the individual taxpayer, not the organization providing care to the taxpayer. (IR-2020-21)

Economic impact payments are intended for the individual taxpayer, even if a nursing home or other facility or provider receives the person's payment as a representative payee, either directly or indirectly by direct deposit or check.

As part of the same notification to nursing homes, the Social Security Administration noted that under the Social Security Act, a representative payee is only responsible for managing Social Security or Supplemental Security Income (SSI) benefits. Representative payees should discuss the economic impact payment with the beneficiary. If the beneficiary wants to use the economic impact payment independently, the representative payee must provide the economic impact payment to the beneficiary. The SSA has more information on this at:

Website
www.ssa.gov/coronavirus/#reppayee

Practice Pointer

Adult children who manage their elderly parent's tax filings when the parent is in a nursing home should inquire with the nursing home about any economic impact payments received by their elderly parent. If the payment went directly to the nursing home, the adult child may not know about it without taking affirmative steps to inquire with the nursing home and/or the IRS.

Economic impact payments don't count as income for benefit programs

Economic impact payments do not count as a resource for purposes of determining eligibility for Medicaid and other federal programs for a period of 12 months from receipt. (IR-2020-21) Economic impact payments also do not count as income in determining eligibility for these programs.

See pages 1-6A and 1-6B.

CHARITABLE CONTRIBUTIONS

Limited above-the-line contribution deduction for 2020

The CARES Act provides that an individual who doesn't itemize deductions may take an above-the-line qualified charitable contribution of up to $300 in cash contributions for the 2020 taxable year. (CARES Act §2204; IRC §62(a)(22)) Normal substantiation requirements must be met whether a taxpayer deducts contributions above-the-line or as an itemized deduction.

Noncash charitable contributions do not qualify for the above-the-line deduction.

Practice Pointer

The hidden language in this provision may catch tax professionals off-guard. If a taxpayer elects to itemize their deductions, they cannot claim the above-the line deduction for charitable contributions.

ECONOMIC IMPACT PAYMENTS (ACRRA)

The Additional Coronavirus Response and Relief Act (ACRRA) also provides another round of economic stimulus payments to qualified individuals in addition to those provided under the CARES Act. (ACRRA §272; IRC §6428A) However, there are some differences between payments authorized under the ACRRA and those authorized under the CARES Act as outlined in the upcoming chart.

According to Treasury Secretary Mnuchin, these payments started going out the week of December 27, 2020. If a direct deposit account is not available, the IRS will mail a paper check. If available, payments will be directly deposited into:

- Any account to which the payee authorized, on or after January 1, 2019, payments of tax refunds;
- Any account belonging to a payee from which that individual, on or after January 1, 2019, made a payment of income taxes; or
- Any Treasury-sponsored account (as defined in Sec. 208.2 of title 31 of the Code of Federal Regulations.

Comment

The list of direct deposit accounts is more expansive than the CARES Act, which limited direct deposits into those accounts for which the taxpayer had previously authorized a federal direct deposit (not payments).

Notices

The ACRRA does require the IRS to send another notice notifying taxpayers of the amount of their additional stimulus payment. After the first round of stimulus payments authorized by the CARES Act, the IRS sent Notice 1444 to taxpayers within 15 days of issuing their payment. The notice notified the taxpayer of the amount they received and the method of delivery (direct deposit or paper check). The ACRRA requires the same information for the new round of notices.

✐ **Practice Pointer**

Both the first and second round of economic stimulus payments are treated as advances against a 2020 tax credit that must be reconciled on a taxpayer’s 2020 income tax return. Because of this, many tax professionals have expressed concern about clients who have lost their Notice 1444. As of publication, the IRS has not indicated whether they will send another notice before tax season or whether they will have a stimulus look-up tool on their website.

“Second round” EIPs are a separate credit

The second round of EIPs authorized by the ACRRA are made available through new IRC §6428A. The first round of EIPs authorized by the CARES Act were made available through IRC §6428. Because the authorizations for the EIPs are made under different sections of the Internal Revenue Code, each round of EIPs is treated as its own separate credit. This means that the income thresholds apply separately to each credit, not on a cumulative basis.

Differences in EIP Payments Authorized Under CARES Act and ACRRA		
Issue	**CARES Act**	**ACRRA**
Amount of payment	$1,200 per qualifying individual plus $500 per qualifying child who is under age 17 at the end of 2020	$600 per taxpayer ($1,200 for MFJ) plus $600 per dependent who is under age 17 at the end of 2020
Based on AGI	From 2018 or 2019 (depending on whether the taxpayer's 2019 tax return was filed prior to payments being issued)	From 2019
AGI limits	Full payments for taxpayers with AGI as follows: • $75,000 single taxpayers • $112,500 HOH • $150,000 MFJ Payment phased out by $5 for every $100 (or 5%) over the AGI threshold and completely phased out at: • $99,000 single taxpayers • $146,500 HOH • $198,000 MFJ if no children • Add $10,000 for each qualified child	Full payments for taxpayers with AGI as follows: • $75,000 single taxpayers • $112,500 HOH • $150,000 MFJ Payment phased out by $5 for every $100 (or 5%) over the AGI threshold and completely phased out at: • $87,000 single taxpayers • $136,500 HOH • $174,000 MFJ if no children • Add $12,000 for each qualified child
Nonfilers	Payments made to Social Security recipients, Social Security disability recipients, VA disability recipients	Same as CARES Act
Social Security number requirements	To receive the payment, the Social Security numbers for the taxpayer, spouse, and qualifying dependent must be included on their tax return. The only exceptions are: • If one spouse is a member of the Armed Forces, then a Social Security number need only be provided for one of the spouses; and • If the credit is taken for a qualifying child who is adopted or placed for adoption, the adoption taxpayer identification number should be used	U.S. citizens and their children are eligible even if they are married to noncitizens. In other words, the U.S. citizen parent with an SSN will receive $600, plus $600 for each child under the age of 17, as long the child has an SSN This expansion would be retroactive and would apply to first round EIPs authorized under CARES Act. However, additional first round EIPs won't be sent if a taxpayer didn't qualify under the original CARES Act, but they do under the ACRRA. Taxpayers in this situation will receive their additional EIP when they reconcile their credit on their 2020 income tax return
Ineligible taxpayers	The credit is not available to: • Nonresident aliens; • Individuals who may be claimed as a dependent on another person's tax return (even if they are not actually claimed); and • Estates or trusts	Same as CARES Act. ACRRA also disallows credit for individuals who were deceased prior to January 1, 2020, (the deceased individual is treated as if his or her valid identification number was not included on the return) (IRC §6428A(e))

> ***Comment***
>
> There was initially some controversy regarding whether "individual" means per-person or per-return and, therefore, whether taxpayers filing are limited to one $300 deduction under this provision. The draft Form 1040 instructions, released on October 23, 2020 make clear that the $300 limitation is per return, even for married couples filing jointly.
>
> The instructions state specifically: "If you don't itemize deductions on Schedule A (Form 1040), you (or you and your spouse if filing jointly) can take a charitable contribution deduction of up to $300 for cash contributions made in 2020. … Enter the total amount of your contributions on line 10b. Don't enter more than $300."

Temporary suspension of charitable contribution limits

For cash contributions only, taxpayers may elect to increase the limits on the deduction for charitable contributions for qualified cash contributions made during the 2020 calendar year up to:

- 100% of their AGI (normally 60%) for individuals; and
- 25% of taxable income (normally 10%) for corporations.
  (CARES Act §2205; IRC §170)

For partnerships and S corporations, the election is made at the partner or shareholder level.

If a taxpayer contributes appreciated property, the existing 20%, 30%, and 50% limits apply.

> ***Comment***
>
> The instructions for Schedule A, line 11, provide details for making the qualified contribution election.

> ***Qualified contribution defined***
>
> Only cash contributions made in 2020 to a charitable organization (defined in IRC §170(b)(1)(A)) are treated as a qualified contribution.
>
> The only contributions that do not qualify are those:
>
> - Made to a 509(a)(3) private foundation or a donor advised fund; or
> - A carryover contribution from a pre-2020 taxable year.

Food inventory contributions

The limitation for charitable contribution deductions of food inventory for contributions made in 2020 is increased from 15% to 25%. (CARES Act §2205(b); IRC §170(e)(3)(C)) See page 4-34 for a discussion of food inventory contributions.

See page 1-7A.

Charitable contribution carryovers

If an individual's charitable contributions exceed the applicable percentage-of-AGI-limitation, the excess may be carried over and deducted for five years. (IRC §170(d)(1)(A)) An extended carryover period of 15 years is available for qualified conservation contributions.

Some charitable contribution provisions extended into 2021

Some of the CARES Act provisions regarding charitable contributions are extended and modified for the 2021 taxable year by the Taxpayer Certainty and Disaster Tax Relief Act (TCDTRA).

Specifically:

- Nonitemizers may claim a $300 above-the-line deduction for cash contributions made to qualified organizations (excluding private foundations or donor advised funds) for 2021. Unlike the above-the-line deduction for the 2020 taxable year, the act clarifies that joint filers may claim up to $600 on the 2021 return (TCDTRA §212; IRC §§63(b), 170(p));
- A 50% accuracy-related penalty will be imposed on any underpayments attributable to overstatements of the 2021 above-the-line deduction. This penalty will not be imposed automatically, but must be approved by an IRS supervisor prior to assessment (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)

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Generally, any contribution carried to a future year remains in its percentage limitation category and can only be deducted *after any contributions made in that category in that future year*, subject to the limitations applicable to that year. The CARES Act provides an exception to the general contribution carryover ordering rules. For 2020 only, taxpayers can deduct cash contribution carryovers from 50% charities (e.g., public charities, religious organizations) first and then deduct 2020 contributions to 50% charities to deduct up to 100% of the taxpayer's AGI. (CARES Act §2205(a)(1))

Comment

For taxable years 2018 through 2025, taxpayers can deduct charitable contributions to 50% charities, up to 60% of their AGI. Despite this temporary rule, public charities, religious organizations, and others are still simply referred to as "50% charities" or "50% organizations."

Example of ordering rules under the CARES Act

Mack's 2020 AGI is $50,000, and he has a $35,000 contribution carryover from a 50% charity (which he can deduct up to 60% of his AGI).

Mack made another $24,000 cash contribution in 2020. He may claim a $50,000 deduction (100% of his AGI) computed as follows:

2019 carryover contributions ($50,000 2020 AGI × 60%)	$30,000
2020 contributions ($50,000 - $30,000 prior year carryover allowed)	$20,000
	$50,000

Mack can carry over $9,000 in unclaimed deduction ($5,000 from pre-2020 carryovers + $4,000 of unused qualified contributions from 2020). The $9,000 will be subject to the 60% AGI limitation in 2021.

Contribution stacking

The draft instructions to Form 1040 confirm that taxpayers can make charitable contributions of appreciated property (up to the regular percentage contribution limit for the property), and then use cash contributions to 50% organizations to deduct up to 100% of their AGI in 2020. (CARES Act §2205(a); IRC §170; Draft Instructions to Form 1040) This beneficial charitable contribution stacking is only available in 2020 under §2205(a) of the CARES Act.

Generally, the regular percentage limits for contributions of property is 50%, but 20% and 30% limitations apply in some cases.

Contribution carryovers when standard deduction is used

Taxpayers with excess charitable contributions and who utilize the standard deduction must reduce their charitable contribution carryover to the following year as if they had itemized. (Treas. Regs. §1.170A-10(a)(2))

Example of contribution carryovers and the standard deduction

Caroline and Joe are married taxpayers who file jointly. Caroline and Joe own a restaurant and their AGI typically hovers around $150,000 per year. However, their business was devastated by the COVID-19 pandemic.

Their 2021 AGI is only $10,000, but they had charitable contributions of $7,000. They also utilized the standard deduction in 2021.

Even though Caroline and Joe utilized the standard deduction, they still must calculate their charitable contribution carryover as if they had itemized their deductions. Their charitable contribution carryover to 2022 is calculated as follows:

Contributions made in 2021		$7,000
AGI	$10,000	
Limitation percentage	60%	
Contributions allowable in 2021		(6,000)
Contribution carryover to 2022		$1,000

NOLs and charitable contributions

Taxpayers can carry forward unused charitable contributions, but there are additional rules to consider when there is a concurrent net operating loss carryover. In this situation, the carryovers must be recomputed.

A charitable contribution carryover is reduced, and an NOL carryover is increased by the amount that a charitable contribution would have been allowed without regard to the NOL that was actually allowed. (IRC §170(d)(1)(B) and (d)(2)(B))

Example of NOL and charitable contribution carryovers

Ben has $50,000 of AGI, a $35,000 charitable contribution, and a $50,000 NOL carryover from prior years. Because the NOL wipes out Ben’s AGI, no charitable contribution would be used due to the AGI limitation on charitable contribution deductions. (Treas. Regs. §1.170A-10(d)(1) and (2))

However, when computing the amount of the NOL and charitable contribution carryovers to subsequent years, there is a “swap.” The charitable contributions are used to the extent they would have been used if not for the presence of the NOL, and the remainder is carried forward.

Ben’s NOL is computed as if the charitable contributions are deducted. Ben will use $30,000 of the charitable contribution amount (60% × $50,000 AGI). As such, instead of a $30,000 charitable contribution carryover and zero NOL carryover, the actual result is a charitable contribution carryover of $5,000 and an NOL carryover of $30,000.

The result, as illustrated in the example, is generally favorable to taxpayers because the NOL carryover period is longer than the charitable contribution carryover period. For taxable years after 2017, NOLs can be carried forward indefinitely.

Different treatment when NOLs are carried back

However, in computing taxable income for purposes of the charitable contribution deduction, no adjustment is made for an NOL carryback. Therefore, in determining the amount of the excess contribution carryover for the year of the contribution or a succeeding year, the carryover isn't increased by an NOL carryback. (Treas. Regs. §1.170A-11(c)(3) and (4)) This means that an NOL carryback won't result in any reduction of charitable contribution deductions for the years to which the loss is carried back.

NOL carrybacks reinstated under the CARES Act

The TCJA eliminated NOL carrybacks for taxable years beginning after December 31, 2017. However, in order to provide immediate relief to taxpayers during the COVID-19 pandemic, the CARES Act allows a five-year carryback for NOLs incurred in 2018, 2019, and 2020, among other changes. See page 4-23 for a full discussion of the CARES Act's NOL changes.

UNEMPLOYMENT COMPENSATION

The COVID-19 pandemic resulted in millions of unemployment claims. This means that tax professionals will be dealing with many more Forms 1099G for 2020.

The Pandemic Unemployment Assistance (PUA) program, authored by the CARES Act, launched in California on April 28, 2020. Under the PUA program, business owners, self-employed individuals, independent contractors, and those with limited work history were also able to apply for benefits.

Unemployment compensation is taxable

All unemployment insurance benefits received are taxable as ordinary income and must be reported on the recipient's federal income tax return. (IRC §85(a)) They are not subject to Social Security and Medicare taxes. (IRC §3402(0)(1)(a))

While these benefits provided much needed immediate relief, taxpayers need to be aware that these benefits are taxable, and unless they had tax withheld or increased the amount of their estimated tax payments to reflect this income, they may be in for a rude awakening when they file their 2020 income tax returns.

California nonconformity

California does not tax unemployment benefits. (UIC §1342.1)

How much could taxpayers have received in 2020?

Taxpayers in California could have received up to $31,500 of unemployment benefits in 2020:

- $450 per week of regular unemployment compensation for up to 46 weeks ($20,700);
- $600 per week of Pandemic Unemployment Assistance through the CARES Act for up to 16 weeks ($9,600);
- $300 per week of Lost Wages Assistance through a Presidential memorandum issued on August 8, 2020, for up to three weeks ($900); and
- $300 per week under the ACRRA (available for a total of 11 weeks, but only one week was available in 2020 because benefits started the week of December 27, 2020). (www.edd.ca.gov/about_edd/coronavirus-2019/cares-act.htm; www.edd.ca.gov/about_edd/coronavirus-2019/lost-wages-assistance.htm)

For taxpayers in California, all three unemployment insurance programs listed are administered and paid through the Employment Development Department.

Underwithholding

Although the claimant may request withholding from the unemployment, the rate is only 10% of the regular weekly unemployment of a maximum of $450 per week. There is no withholding on the additional payments.

☑ Planning Pointer

Assume a California taxpayer received the maximum $31,500 in UI benefits in 2020.

For a client in the 22% tax bracket, the tax liability on the maximum unemployment compensation is $6,930 ($31,500 × 22%). It's likely the client had no withholding on these payments.

✎ Practice Pointer

In addition to unemployment compensation, taxpayers were eligible to receive paid sick leave and paid family leave under the Families First Coronavirus Response Act (FFCRA). The additional paid sick leave and paid family leave provided are considered wage replacements and are therefore taxable compensation that should appear on your client's Form W-2. This also means that the additional paid sick leave and paid family leave are subject to the same wage withholding as other wages.

The FFCRA will be discussed in more detail at page 4-5.

See pages 1-11A and 1-11B.

HIGHER EDUCATION GRANTS

The IRS has stated, through FAQs on its website, that emergency financial aid grants provided to students are excludible disaster relief payments under IRC §139. (www.irs.gov/newsroom/faqs-higher-education-emergency-relief-fund-and-emergency-financial-aid-grants-under-the-cares-act)

The updated FAQs were issued to provide clarification to the CARES Act, which provides that educational institutions can use funds they received through the Higher Education Act to support students who experience "unexpected expenses and unmet financial need" due to the COVID-19 pandemic. (CARES Act §§3504, 18004, 18008)

Example of higher education grants

JJ was a full-time student at Sacramento State. The school went to online learning in March 2020. JJ lived in San Diego and had to purchase a plane ticket and pay to ship her belongings home. The cost of the plane ticket was $300, and she spent $100 to ship her belongings home. She received a $400 grant from the university. Because she used her grant for expenses due to the COVID-19 pandemic, none of the funds are taxable.

Unemployment provisions of the year-end stimulus bill

Under the ACRRA, COVID-related unemployment benefits are extended for an additional 11 weeks, for a total of 50 weeks. (ACRRA §201) These benefits will be available beginning December 27 and will run at least through March 14, 2021. Individuals who are still receiving benefits on March 14, 2021, and who have not exhausted their claims can continue receiving benefits through weeks beginning before April 6, 2021.

The additional $600 per week benefits that were available under the unemployment assistance provision of the CARES Act have been reduced to $300 per week for weeks of unemployment beginning after December 26, 2020. (ACRRA §203(b))

> **☑ Planning Pointer**
>
> The total additional unemployment compensation available to a worker through the Continued Assistance for Unemployed Workers Act of 2020 is $3,300 ($300 per week x 11 weeks). Remember, Pandemic Unemployment Assistance is taxable on the recipient's federal income tax return, but withholding is not available on the benefits. Taxpayers with other sources of income should plan ahead for the additional income tax liability and consider making estimated tax payments.

States can elect to modify their agreements with the federal government to provide an additional $100 per week, which is available to earners who have self-employment income of at least $5,000 in the most recent taxable year ending prior to the taxpayer's application for regular UI compensation. (ACRRA §261) These additional payments end on March 14, 2021.

Pandemic unemployment assistance overpayments

Individuals who were paid Pandemic Unemployment Assistance to which they were not entitled must repay the overpayments. However, the state agency administering unemployment benefits may waive such repayment if it determines that:

- The payment was without fault on the part of the individual; and
- Such repayment would be contrary to equity and good conscience.
  (ACRRA §201(d))

Return-to-work reporting requirements

States providing expanded unemployment benefits must, within 30 days from the date of enactment of the act, establish a method to address circumstances where UI claimants refuse to return to work or to accept an offer of suitable work without good cause. (ACRRA §251, amending CARES Act §2117). Such methods must include:

- Reporting method for employers, such as through a phone line, e-mail, or online portal to notify the state agency when an individual refuses an offer of employment; and
- A plain language notice for claimants about state return-to-work laws, rights to refuse to return to work or to refuse suitable work, and claimant's right to refuse work that poses a risk to the claimant's health or safety.
  (ACRRA §251)

Comment

The return-to-work reporting requirement appears to be targeting those workers who decided that receiving unemployment compensation was more lucrative than working. This was a problem for some employers during the first COVID-19 shutdowns in the spring of 2020. This second round of unemployment compensation pays only $300 per week versus the $600 per week provided when the CARES Act was originally enacted on March 27, 2020. Because of this reduced benefit, fewer employers should be faced with employees refusing to return to work.

Appeal rights

Individuals receiving Pandemic Unemployment Assistance have the same rights to appeal to the state agency administering the program as those available to applicants for regular unemployment insurance benefits. (ACRRA §201(c))

California conformity

California conforms to the federal exclusion for disaster relief payments under IRC §139. (R&TC §17131)

See page 1-12A.

DISASTER RELIEF PAYMENTS

Emergency financial aid grants under the CARES Act for unexpected expenses, unmet financial needs, or expenses related to the disruption of campus operations on account of the COVID-19 pandemic, such as unexpected expenses for food, housing, course materials, technology, health care, or child care, are qualified disaster relief payments. (IRC §139) As such, they are not includible in income.

Quick Law: Disaster relief payments

Disaster relief payments, excludible from income under IRC §139, are amounts paid to or for the benefit of an individual under any one of the following four sets of circumstances:

- To reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster;
- To reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster;
- By a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster (for example, payments made by a commercial airline to families of passengers killed in a crash); or
- If such amount is paid by a federal, state, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare. (IRC §139(b))

Amounts are excludible only to the extent they are not compensated by insurance or otherwise.

A qualified disaster includes a federally declared disaster. (IRC §139(c)(2)) The COVID-19 pandemic is a federally declared disaster for all U.S. states and territories. (www.fema.gov/disasters/coronavirus/disaster-declarations)

Paid sick and family leave are taxable

Many people have asked whether paid sick leave and family leave payments made under the Families First Coronavirus Response Act are excludible from the employee's income under IRC §139 as disaster relief payments.

Disaster relief payments under IRC §139 do not include wage replacements. For example, if an employer provides funds to its employees to help the employees meet living expenses due to a stay-at-home order (e.g., food or rent), then such payments can be deductible by the employer and excluded from the employee's income. Thus, the sick leave and family leave payments, which are treated as wages, under the FFCRA are not excludable under IRC §139 and are taxable.

Emergency financial aid grants expanded under year-end stimulus bill

Qualified emergency financial aid grants made after March 26, 2020:

- Are excludable from a student's taxable income; and
- Will not be treated as a qualified scholarship, an educational assistance allowance, or other payment that will reduce the amount of the student's American Opportunity Tax Credit (AOTC) or Lifetime Learning Credits.
  (ACRRA §227)

A "qualified" emergency financial aid grant is:

- Any emergency financial aid grant awarded by an institution of higher education under §3504 of the CARES Act;
- Any emergency financial aid granted from an institution of higher education made with funds available under §18004 of the CARES Act; and
- Any other federal, state, or tribal emergency financial aid grant or grant made by a scholarship-granting organization for the purpose of providing financial relief to students at institutions of higher education in response to a qualifying emergency.

However, payments for teaching, research, or other services required as a condition for receiving the qualified emergency financial aid do not qualify for this special treatment.

A qualifying emergency is:

- A public health emergency related to the coronavirus declared by the Secretary of Health and Human Services pursuant to section 319 of the Public Health Service Act (42 U.S.C. §247d);
- An event related to the coronavirus for which the President declared a major disaster; or
- A national emergency related to the coronavirus declared by the President under section 201 of the National Emergencies Act (50 U.S.C. §1601 et seq.).

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COVID-19 RELIEF FOR SELF-EMPLOYMENT TAX

The Families First Coronavirus Response Act (FFCRA) and the CARES Act provide credits against self-employment tax for 2020 and a deferral of 2020 Social Security tax (but not Medicare tax). We will discuss these items in more detail starting on page 4-9.

PERSONAL EXEMPTIONS AND DEPENDENTS

NO PERSONAL EXEMPTION DEDUCTION

The TCJA temporarily suspended the personal and dependent exemption deduction. For tax year 2020, 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.

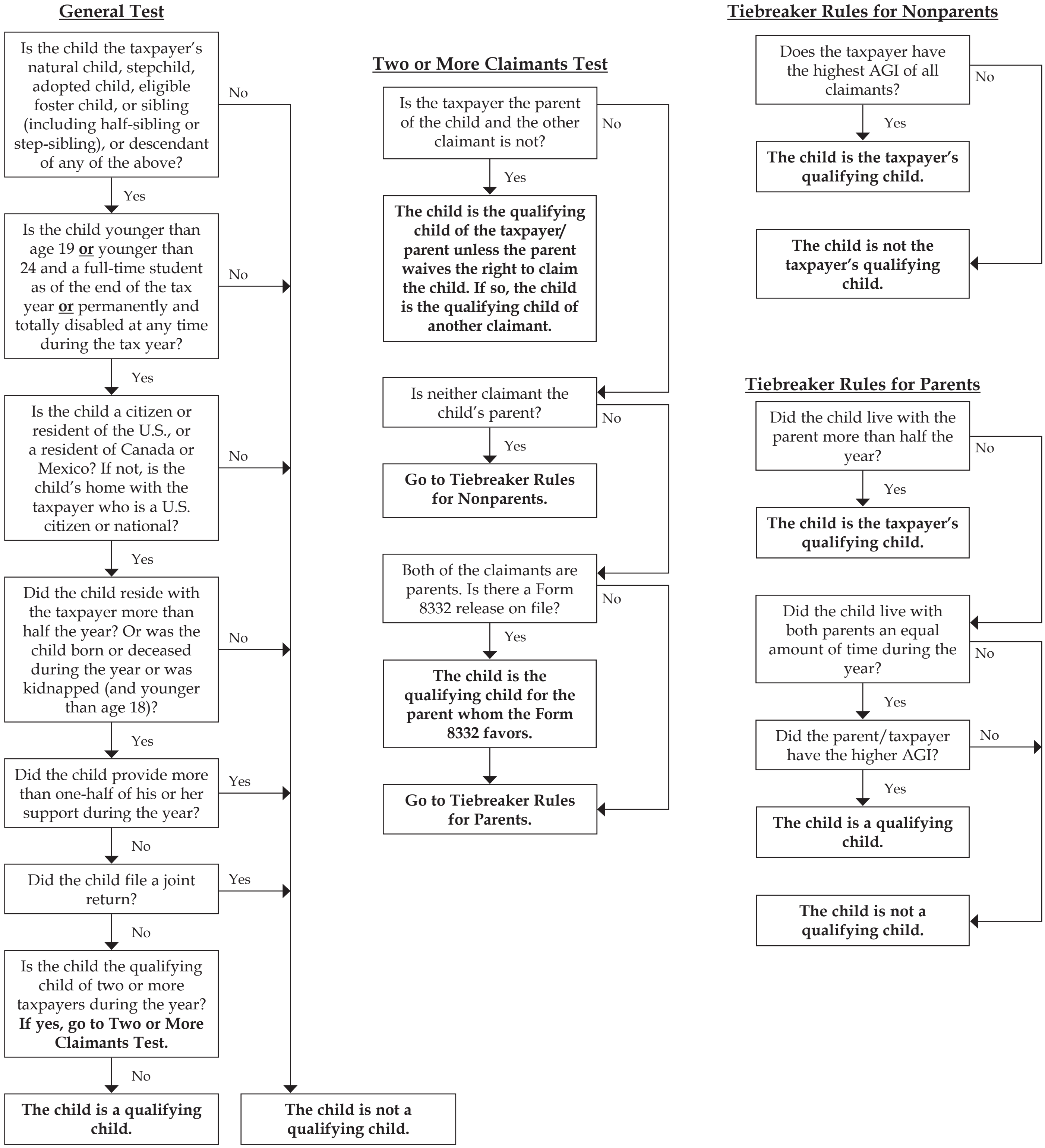
Personal Exemption Amount	
2020 (Rev. Proc. 2019-44)	**2021 (Rev. Proc. 2020-45)**
$4,300	$4,300

There are two types of dependents: qualifying children and qualifying relatives. The personal exemption amount 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)) It is also still relevant for purposes of the maximum $500 credit for an "other dependent" under the Child Tax Credit (see discussion on page 1-40). (IRC §24(h)(4))

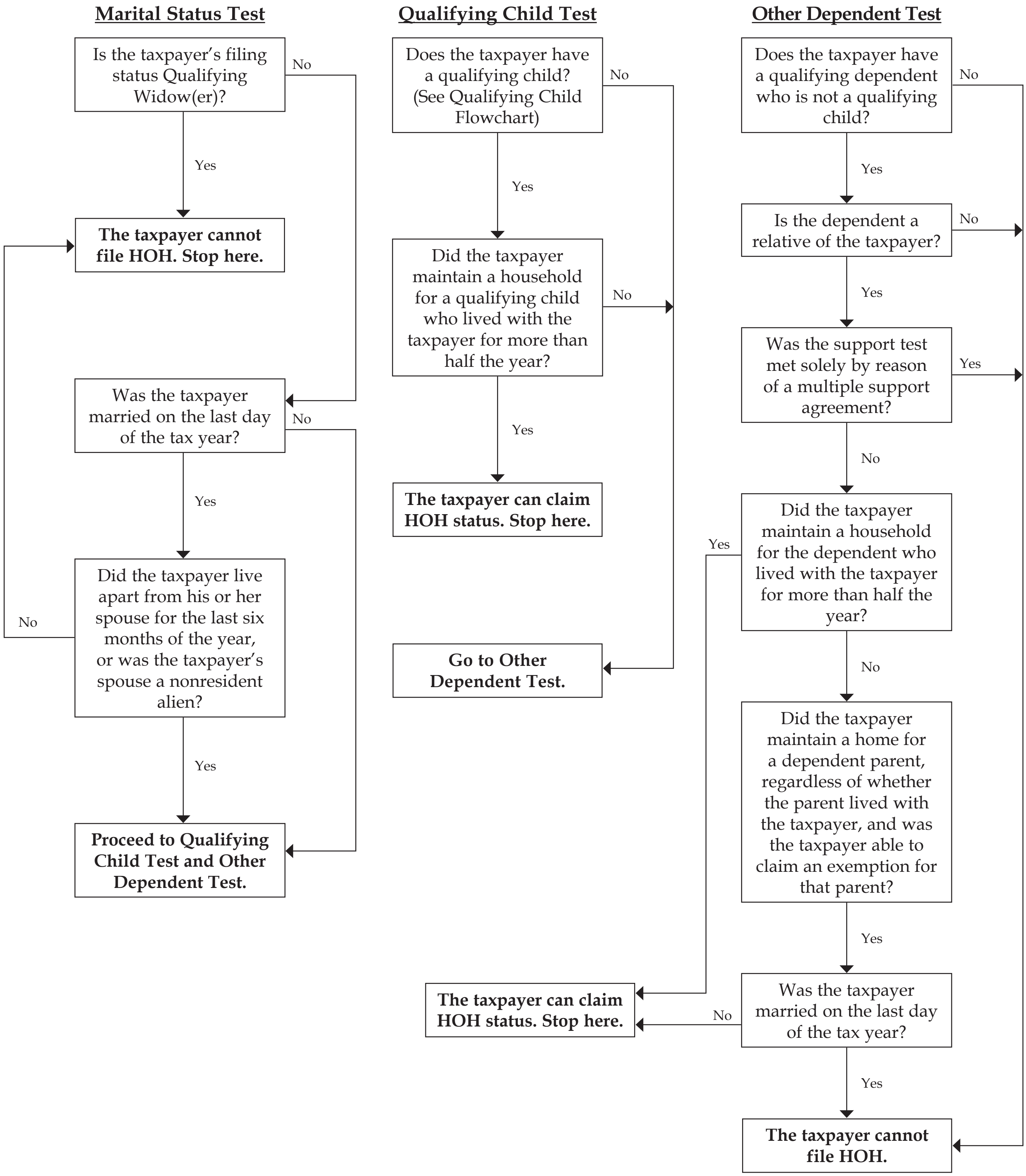
California nonconformity

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. (R&TC §17054.1) See page 12-53.

Qualifying child flowchart: California conforms



Head of household flowchart: California conforms



FILING ISSUES

FILING REQUIREMENTS

With the suspension of the personal and dependent exemption deduction, generally every individual must file an income tax return if:

- Their gross income for the tax year is greater than their standard deduction amount; or
- They have self-employment income in excess of $400.

UNEARNED INCOME OF CHILDREN (KIDDIE TAX)

For taxable years beginning on or after January 1, 2020, the Further Consolidated Appropriations Act of 2020, which was passed into law on December 20, 2019, repealed the TCJA changes to the kiddie tax.

Under the TCJA, children were not required to report their income on their parents' income tax returns. Thus:

- A child's *earned* income was taxed according to an unmarried taxpayer's brackets and rates; and
- A child's *unearned* income was taxed using the estate and trust rates.

Amending returns

Taxpayers whose children paid a higher rate of tax under the TCJA's kiddie tax provisions in 2018 or 2019 have the option to amend their child's income tax returns for those years and elect to apply the pre-TCJA kiddie tax rules. To do so, parents must attach Form 8615, Tax for Certain Children Who Have Unearned Income, to their child's amended income tax return and attach a statement specifying "election to modify tax of unearned income." (Instructions to Form 8615)

Example of parents who may want to amend child's 2018 or 2019 returns

Bill and Patricia are married with one child, Eric (age 5). Bill and Patricia filed a joint return and had taxable income in 2018 of $60,000, placing them in the 22% tax bracket.

Patricia comes from a wealthy family, and her parents opened an investment account for Eric when he was born. In 2018, Eric's investment account generated $25,000 of unearned income for him. As such his marginal rate was 37% while his parents' marginal rate was 22%.

The following calculation illustrates the benefit of amending Eric's income tax return for 2018.

Gross income	$25,000
Standard deduction	1,050
Taxable income	23,950
Tax liability (TCJA rules)	7,248
Tax liability (pre-TCJA rules)	(4,524)
Refund if amended 2018 return filed	$ 2,724

Bill and Patricia will have to amend *both* their own return and Eric's return. Their situation will likely be similar in 2019, so they'll want to consider amending the 2019 returns as well.

> ✐ **Practice Pointer**
>
> As practitioners we can only hope that our software will be updated for this change. Otherwise, we will be forced to prepare the amended returns and do the computations by hand.

Kiddie tax rules

The kiddie tax rules for 2020 and beyond are the same as those that were in effect prior to 2018. As previously stated, the Further Consolidated Appropriations Act allows parents to elect to use these same rules for 2018 and 2019 as well.

Children who meet the following listed requirements must attach Form 8615 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 $2,200 (for 2019 and 2020 tax years);
- 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 $11,000 for the tax year (2019 and 2020 tax years);
- 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 never conformed to the TCJA kiddie tax rules. A child's unearned income remains taxed at the parent's rate on the California return. (R&TC §17041)

GROSS INCOME

CAPITAL GAINS

Individual Long-Term Capital Gains Rates (IRC §1(h))		
Rate	**Taxable income breakpoint (2020) (Rev. Proc. 2019-44)**	**Taxable income breakpoint (2021) (Rev. Proc. 2020-45)**
0%	Single: $40,000 MFS: $40,000 MFJ: $80,000 HOH: $53,600 Estates and trusts: $2,650	Single: $40,400 MFS: $40,400 MFJ: $80,800 HOH: $54,100 Estates and trusts: $2,700
15%	Single: $441,450 MFS: $248,300 MFJ: $496,600 HOH: $469,050 Estates and trusts: $13,150	Single: $445,850 MFS: $250,800 MFJ: $501,600 HOH: $473,750 Estates and trusts: $13,250
20%	No breakpoint	No breakpoint

California nonconformity

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)

Business versus nonbusiness bad debts

The tax treatment of a bad debt depends on whether the debt is a business bad debt, which is one that is created or acquired in connection with a trade or business of the taxpayer. (IRC §166(a)) A nonbusiness bad debt is any bad debt that is not a business bad debt.

Business bad debts are deductible by the taxpayer as an ordinary and necessary business deduction. For a sole proprietor, for example, a business bad debt is deducted on Schedule C on the date the debt becomes worthless.

Comment

Cash basis Schedule C businesses will rarely have business bad debt. Clients who can't collect from their customers often want to treat the value of their services as a bad debt.

The Tax Court last issued a ruling on this issue in October 2019 where a Maryland attorney claimed that he had basis in his labor and that the value or cost of his labor was its fair market value. (***Worsham v. Comm.***, TCM 2019-132) The attorney was a cash-basis taxpayer who attempted to deduct the time he spent performing services for clients for which he couldn't collect payment. The court ruled that taxpayers do not have tax basis in their labor and therefore cannot claim a tax deduction for their wasted time.

Nonbusiness bad debts are deductible as short-term capital losses on Schedule D to Form 1040 as of the date the debt becomes worthless. (IRC §166(d))

Example of nonbusiness bad debt

Jessica loaned her friend Raymond $5,000 in 2018. Jessica is not engaged in the trade or business of loaning money, nor did she make the loan during the course of any other trade or business. Raymond never made any payments on the loan.

In 2020, Jessica made multiple attempts to collect on the debt but ultimately determined that Raymond was never going to pay her back and she determined that the debt was worthless.

On her 2020 income tax return, Jessica will treat $5,000 nonbusiness bad debt as a short-term capital loss. It does not matter that she made the loan two years earlier.

Jessica does not issue a 1099-C, Cancellation of Debt, to Raymond because Jessica is not in the trade or business of lending money.

✐ **Practice Pointer**

When determining when a debt has become worthless, the IRS will consider all pertinent evidence, including the value of any collateral, if any, and the financial condition of the debtor. (Treas. Regs. §1.166-2(a)) It is not necessary for a taxpayer to pursue legal action when determining the date a debt has become worthless if it is unlikely that legal action will result in satisfaction of the debt. (Treas. Regs. §1.166-2(b))

In order to help audit-proof the taxpayer's return where a bad debt from a loan is involved, the taxpayer should be able to show that the loan was a *bona fide* debt, evidenced by a promissory note carrying an adequate rate of interest. Additionally, taxpayers should be able to provide proof of their collection efforts by sending certified letters to the debtor.

Taxpayer overcame IRS's challenge to business bad debt deduction

Taxpayers claimed a $100,000 business bad debt deduction on Schedule C of their tax return for a loan the taxpayer-husband made to fund a furniture business. (***Bercy v. Comm.***, TCM 2019-118) On audit, the IRS determined the bad debt was a nonbusiness bad debt and should be treated as a short-term capital loss because the taxpayer made the loan from his personal bank account.

The taxpayers were able to show that the husband had a practice of making personal loans to a variety of borrowers on a regular basis, which amounted to a trade or business. His personal lending activity was substantial, comprising numerous loans totaling an estimated $25 million, and was entered into with the intent of making a profit.

VIRTUAL CURRENCY TRANSACTIONS

The IRS has removed two online game currencies from its list of "convertible virtual currencies" that need to be reported on a taxpayer's return (see www.irs.gov/newsroom/irs-statement-on-changes-to-virtual-currency-webpage). The two currencies are Roblox and V-bucks. Therefore, transactions occurring in the online games Roblox and Fortnite, using Roblox and V-bucks currencies, do not need to be reported. A convertible virtual currency is a virtual currency that has an equivalent value in real currency (or acts as a substitute for real currency). (IRS Notice 2014-21)

Virtual currency question moved to top of 1040

Starting with 2019 income tax returns, the IRS included a virtual currency question to the top of Form 1040, Schedule 1. The question asked whether the taxpayer, at any time during the year, sold, sent, exchanged, or otherwise acquired any financial interest in any virtual currency.

For the 2020 tax year, the virtual currency question has been moved to the top of Form 1040, just below the taxpayer's name and address.

EXCLUSIONS FROM INCOME

INCOME EXCLUSION FOR IN-HOME SUPPORTIVE SERVICES (IHSS) PAYMENTS

The IRS has announced that it will acquiesce to the Tax Court's holding in ***Feigh v. Comm.*** *(*(2019) 152 TC 15*)* in which the court held that in-home supportive service (IHSS) workers who excluded their IHSS payments from gross income under IRS Notice 2014-7 could include these payments in "earned income" for purposes of computing their Earned Income Credit and Additional Child Tax Credit. (Action on Decision 2020-02)

This means that taxpayers are able to not only exclude IHSS income for purposes of determining their taxable income, but can count it for purposes of qualifying for, or increasing the amount of, the Earned Income Credit. They can amend and claim the credit for prior years as long as the statute of limitations is open.

California nonconformity

Although California conforms to the IRC §131 exclusion of IHSS payments, California's Earned Income Tax Credit is only available for wage income subject to California withholding, which IHSS payments are not. (R&TC §§17052, 17131) See page 9-23.

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; TCDTRA §114)

Comment

Originally, the exclusion from income for discharged debt from the taxpayer's qualified principal residence expired for debt discharged after December 31, 2017. However, this provision was retroactively extended through 2020 by the Further Consolidated Appropriations Act of 2020, signed into law on December 20, 2019.

File amended returns for 2018 or 2019 if the exclusion applies.

California nonconformity

California has not allowed the principal residence exclusion since 2013. (R&TC §§17024.5, 17131, 17144)

Income exclusion for discharged student loans

Over the last few years, the IRS has issued guidance allowing for an exclusion from income for discharged student loans due to a specific school closure. (Rev. Procs. 2015-57, 2017-24, 2018-39)

In order to avoid having to issue new guidance each time a school closes, the IRS issued Rev. Proc. 2020-11 to establish a safe harbor that can be applied to all taxpayers. Rev. Proc. 2020-11 applies to any taxpayer:

- Who took out federal or private student loans to finance attendance at a nonprofit or for-profit school;
- Who was a student at the time of the closing or left the school within a certain period of time prior to the closing date (Rev. Proc. 2020-11 does not define this time period); and
- Whose:
  - Federal loans are discharged by the U.S. Department of Education based on the Closed School or Defense to Repayment discharge process; or
  - Private loans are discharged based on a settlement of a legal cause of action resolving various allegations of unlawful business practice.

California conformity

California excludes from gross income student loans used to attend for-profit higher education institutions that are discharged after 2014 and before 2020 if the student couldn't complete school due to the school's closure or the school did something wrong or failed to do something it should have done. (R&TC §17144.6)

ADJUSTMENTS TO GROSS INCOME

EDUCATOR EXPENSES

The maximum above-the-line deduction for eligible educator expenses is $250 ($500 if both taxpayers on a joint return are eligible educators). (IRC §62(a)(2)(D))

Homeschool expenses don't count

Parents who homeschool their children are not eligible for the above-the-line deduction for educator expenses because they don't qualify as eligible educators.

The term "eligible educator" means an individual who is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aid in a school for at least 900 hours during a school year. (IRC §62(d)(1)(A)) For these purposes, the term "school" means any school that provides elementary or secondary education (kindergarten through grade 12), as determined under state law. (IRC §62(d)(1)(B))

California nonconformity

California does not allow an above-the-line deduction for educator expenses. (R&TC §17072(b)) As such, there is an increase in AGI for the amount of the federal deduction, and the expense may be claimed as a 2% miscellaneous itemized deduction on the California return.

Eligible expenses for K-12 educators expanded

The above-the-line educator expense deduction available under IRC §62(a)(2)(D)(ii) may be claimed for purchases of personal protective equipment (PPE), disinfectant, and other supplies used for the prevention of the spread of COVID-19, retroactively to expenses paid or incurred after March 12, 2020. The IRS must publish regulations or other guidance clarifying what qualifies for the deduction. (ACRRA §275)

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.

Grandfathered divorce or separation agreements

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

California does not conform to the TCJA changes to the payment and receipt of alimony. As such, alimony remains deductible by the payor and included in the recipient's income no matter the date of the divorce or separation agreement. (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 2020, 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 $170,000 for joint returns. (Rev. Proc. 2019-44) For 2021, the MAGI phaseout range remains unchanged. (Rev. Proc. 2020-45)

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. (CARES Act §2206; TCDTRA §120; 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.

The employer can deduct the payments as a business expense and is not required to pay payroll 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 2020 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, 2021, as part of their educational assistance program. Any loans paid as part of the employer's educational assistance program will be treated as taxable income on the California return.

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.

5% ownership limitation

The IRC §127 prohibition against providing more than 5% of the educational assistance benefits to individuals who are more than 5% shareholders/owners of the business (or their spouses or dependents) applies. The 5% limit applies to each individual shareholder or owner on any day of the year and to their spouses and dependents. This effectively precludes businesses with few or no employees from providing this benefit to the owners (or spouses or dependents).

Example of ownership limitation

Don has a small S corporation law practice. He has three employees, one of whom is his wife. Don cannot pay his wife's student loans through his firm's educational assistance program because he owns 100% of the business, and his payments for his wife's student loans would exceed the 5% limitation.

If Don instead had 20 employees and paid $20,000 in benefits to these employees, he could pay up to $1,000 of his wife's loan (5% of $20,000, the total benefits paid to all employees).

Antidiscrimination limit: An employer's educational assistance program also cannot discriminate in favor of "highly compensated employees" or their dependents. A "highly compensated employee" for 2020 is an employee who meets either of the following tests:

- The employee was a 5% owner at any time during the year or the preceding year; or
- The employee received more than $125,000 in compensation for the preceding year. (IRS Publication 15-B, Employer's Tax Guide to Fringe Benefits)

To satisfy the antidiscrimination rule, the program must benefit the employer's employees generally and cannot discriminate in favor of the highly compensated employees (or their spouses or dependents). (Treas. Regs. §1.127-2(e)) Thus, for example, a plan would be discriminatory if an employer's plan provides that all employees are eligible for educational assistance, but limits that assistance to courses of study leading to postgraduate degrees in fields relating to the employer's business, and only the highly compensated employees would be qualified to pursue the degree.

TUITION AND FEES DEDUCTION

The Further Consolidated Appropriations Act of 2020 retroactively extended the above-the-line deduction for higher education tuition and fees through December 31, 2020. (IRC §222) The tuition and fees deduction is claimed on Form 8917 and is limited based on the taxpayer's MAGI. The tuition and fees deduction is not adjusted annually for inflation.

Tuition and Fees Deduction Phaseout	
MAGI	**Maximum deduction**
• Less than $130,000 (MFJ) • Less than $65,000 (Single, HOH) • No deduction allowed for MFS	$4,000
• $130,000–$160,000 (MFJ) • $65,000–$80,000 (Single, HOH) • No deduction allowed for MFS	$2,000

The deduction must be coordinated with the higher education credits, discussed at page 1-44. Taxpayers may not claim the tuition and fees deduction in any year in which they claim the American Opportunity Tax Credit or the Lifetime Learning Credit with respect to the same student.

California nonconformity

California does not allow a tuition deduction or the education credits. (R&TC §17204.7)

See page 1-25A.

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						
	2019 (Rev. Proc. 2018-30)		**2020 (Rev. Proc. 2019-25)**		**2021 (Rev. Proc. 2020-32)**	
	Family	**Self only**	**Family**	**Self only**	**Family**	**Self only**
Contribution limit	$7,000	$3,500	$7,100	$3,550	$7,200	$3,600
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	$2,700	$1,350	$2,800	$1,400	$2,800	$1,400
Maximum out of pocket	$13,500	$6,750	$13,800	$6,900	$14,000	$7,000

QUALIFIED TUITION DEDUCTION REPEALED/LIFETIME LEARNING CREDIT INCREASED STARTING IN 2021

The qualified tuition deduction under IRC §222 is repealed, effective for taxable years beginning after December 31, 2020. (TCDTRA §104(b))

In lieu of the deduction, the phaseout modified AGI limitation for the IRC §25A Lifetime Learning Credit is increased to match the limitations applied to the American Opportunity Credit. (TCDTRA §104(a)) Thus both credits will now begin to phase out when modified AGI reaches \$80,000 (\$160,000 for MFJ). Previously, the Lifetime Learning Credit began to phase out when the taxpayer's modified AGI reached \$40,000 (\$80,000 MFJ).

Prior to the TCDTRA, 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. (TCDTRA §104(a)(2))

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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).

See page 1-26A.

STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

STANDARD DEDUCTION

Standard Deductions (IRC §63)			
Filing status	**2019 (Rev. Proc. 2018-57)**	**2020 (Rev. Proc. 2019-44)**	**2021 (Rev. Proc. 2020-45)**
Married filing joint and qualifying widow(er)	$24,400	$24,800	$25,100
Head of household	$18,350	$18,650	$18,800
Single	$12,200	$12,400	$12,550
Married filing separate	$12,200	$12,400	$12,550

Additional Standard Deductions for Elderly and Blind			
Filing status	**2019**	**2020**	**2021**
Unmarried			
Elderly or blind	$1,650	$1,650	$1,700
Elderly and blind	$3,300	$3,300	$3,400
Married			
Elderly or blind (per taxpayer)	$1,300	$1,300	$1,350
Elderly and blind (per taxpayer)	$2,600	$2,600	$2,700

FLEXIBLE SPENDING ACCOUNT CARRYOVERS

Individuals may carry over any unused 2020 benefits or contributions remaining in any health and dependent care flexible spending accounts to their 2021 accounts without disqualifying the cafeteria plan. Individuals may likewise carryover any unused 2021 benefits to a plan year ending in 2022.

Other amendments soften 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)

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California nonconformity

California does not increase standard deductions for any of these amounts, including for age and blindness. (R&TC §17073.5(b)) Instead, California allows an additional exemption credit for age and blindness. (R&TC §17054) See page 12-53 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 12-53); or
- 80% of the itemized deductions otherwise allowable.

MEDICAL EXPENSES

7.5% threshold made permanent for all filers

The 7.5% medical expense threshold has been made permanent by the TCDTRA. (IRC §213; TCDTRA §101)

California conformity

California uses federal AGI to compute this threshold, and taxpayers will use 7.5% of *federal* AGI. (R&TC §17241)

Medical mileage rates

The medical mileage rate for 2020 is 17 cents. (Notice 2020-05) The medical mileage rate for 2021 is 16 cents. (Notice 2021-02)

California conformity

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

Long-term care insurance

For 2020, up to $5,430 in premiums paid for long-term care insurance, per person, can qualify as a deductible medical expense. (IRC §213; Rev. Proc. 2019-44) The 2021 amount is $5,640. (Rev. Proc. 2020-45)

Self-employed individuals may include their qualified long-term care insurance premiums in the self-employed health insurance deduction, subject to the maximum amounts. (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 2020 (Rev. Proc. 2019-44)**	**Maximum deductible premium for 2021 (Rev. Proc. 2020-45)**
40 or less	$430	$450
More than 40 but not more than 50	$810	$850
More than 50 but not more than 60	$1,630	$1,690
More than 60 but not more than 70	$4,350	$4,520
More than 70	$5,430	$5,640

California conformity

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

Lifetime care contracts

Many retirement communities require large lump-sum fees when a retiree moves into the community. These fees are often referred to as "lifetime care contracts," "founder's fees," or "life-care fees" and can be partly allocated to deductible medical expenses.

In order to give rise to a medical expense deduction in the year a taxpayer moves into a retirement community, the agreement must require that the taxpayer pay a specific fee as a condition for the retirement community's promise to provide lifetime care that includes medical care.

Retirement communities often provide a statement to their new residents to prove how much of the lifetime care contract is allocable to medical care. The IRS accepts these statements as proof of the medical expense deduction. The statement must be based on either the home's prior experience or on information from a comparable home. (IRS Publication 502, Medical and Dental Expenses)

Planning for move into graduated senior living community

The upfront cost of moving into a retirement community can often reach into the high six figures. If even a fraction of these costs are allocable to a lifetime care contract, then the taxpayer will have very large medical expense deductions in the year they move into the retirement community.

If the taxpayer has modest income, then they could be wasting a large medical expense deduction because unused medical expenses in one year do not carry over to another year. In situations like this, timing a Roth IRA rollover to coincide with the year of a retirement community move-in can provide large savings for your client.

Example of rollover

The lump-sum fee to move into his retirement community of choice was $600,000, and Bob received a statement indicating that 20% of his fee was allocated to a lifetime care contract. Bob's income tax return for 2020 contains the following:

Adjusted gross income		$120,000
Medical expenses		
Doctors, prescriptions, insurance, etc.	$ 10,000	
Lifetime care contract[1]	120,000	
Total medical expenses	$130,000	
Deductible medical expenses[2]		(121,000)
State and local taxes		(10,000)
Taxable income		($ 11,000)

[1] $600,000 × 20%

[2] Total medical expenses that exceed 7.5% of Adjusted gross income

Bob's taxable income is negative $11,000. In 2020, he filed married filing joint with his recently deceased spouse. For the remainder of his retirement, Bob expects to be in the 24% tax bracket.

If Bob had rolled over $150,000 from a traditional IRA to a Roth IRA, this would have put him toward the top of the 22% tax bracket for 2020, and he would have received the following benefits:

- Roth IRA rollover would be taxed in 2020 at an effective rate of 16.5%;
- Roth IRA funds are not subject to required minimum distributions; and
- Roth IRA funds, as well as their growth, are not taxable when they are distributed.

Bob's tax liability in 2020 would be $24,772 if he engaged in the Roth IRA rollover of $150,000. But if he had pulled out that same $150,000 during the remainder of his retirement years when his expected tax rate is 24%, his tax liability would be $36,000 on $150,000 of IRA distributions ($150,000 × 24%).

Taxpayers in Bob's position are not limited to a specific amount they can roll over into a Roth IRA. The $150,000 amount used in this example is for illustrative purposes only.

Practice Pointer

Retirement communities that provide medical care to their residents should provide a letter each year allocating a portion of the community's fees to medical expenses. For example, the letter might say:

"We have determined that 28.36% of the monthly fees paid (or $1,026 paid per person per month) of occupancy during the year may be deductible as an expense for medical care."

Tax professionals must get a copy of these letters each year from their clients who live in retirement communities.

Practice Pointer

Taxpayers who have an RMD requirement in the year they move into a graduated senior living community must take their RMD for the year and cannot do a Roth rollover of their entire account. RMDs are discussed in greater detail starting at page 5-13.

TAXES

Taxpayers may claim an itemized deduction of up to $10,000 ($5,000 in the case of married taxpayers filing separate) 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).

Comment

Thus, taxpayers will choose between state income taxes and sales taxes. To the chosen amount, the taxpayer will add property taxes and other deductible taxes with an overall limit of $10,000.

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)

Tax benefit rule and the SALT limitation

Determining whether a state refund is taxable at the federal level under the tax benefit rule is much easier under the TCJA's $10,000 SALT limitation.

Stated simply, if the taxpayer paid exactly the right amount of state and local income taxes (such that they would not have received a state income tax refund), but the taxpayer would still only be able to deduct the maximum $10,000 of state and local taxes on Schedule A ($5,000 for married taxpayers filing separately), then the taxpayer did not receive a tax benefit. (Rev. Rul. 2019-11) This is illustrated by the following example, taken directly from the revenue ruling.

Example of no tax benefit

Molly is single and paid the following itemized deductions on her 2019 federal income tax return:

Real property taxes	$ 5,000	
State income taxes	7,000	
Total SALT paid	$12,000	
Deductible SALT		$10,000
Other itemized deductions		5,000
Total itemized deductions claimed		$15,000

In 2020, Molly's state tax liability was $6,250, and she received a $750 state income tax refund due to an overpayment of her 2019 state income taxes.

Had Molly paid only the proper amount of state income taxes ($6,250) in 2019, her state and local income tax deduction would have still exceeded the $10,000 limitation, and her overall itemized deductions would have remained the same ($15,000).

Molly received no tax benefit from the overpayment of $750 in state income taxes in 2019. Therefore, Molly is not required to include the $750 of state income tax refunds in her gross income in 2020.

An additional twist is added when a taxpayer's itemized deductions hover around the standard deduction amount, as the following example illustrates.

Example of including refund in income

Herman is single and paid the following itemized deductions on his 2019 federal income tax return:

Real property taxes	$ 4,250	
State income taxes	6,000	
Total SALT paid	$10,250	
Deductible SALT		$10,000
Other itemized deductions		2,500
Total itemized deductions claimed		$12,500

In 2020, Herman's state tax liability was $5,000, and he received a $1,000 state income tax refund due to an overpayment of his 2019 state income taxes.

Had Herman paid only the proper amount of state income tax ($5,000) in 2019, his state and local income tax deduction would have been reduced to $9,250, and, as a result, Herman's itemized deductions would have been reduced from $12,500 to $11,750, which is less than the 2019 standard deduction of $12,200.

The difference between Herman's claimed itemized deductions ($12,500) and the standard deduction he could have taken ($12,200) is $300. Therefore, Herman is required to include $300 of his state income tax refund in his gross income in 2020 ($1,000 refund less $700 of refund with no tax benefit).

California nonconformity

California does not allow a deduction for sales tax or state income taxes and does not limit the deduction for property taxes to $10,000. (R&TC §§17024.5, 17201, 17220)

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)

See page 1-32A.

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.

Disaster-related personal casualty losses

Individuals with a net disaster loss for any taxable year may claim a personal casualty loss under IRC §165(h) (TCDTRA §304(b)), modified as follows:

- The 10% floor on net casualty losses is not applicable;
- The $100 limit per casualty is increased to $500;
- Taxpayers are not required to itemize to claim a casualty loss deduction. Taxpayers who take the standard deduction can increase their standard deduction by the amount of the net disaster loss); and
- If a taxpayer increases their standard deduction by the net disaster loss, then IRC §56(b)(1)(E), which generally disallows the standard deduction for AMT purposes, will not apply to the portion attributable to the net disaster loss.

A net disaster loss is the excess of qualified disaster-related personal casualty losses over personal casualty gains.

California nonconformity

California does not conform to the disaster-related personal casualty loss provisions of the TCDTRA.

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Don't forget the new Schedule A checkbox for equity debt

Starting with the 2018 tax year, the IRS added a new check box to Schedule A that requires taxpayers to indicate if they didn't use their entire home mortgage loan to buy, build, or improve their home.

Many taxpayers have equity loans that were in place prior to the TCJA that may contain some acquisition debt and some equity debt. Often, neither taxpayers nor their tax professionals tracked how much of the loan was used to buy, build, or improve the home prior to the TCJA because it often didn't matter.

On audit, the vast majority of taxpayers in this situation will have a very difficult time proving how much of their equity loan is properly allocable to acquisition debt. After all, what taxpayer can effectively track loan proceeds years later?

The regulations provide debt payoff ordering rules. Under the rules if, at any time, any portion of a debt is repaid and the debt is allocated to more than one expenditure (such as acquisition debt and equity debt), then the debt is treated as repaid in the following order:

- Amounts allocated to personal expenditures;
- Amounts allocated to investment expenditures and passive activity expenditures (other than passive activity expenditures described in the next bullet point);
- Amounts allocated to passive activity expenditures in connection with a rental real estate activity with respect to which the taxpayer actively participates;
- Amounts allocated to former passive activity expenditures;
- Amounts allocated to trade or business expenditures and to expenditures with respect to certain low-income housing projects; and lastly
- Acquisition debt.
  (Treas. Regs. §1.163-8T(d)(1))

The debt payoff ordering rules are beneficial to taxpayers because they treat debt payoff as allocated to the least favorable debt first and most favorable debt last.

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 second homes, within the lower dollar caps.

Deduction is per taxpayer, not per residence

The limitation of indebtedness for qualified residence interest are determined on a per-taxpayer basis and not on a per-residence basis. (IRB 2016-31; ***Voss v. Comm.*** (2015) 796 F.3d 1051) Married taxpayers are deemed to be a single taxpayer for these purposes. Thus, two (or more) unmarried co-owners are individually limited to a deduction for interest paid on the first $750,000 of acquisition debt ($1 million for acquisition debt incurred on or before December 15, 2017).

Practice Pointer

If two people own a home and deduct mortgage interest on two separate returns, then each person should report the mortgage interest differently on Schedule A to avoid an automated matching problem by the IRS.

The person whose name appears first on the Form 1098 (the one whose SSN or TIN is on the Form 1098), should report mortgage interest on Form 1040, Schedule A, line 8a (Home mortgage interest and points reported to you on Form 1098).

The person(s) whose name does not appear first on the Form 1098 should report mortgage interest on Form 1040, Schedule A, line 8b (Home mortgage interest not reported to you on Form 1098).

Points

Although points are still deductible on Schedule A, for tax years beginning in 2018 but before 2026, the deduction for points is not allowed under the TCJA to the extent they are allocable to equity indebtedness. (IRC §461(g)(2)) If points are paid on acquisition debt in excess of the mortgage interest limitation ($750,000 for new loans after December 15, 2017), then points must be reduced in the same manner as mortgage interest.

Mortgage insurance premiums

Mortgage insurance premiums are deductible as qualified residence interest. (IRC §163(h)(3)(E)) The itemized deduction or mortgage insurance premiums expired on December 31, 2017, but was retroactively extended through 2020 by the Further Consolidated Appropriations Act of 2020, then again through 2021 by the TCDTRA. (TCDTRA §133)

Practice Pointer

In March 2020, the IRS reissued the 2018 Schedule A to allow taxpayers to amend their 2018 tax returns to take advantage of the retroactive extension of mortgage insurance premiums. As such, taxpayers who paid, but could not deduct, mortgage insurance premiums for 2018, can amend their 2018 tax returns and claim these additional deductions.

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. (R&TC §§17024.5, 17201)

CHARITABLE CONTRIBUTIONS

Charitable contribution deduction denied where basis was not reported

A taxpayer was denied a charitable deduction for donated property because the taxpayer failed to provide the cost basis of the property on its Form 8283, Noncash Charitable Contributions. (***Oakhill Woods, LLC v. Comm.***, TCM 2020-24)

The instructions to the form state that "[i]f you have reasonable cause for not providing the information … attach an explanation so your deduction will not be automatically disallowed." The taxpayer submitted a statement saying that the basis was not taken into consideration to compute the deduction, and so it was not reported on the form. Simply saying the information was not necessary did not comply with the requirement to report the cost basis (Treas. Regs. §1.170A-13(c)), and so the deduction was disallowed.

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 1-32 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; 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.

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 W-2 wages and the unadjusted basis of assets immediately before acquisition (UBIA).

IRC §199A Phaseout Range		
Filing status	**2020 (Rev. Proc. 2019-44)**	**2021 (Rev. Proc. 2020-45)**
Married filing joint	$326,600–$426,600	$329,800–$429,800
Married filing separate	$163,300–$213,300	$164,925–$214,925
Single and HOH	$163,300–$213,300	$164,900–$214,900
Note: The above are taxable income amounts immediately before the IRC §199A deduction and are not reduced for net capital gains.		

QBI AND CHARITABLE CONTRIBUTIONS

In October 2020, the IRS released the 2020 draft instructions to Form 8995, Qualified Business Income Deduction Simplified Computation. Contained within the draft instructions is a subtle, but important, change from the 2019 form instructions that appears to remove charitable contributions from the list of items the IRS believes should reduce a taxpayer's QBI.

For 2019, the IRS's instructions to Form 8995 stated that in order to figure the total amount of QBI, taxpayers must consider all items that are related to a trade or business, including:

- Charitable contributions;
- Unreimbursed partner expenses;
- Interest expense for the purchase of a partnership interest or S corporation stock;
- Deductible part of self-employment tax;
- Self-employed health insurance deduction; and
- Contributions to qualified retirement plans.

Example of charitable contributions reducing QBI

ABC, LLC owns a cleaning supply business and reports the following K-1 items to Jay, who is a 60% owner of the business:

2019 K-1 Items

Line #	Description	Amount
1	Ordinary income (loss)	$100,000
13A	Charitable contributions	$3,000
20Z	IRC §199A qualified business income	$ 97,000

Pursuant to the 2019 draft instructions to Form 8995, Jay's QBI should be $97,000 ($100,000 ordinary income - $3,000 charitable contributions). However, prior to the release of the 2019 draft instructions, the tax community, including tax preparation software companies, would have reported Jay's QBI as $100,000.

As this example illustrates, Jay's IRC §199A deduction will be reduced by as much as $600 ($3,000 charitable contribution × 20% maximum IRC §199A deduction) merely because his business made charitable contributions.

Amending 2019 returns

Unfortunately, the IRS has not provided direct guidance addressing the charitable contribution issue. So, does this mean that our tax software will no longer reduce our client's QBI by charitable contributions reported on a K-1? Can we go back and amend our clients' 2019 income tax returns to increase their IRC §199A deduction?

It's unlikely that you would need to amend your clients' 2018 income tax returns on this issue because at the time we prepared 2018 income tax returns, the tax community, including tax software companies, didn't believe that charitable contributions reduced QBI and therefore 2018 income tax returns were prepared without the reduction.

MAXIMIZING THE QBI DEDUCTION ON THE 1040

It is often possible to leverage other deductions with the IRC §199A deduction to increase the IRC §199A deduction.

This is most often true when:

- The taxpayer's IRC §199A deduction is limited by the taxable income limitation; or
- The taxpayer is within or over the phaseout range.

Taxable income limitation

When a taxpayer is limited by the IRC §199A taxable income limitation, additional income may benefit from the 20% qualified business income deduction even if the income itself is not QBI (and not capital gains).

Example of taxable income limitation

Phyllis operates a Schedule C business that generates $210,000 of QBI. She files a joint return with her husband, Oscar, who is unemployed. Their taxable income is $165,000.

They can claim an IRC §199A deduction of $33,000 (lesser of 20% of QBI or 20% of taxable income). If Oscar gets a job and earns $40,000, they will have taxable income of $205,000. Their IRC §199A deduction will increase to $41,000. Effectively, they get a 20% deduction on Oscar's wages.

The reason is that their IRC §199A deduction is limited because their taxable income is less than their QBI before Oscar starts working. Any additional income, other than capital gains, will increase their IRC §199A deduction until their taxable income equals their QBI.

Example of within the phaseout range

George operates a tax practice which is a specified service trade or business (SSTB). He reports $150,000 of QBI on his Schedule C and has taxable income of $175,000 before IRC §199A (so he is within the phaseout range for a single individual). He is 55 years old. If he makes a traditional IRA contribution of $7,000, it will:

- Give him a $7,000 deduction for the retirement contribution; and
- Reduce his phaseout percentage from 28.55% to 14.55% ($7,000 ÷ $50,000 = 14%), thereby increasing the IRC §199A deduction.

George can get even more aggressive if he opens a solo 401(k) because his contribution limit is much higher than a traditional IRA. For taxable years beginning in after December 31, 2019, the SECURE Act now allows taxpayers to adopt retirement plans, such as 401(k)s, up to the extended due date of a plan sponsor's income tax return. See page 5-23 for a complete discussion.

Example of using a Roth conversion

Rex is married and has a business with Schedule C income of $100,000. He is a realtor, so his business is not a specified service business. His standard deduction is $24,800.

Calculation of QBI:

Net Schedule C income	$100,000
Less: Self-employment tax deduction	(7,065)
Qualified business income	$ 92,935
Tentative IRC §199A deduction ($92,935 × 20%)	$ 18,587

However, the QBI deduction is limited to 20% of taxable income before the IRC §199A deduction (the taxable income limitation):

Total income	$100,000
Less: SE tax deduction	(7,065)
Less: Standard deduction	(24,800)
Taxable income before IRC §199A deduction	$ 68,135
$68,135 × 20%	$ 13,627

If Rex does a Roth conversion during the tax year, then he can convert up to $24,800 ($92,935 QBI – $68,135 taxable income without regard to the Roth conversion) and receive a 20% deduction on his Roth conversion.

Rex's IRC §199A deduction is limited because his taxable income is less than his QBI before the Roth conversion. Any additional income, other than capital gains, will increase his IRC §199A deduction until the point where his taxable income equals his QBI.

Effect of capital gains and losses on the QBI deduction

Net capital gains are:

- Not included in taxable income for purposes of the IRC §199A taxable income limitation; and
- Included in taxable income for purposes of the IRC §199A phaseout.

Therefore, if the taxpayer is within the phaseout range and has net capital gains, harvesting losses can reduce the taxpayer's phaseout percentage and increase the IRC §199A deduction.

Example of taking capital losses to increase IRC §199A deduction

Edgar has QBI of $100,000 from a non-SSTB business and taxable income of $173,300 including $20,000 of net capital gains. His initial deduction is $20,000 (20% × $100,000). However, he is 20% into the phaseout range, so his deduction is reduced to $16,000.

If he sells stock at a $10,000 loss before year-end, he will reduce his taxable income to $163,300 and have no phaseout. He will get the full $20,000 deduction.

Marriage and the qualified business income deduction

Marriage (or not getting married) can be a substantial penalty or benefit when it comes to the IRC §199A deduction.

Example of marriage penalty

Jan is a self-employed attorney who nets $400,000 per year, and John is a self-employed financial planner who nets $120,000 per year. They get married. Because they are married and their income is from SSTBs, they won't get the IRC §199A deduction on either business because they're over the top of the phaseout range for married taxpayers filing jointly. Had they stayed single, John would have gotten a $24,000 deduction (20% × $120,000). Marriage will cost them about $5,000 per year in taxes (just for the lost IRC §199A deduction).

Example of marriage benefit

Mary is a self-employed physician who nets $250,000 per year, and Albert is an employee who makes $50,000 per year. As a single taxpayer in an SSTB, Mary is not entitled to a deduction because her taxable income is over the top of the phaseout range for a single taxpayer. They are considering getting married. Filing jointly, Mary would be entitled to a full deduction of $50,000 because their joint taxable income is below the phaseout threshold ($321,400). Marriage will save them about $20,000 per year in taxes.

California nonconformity

California does not have a 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	**2020 (Rev. Proc. 2019-44)**	**2021 (Rev. Proc. 2020-45)**
Single, HOH	$72,900	$73,600
MFJ, surviving spouse	$113,400	$114,600
MFS	$56,700	$57,300
Estates and trusts	$25,400	$25,700

The AMT exemption phaseout threshold is adjusted annually for inflation.

AMT Exemption Phaseout Threshold		
Filing status	**2020 (Rev. Proc. 2019-44)**	**2021 (Rev. Proc. 2020-45)**
Single, HOH	$518,400	$523,600
MFJ, surviving spouse	$1,036,800	$1,047,200
MFS	$518,400	$523,600
Estates and trusts	$84,800	$85,650

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 12-53). (R&TC §17062(b)(5)(A)–(C) and (b)(6)(A)–(C))

SELF-EMPLOYMENT TAX

Deferred compensation and SE tax

An independent contractor who received payments from a nonqualified deferred compensation plan was liable for self-employment tax on those payments. (***Dunlap v. Comm.***, TCS 2020-10)

Self-employment income includes the net earnings from self-employment, and to be taxable as such, must be tied to the quality or quantity of the taxpayer's labor. The payments from the deferred compensation plan were calculated based on the taxpayer's prior work and income activity with Mary Kay. (Also see ***Peterson v. Comm.***, TCM 2013-271) Therefore, the payments were tied to the quality and quantity of her work, and self-employment tax applied.

INDIVIDUAL TAX CREDITS

CHILD TAX CREDIT

For tax years 2018 through 2025, the Child Tax Credit is $2,000 per qualifying child. (IRC §24(h)) Of this, up to $1,400 per child is refundable. (IRC §24(h)(5))

Taxpayers may also claim a credit of $500 per dependent that 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))

Qualifying children must have a Social Security number that is issued by the due date of the taxpayer's income tax return. 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).

Refundable portion of credit

Although the basic credits of $2,000 and $500 will not be indexed for inflation, the $1,400 refundable limit is increased for inflation after 2018. (IRC §24(h)(5)(A))

Maximum Refundable Portion of Child Tax Credit	
2018 (TCJA)	$1,400
2019 (Rev. Proc. 2018-57)	$1,400
2020 (Rev. Proc. 2019-44)	$1,400
2021 (Rev. Proc. 2020-45)	$1,400

Election to use 2019 earned income

The TCDTRA allows taxpayers who claim the refundable child tax credit to elect to base their 2020 credit on their 2019 earned income rather than their 2020 earned income, but only if their 2019 earned income is higher than 2020. (TCDTRA §211)

Minimum earned income threshold for refundable credit

In order to qualify for the refundable portion of the Child Tax Credit, a taxpayer must have at least $2,500 of earned income. Once a taxpayer's earned income hits the $2,500 threshold, the refundable portion of the credit is phased in (it's not a cliff). (IRC §24(d))

Earned income for purposes of the Child Tax Credit includes wages, any net profit (or loss) from Schedule C and Schedule F, Schedule K-1 (Form 1065) box 14A (self-employment income), and IHSS payments. Amounts flowing from a K-1 that are not subject to self-employment tax are not counted as earned income for purposes of the Child Tax Credit.

Example of Child Tax Credit earned income

John is the sole shareholder of HJK, Inc., an S corporation and he has three children. HJK's ordinary income, reported to John on Schedule K-1, line 1 is $100,000. However, John does not pay himself a salary, so his only income is the $100,000 flowing to him on his S corporation K-1.

For purposes of calculating the Child Tax Credit, John has zero earned income and cannot claim any Child Tax Credit.

✐ **Practice Pointer**

Taxpayers in John's scenario are required to pay themselves reasonable salaries and wages, but that doesn't mean they always do so. The higher Child Tax Credit may provide incentive to start paying themselves wages.

AGI phaseout

The Child Tax Credit and the other dependent credit begin to phase out for taxpayers with AGI in excess of $400,000 in the case of married taxpayers filing jointly and $200,000 for all other taxpayers. The phaseout thresholds are not indexed for inflation.

California nonconformity

California has no comparable Child Tax Credit but continues to allow a personal exemption credit for dependents. (R&TC §17054)

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))**
2019 (Rev. Proc. 2018-57)	$14,080	$14,080
2020 (Rev. Proc. 2019-44)	$14,300	$14,300
2021 (Rev. Proc. 2020-45)	$14,440	$14,440

Phaseout amounts

For 2020, both the Adoption Credit and the exclusion are phased out ratably when modified AGI is $214,520–$254,520. (Rev. Proc. 2019-44) The same phaseout amounts apply for all filing statuses.

For 2021, the phaseout range is $216,660–$256,660 (Rev. Proc. 2020-45)

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 nonconformity

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. The EIC is not available to married individuals who file separate returns. 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**	**2020 (Rev. Proc. 2019-44)**	**2021 (Rev. Proc. 2020-45)**
None	7.65%	$7,030	$7,100
One	34%	$10,540	$10,640
Two	40%	$14,800	$14,950
Three or more	45%	$14,800	$14,950

Beginning point of phaseout range increased 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					
		2020 (Rev. Proc. 2019-44)		**2021 (Rev. Proc. 2020-45)**	
Qualifying children	Phaseout percentage	Other than joint returns	Joint returns	Other than joint returns	Joint returns
None	7.65%	$8,790–$15,820	$14,680–$21,710	$8,880–$15,980	$14,820–$21,920
One	15.98%	$19,330–$41,756	$25,220–$47,646	$19,520–$42,158	$25,470–$48,108
Two	21.06%	$19,330–$47,440	$25,220–$53,330	$19,520–$47,915	$25,470–$53,865
Three or more	21.06%	$19,330–$50,954	$25,220–$56,844	$19,520–$51,454	$25,470–$57,414

Election to use 2019 earned income

The TCDTRA allows taxpayers who claim the Earned Income Credit to elect to base their 2020 credit on their 2019 earned income rather than their 2020 earned income, but only if their 2019 earned income is higher than 2020. (TCDTRA §211)

California conformity

California's Earned Income Tax Credit (EITC) is available for the 2020 taxable year. The credit is only available to individuals who have a qualifying principal place of abode in California. See page 9-23 for a discussion of the California EITC.

EDUCATION CREDITS

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	Credit begins to phase out at $59,000 modified AGI and is fully phased out at $69,000 ($118,000 and $138,000 thresholds for joint returns) in 2020; phaseout is inflation-adjusted. The phase out ranges for 2021 are $80,000–$90,000 ($160,000–$180,000 for joint returns). (TCDTRA)
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.

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.

Saver's Credit Rate Chart				
	AGI			
Year	**Joint**	**Head of household**	**All other filers**	**Credit %**
2020 2021	$0–$39,000 $0–$39,500	$0–$29,250 $0–$29,625	$0–$19,500 $0–$19,750	50%
2020 2021	$39,001–$42,500 $39,501–$43,000	$29,251–$31,875 $29,626–$32,250	$19,501–$21,250 $19,751–$21,500	20%
2020 2021	$42,501–$65,000 $43,001–$66,000	$31,876–$48,750 $32,251–$49,500	$21,251–$32,500 $21,501–$33,000	10%
2020 2021	Over $65,000 Over $66,000	Over $48,750 Over $49,500	Over $32,500 Over $33,000	0%
2020: Rev. Proc. 2019-59; 2021: Rev. Proc. 2020-45				

2020 credit for 2021 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 contribution for the 2020 taxable year up until April 15, 2021, and be entitled to a 2020 credit.

California nonconformity

California has no comparable credit.

NONBUSINESS ENERGY PROPERTY CREDIT

The Further Consolidated Appropriations Act of 2020, signed into law on December 20, 2019, retroactively extended the nonbusiness energy property credit through 2020, and the TCDTRA extended it again through 2021. (IRC §25C; TCDTRA) The nonbusiness energy property credit provides a credit of 10% of qualifying energy efficient improvements to a taxpayer's principal residence. Qualifying property includes energy efficient windows, doors, and skylights among other items.

The credit is capped at $500 over the taxpayer's lifetime with lower caps for certain property. For example, the lifetime credit cap for installing energy efficient windows is $200.

Practice Pointer

In March 2020, the IRS reissued 2018 Form 5695, Residential Energy Credits, which is used to calculate the nonbusiness energy property credit under IRC §25C. Ordinarily, the nonbusiness energy property credit would be reported on Part II of Form 5695. As originally issued for 2018, Part II was simply left "reserved."

Due to the reissuance of the 2018 Form 5695 in March 2020, taxpayers can now amend their 2018 income tax returns to claim the nonbusiness energy property credit.

RESIDENTIAL ENERGY EFFICIENT (SOLAR) PROPERTY (REEP) CREDIT

The credit for qualified solar electric property and qualified solar water heating property placed in service before January 1, 2023, is:

- For property placed in service between January 1, 2020, and December 31, 2021, 26%; and
- For property placed in service between January 1, 2022, and December 31, 2022, 22%. (IRC §25D)

The TCDTRA extended the 26% credit through 2021, thus extending the complete phaseout of the residential energy efficient property credit through 2022. (TCDTRA §148)

California nonconformity

California has no comparable credit.

Residential Energy Efficiency Tax Credits Comparison Chart		
	IRC §25C credit	**IRC §25D credit**
Types of qualifying property	Qualifying energy efficiency improvements: • Insulation; • Windows (including skylights); • Doors; • Qualifying metal roof; and • Asphalt roof with cooling granules Qualifying energy efficient building property that meets specific standards: • Electric heat pump water heater; • Electric heat pump; • Central air conditioner; • Natural gas, propane or oil water heater; and • Biomass fuel stove	Solar property: • Solar electric; and • Solar water heating Other energy efficient property: • Fuel cell; • Small wind energy; • Geothermal heat pumps; and • Biomass fuel property expenditures (TCDTRA §148)
Calculation of credit	10% of qualifying energy efficiency improvements installed plus qualifying energy property expenditures	30% of residential energy efficient property. Reduced to: • 26% for property placed in service in 2020–2021; and • 22% for property placed in service in 2022
Credit cap	$200 for windows (lifetime cap) $500 (lifetime cap) Energy property and associated caps: • Electric heat pump; central air conditioner; natural gas, propane, or oil water heater; biomass stove: $300; • Natural gas, propane, or oil furnace or hot water boiler: $150; and • Advanced main air circulating fan: $50	**Fuel cell:** $500 per 0.5kW of capacity per taxable year
		(continued)

Residential Energy Efficiency Tax Credits Comparison Chart (continued)		
	IRC §25C credit	**IRC §25D credit**
Qualifying residence	Existing U.S. principal residence only as defined under IRC §121. New residence does not qualify	Any residence of the taxpayer (except for fuel cell — principal residence only). Both existing residence and new residence qualify
Applicable against AMT	Yes	Yes
Refundable	No	No
Carryover	No	Yes (indefinite)
Expiration	December 31, 2021	December 31, 2022

QUALIFIED PLUG-IN ELECTRIC DRIVE VEHICLES CREDIT

IRC §30D allows a credit for new qualified plug-in electric drive vehicles (plug-in credit) purchased after December 31, 2010.

A phaseout of the credit begins with respect to a particular manufacturer's vehicles when that manufacturer has sold a total of 200,000 new qualified plug-in electric drive motor vehicles for use in the United States after December 31, 2009.

The IRS provides a list of vehicles that qualify and their applicable credit amounts on its website.

Website
www.irs.gov/Businesses/Qualified-Vehicles-Acquired-after-12-31-2009

$7,500 maximum credit

The *base* credit amount is $2,500 and applies for each qualifying vehicle placed in service by the taxpayer during the tax year.

The second part of the credit is calculated based on the size of the battery. For a vehicle that uses a battery that has at least five kilowatt hours of capacity, the credit is increased by $417, plus $417 for each kilowatt hour of battery capacity over five kilowatt hours. This additional credit amount may not exceed $5,000. So, the maximum credit allowed is $7,500.

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

Plug-in credit vehicle list updated

The IRS has released an updated list of vehicles that qualify for the New Qualified Plug-in Electric Drive Motor Vehicle Credit, and includes the amount of credit for which each model qualifies. The list can be found at:

Website
www.irs.gov/businesses/irc-30d-new-qualified-plug-in-electric-drive-motor-vehicle-credit

AFFORDABLE CARE ACT (ACA)

ACA INDIVIDUAL MANDATE

Reduced to zero beginning in 2019

Beginning January 1, 2019, the ACA's individual shared responsibility payment is zero, effectively repealing the individual mandate. So taxpayers without health insurance will not be penalized at tax time.

California conformity

In response to the TCJA's reduction of the individual mandate penalty to zero, California enacted SB 78 on June 27, 2019. The bill provides that effective January 1, 2020, California residents must maintain monthly health care insurance coverage or be subject to state penalties. (SB 78 (Ch. 19-38))

California also offers its own health insurance subsidies to provide financial assistance to low-income taxpayers. California's subsidy program is more expansive than the federal government's because it is available to California residents whose income is at or below 600% of the federal poverty level. The federal program provides assistance to taxpayers whose income is at or below 400% of the federal poverty level.

California's individual mandate penalty as well as its subsidy program are discussed on page 9-1.

Refund claims

The U.S. Supreme Court has agreed to hear ***California v. Texas*** (U.S. Supreme Court Docket 19-840), which addresses the constitutionality of the Affordable Care Act (ACA). If the Court holds that all, or a portion, of the ACA is unconstitutional, taxpayers may be entitled to refunds for the taxes imposed by the ACA. These include the extra 0.9% Medicare tax and the 3.8% net investment income tax that have been paid on prior-year returns. Refunds are limited to years where the statute of limitations is still open.

PREMIUM TAX CREDIT

Lower-income 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 tax year. The 2020 and 2021 applicable percentages and poverty lines are:

Applicable Percentage		
Household income relative to poverty line	**2020 Premium percentage range (Rev. Proc. 2019-29)**	**2021 Premium percentage range (Rev. Proc. 2020-36)**
Up to 133%	2.06%–2.06%	2.07%–2.07%
133%–150%	3.09%–4.12%	3.10%–4.14%
150%–200%	4.12%–6.49%	4.14%–6.52%
200%–250%	6.49%–8.29%	6.52%–8.33%
250%–300%	8.29%–9.78%	8.33%–9.83%
300%–400%	9.78%	9.83%

2020 Federal Poverty Line for Washington, D.C., Plus All States Except Alaska and Hawaii		
Size of family	**Poverty line**	**400%**
1	$12,760	$51,040
2	$17,240	$68,960
3	$21,720	$86,880
4	$26,200	$104,800

Note: The poverty line is $12,760, plus $4,480 for each additional family member. Thus, for a family of nine, it would be $48,600 ($12,760 + (8 × $4,480)). In Alaska and Hawaii, the poverty lines are slightly higher.

Poverty lines for several recent years are available at:

Website
http://aspe.hhs.gov/poverty/figures-fed-reg.cfm

Limitation of Payback of Excess Advance Credits for 2021 (Rev. Proc. 2020-45)		
Household income relative to poverty line	**All filing statuses except single**	**Single**
Less than 200%	$650	$325
At least 200% but less than 300%	$1,600	$800
At least 300% but less than 400%	$2,700	$1,350
400% or more	No limit	No limit

Premium tax credit planning

Whether to tie the knot before or after midnight on New Year's Eve has always been an issue. But the ACA shed a whole new light on whether or not to marry. Although the federal penalty for failure to maintain health insurance is zero beginning January 1, 2019, the repayment of health insurance subsidies remains. Consider incomes of both spouses when one or the other has received a subsidy.

If one spouse had little income but received a large advance premium tax credit and he or she marries a spouse with modest to high income, all or a portion of the credit must be repaid.

California conformity

Beginning January 1, 2020, California will have a penalty for failure to have insurance (see page 9-1). Thus, at the end of 2020, taxpayers must consider the marriage penalty for California purposes.

As in the previous situations, check to see if the tax savings from filing a joint return and the cost of insurance for both spouses is less than the cost of both filing as single and paying for insurance and/or insurance-related penalties.

HEALTH COVERAGE TAX CREDIT

The Health Coverage Tax Credit (HCTC) under IRC §35 was scheduled to expire at the end of 2019 but was extended for all coverage months beginning in 2020 and 2021 by the Further Consolidated Appropriations Act of 2020 then by the TCDTRA. (TCDTRA §134) Eligible individuals can receive a tax credit to offset the cost of their monthly health insurance premiums for 2020 if they have qualified health coverage for the HCTC.

The Health Coverage Tax Credit is a limited credit available only to the following:

- Individuals eligible for Trade Adjustment Assistance (TAA) allowances because of a qualifying job loss; and
- Individuals between ages 55 and 64 whose defined benefit pension plans were taken over by the Pension Benefit Guaranty Corporation (PBGC).

Eligible individuals must claim the Health Coverage Tax Credit using Form 8885.

NANNY TAX THRESHOLD

For 2020, the nanny tax threshold is $2,200. For 2021, it is $2,300. (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. When the fall 2020 school year started, many schools were engaged in "distance learning" where students attended class online.

Many parents, especially those with two full-time working spouses, were forced to hire tutors simply to manage their children and make sure they attended all their classes and did their homework. These workers are also subject to the nanny tax.

California nonconformity

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.

COLLEGE SAVINGS AND ABLE ACCOUNTS

SECURE ACT EXPANDS ALLOWABLE EDUCATION EXPENSES

Starting in 2018, the TCJA expanded nontaxable IRC §529 distributions to include up to $10,000 annually for K-12 tuition.

The SECURE Act further expands the IRC §529 distribution rules. The list of qualified higher education expenses that are permitted for §529 account distributions now also include:

- Costs, fees, and supplies associated with registered apprenticeships; and
- Student loan repayments (limited to $10,000 over the student's lifetime).
  (SECURE Act §302(a) and (b); IRC §529(c)(8) and (9))

Apprenticeships

The SECURE Act adds IRC §529(c)(8) to the Code, which provides that "expenses for fees, books, supplies, and equipment required for the participation of a designated beneficiary in an apprenticeship program registered with the Secretary of Labor" are eligible distributions from a §529 college savings account.

Finding or creating registered apprenticeships

Taxpayers can find registered apprenticeship programs directly through the U.S. Department of Labor's apprenticeship website:

Website
www.apprenticeship.gov

Employers and educators can use the same website to create and register an apprenticeship program.

§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 nonconformity

California does not conform to the Tax Cuts and Jobs Act provision allowing §529 distributions to be used for K–12 education nor does it conform to the SECURE Act provisions permitting §529 distributions to be used for registered apprenticeships or to repay student loans. As such, California residents who use distributions from §529 accounts for any of these reasons 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)

RECONTRIBUTING TUITION REFUNDS TO §529 PLANS

With the onset of COVID-19, many colleges began canceling on-campus classes and closing student dormitories, sending many parents or students full or partial refunds for room and board. If these expenses were paid with funds distributed from a §529 plan, there may be a taxable event. Luckily, there are options available to avoid tax and penalties.

Rollover deadline extension

Any refunded §529 distributions typically have 60 days from receipt to be deposited back into the §529 plan to be treated as a nontaxable recontribution. But as part of the various COVID-19 relief efforts, the IRS extended the deadline for recontributions. (Notice 2020-23) As a result, if the 60-day period fell after April 1, 2020, and before July 15, 2020, the recontribution could be made any time before the later of July 15, 2020, or 60 days from receipt to avoid tax and the imposition of the early withdrawal penalty.

Other options

Depending on the amount of the refund, there are options to utilize the returned cash without having tax or penalties imposed, even if the funds were not recontributed to the student's §529 plan. As long as the amounts were used for qualified educational expenses in 2020, the distributions are not subject to tax. Consider:

- **Paying down a student loan:** Beginning with distributions made after 2018, the SECURE Act treats up to $10,000 of student loan principal and interest payments as §529 qualified educational expenses. (SECURE Act §302(b); IRC §529(c)(9)) The $10,000 limit applies over the student's lifetime, not per taxable year;
- **Covering other qualified tuition costs:** If the student will be switching to online learning for which additional amounts will be charged, those tuition costs could be covered. It is best to check with the online provider before making the decision; and
- **Buying a computer:** With students completing their current course work off campus, the purchase of a computer could be a good use of the returned money and is treated as a qualified educational expense.

Example of qualified educational expenses

Ellie was attending the University of San Diego. By mid-March, the university was ordered to close due to the COVID-19 pandemic. Ellie lived on campus. On April 10, 2020, Ellie's parents received a full refund of her qualified education expenses that had been paid for with a distribution from her §529 plan. Ellie's parents had until July 15, 2020 to recontribute the funds to her §529 account, but they failed to do so.

Ellie took online classes for the fall 2020 semester. She purchased a computer and used the refunded tuition from the spring semester to enroll in the fall semester.

As long as Ellie's qualified educational expenses paid during the year are equal to or greater than her §529 distributions for the year, she won't have any taxable income and won't face the 10% withdrawal penalties for improperly using her §529 funds.

Practice Pointer

Tax professionals whose clients paid for their spring 2020 semester with §529 funds, then received tuition refunds, should spend some extra time probing their clients about how they spent the tuition refund. If the client missed the deadline to recontribute the funds back into their §529 account, you may find that the client still made proper use of the funds for expenses associated with the fall 2020 semester.

California conformity

California conforms the provision allowing the 60-day rollovers for §529 plans. (R&TC §§17140, 17140.3, 23711) California also conforms to both IRS Notice 2020-23 (extending the 60-day recontribution deadline to July 15, 2020).

ROLLOVER TO AN ABLE ACCOUNT (IRC §529A)

Distributions from an IRC §529 account are tax-free and without penalty if, within 60 days of the distribution and before January 1, 2026, the funds are transferred to an ABLE account under IRC §529A belonging to the same beneficiary or a member of the beneficiary's family. (IRC §529(c)(3)(C)(i)(III))

The contributed distribution, when added to all other contributions to the ABLE account for the taxable year, count toward the annual contribution limit ($15,000 for 2019 and 2020).

California conformity

California conforms to the federal changes. (R&TC §§17140.4, 23711.4)

MISCELLANEOUS YEAR-END STIMULUS PROVISIONS

Miscellaneous provisions include:

- The Two-Wheeled Plug-In Electric Vehicle Credit (TCDTRA §144; IRC §30D); and
- Restoring taxpayer confidentiality protections removed by the CARES Act related to tax information provided by the IRS to the Department of Education for evaluating student loan applications. (ACRRA §284)

2020–2021 PHASEOUT CHART

2020 AGI Phaseout (2021 in italics where changed from 2020)					
Provision	**IRC §**	**Joint return**	**Single**	**Head of household**	**Married filing separate**
Savings bond interest	135	$123,550–$153,550 *$124,800–$154,800*	$82,350–$97,350 *$83,200–$98,200*	$82,350–$97,350 *$83,200–$98,200*	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)	$104,000–$124,000 *$105,000–$125,000*	$65,000–$75,000 *$66,000–$76,000*	$65,000–$75,000 *$66,000–$76,000*	$0–$10,000
IRA deduction with spouse covered	219(g)(7)	$196,000–$206,000 *$198,000–$208,000*	N/A	N/A	N/A
Roth IRA contribution	408A	$196,000–$206,000 *$198,000–$208,000*	$124,000–$139,000 *$125,000–$140,000*	$124,000–$139,000 *$125,000–$140,000*	$0–$10,000
Passive rental loss	469(i)	$100,000–$150,000	$100,000–$150,000	$100,000–$150,000	$50,000–$75,000
Provision	IRC §	Joint return	Single	Head of household	Married filing separate
Student loan interest	221(b)(2)	$140,000–$170,000	$70,000–$85,000	$70,000–$85,000	None allowed
$4,000 tuition deduction	222	Less than $130,000 *N/A*	Less than $65,000 *N/A*	Less than $65,000 *N/A*	None allowed
$2,000 tuition deduction	222	$130,000–$160,000 *N/A*	$65,000–$80,000 *N/A*	$65,000–$80,000 *N/A*	None allowed
Education savings account	530	$190,000–$220,000	$95,000–$110,000	$95,000–$110,000	$95,000–$110,000
American Opportunity Tax Credit	25A	$160,000–$180,000	$80,000–$90,000	$80,000–$90,000	None allowed

(continued)

2020 AGI Phaseout (2021 in italics where changed from 2020) (continued)					
Provision	**IRC §**	**Joint return**	**Single**	**Head of household**	**Married filing separate**
Lifetime Learning Credit	25A	$118,000–$138,000 *$160,000–$180,000*	$59,000–$69,000 *$80,000–$90,000*	$59,000–$69,000 *$80,000–$90,000*	None allowed
AMT exemption phaseout	55(d)	$1,036,800 *$1,047,200*	$518,400 *$523,600*	$518,400 *$523,600*	$518,400 *$523,600*
Adoption Credit	23, 137	$214,520–$254,520 *$216,660–$256,660*	$214,520–254,520 *$216,660–$256,660*	$214,520–$254,520 *$216,660–$256,660*	None allowed
Child Tax Credit	24	$400,000	$200,000	$200,000	N/A
Dependent Care Credit	21	$15,000–$43,000	$15,000–$43,000	$15,000–$43,000	None allowed
Retirement contribution 50% credit 20% credit 10% credit	25B	See page 1-45	See page 1-45	See page 1-45	See page 1-45

PRESIDENT BIDEN: WHAT CAN WE EXPECT?

Joe Biden has advocated numerous tax policy positions, including:

- Repeal the reduced capital gains and qualified dividends tax rate for taxpayers making over $1 million per year. Their gains would be taxed at the 39.6% tax rate (plus the 3.8% NIIT rate);
- Increase taxes on those earning more than $400,000 by:
  - Reinstating the 39.6% tax bracket for individuals earning more than $400,000 that was in place prior to the TCJA reduction to 37%;
  - Phasing out the IRC §199A qualified business income deduction for households with taxable income in excess of $400,000; and
  - Imposing Social Security payroll taxes on earnings of $400,000 and above, creating a "donut hole" in the current Social Security payroll tax system, where wages between $137,700, the current wage cap, and the $400,000 would not be subject to FICA;
- Further limit itemized deductions by placing a cap on the tax benefit that can be received to 28% and reinstating the pre-TCJA overall limit on itemized deductions. In 2017 when the limit was still in effect, the phaseout threshold was $261,500 ($313,800 for MFJ);
- Repeal the step-up in basis for inherited properties (it is unclear whether the assets would be taxed at death or whether the beneficiary would receive a carryover basis);
- Increase the corporate tax rate from 21% to 28%;
- Restore and make permanent the Energy Investment Tax Credit, Residential Energy Efficiency Credits, and the Electric Vehicle Tax Credit;
- Adopt the ABC test for worker classification purposes (similar to California's AB 5);
- Establish first-time homebuyers and renters tax credits; and
- Expand the EITC for childless workers age 65 and over.

Biden has stated that tax changes are not at the top of his to-do list. Looking at the Obama and Trump administrations, it took more than a year to implement Obamacare and the TCJA. However, our country is facing massive deficits, so it seems inevitable that change will come.

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 of these statements regarding economic impact payments (EIPs) is correct?

   a) They are taxable
   b) For purposes of EIPs, adjusted gross income is based only on a taxpayer's 2019 income tax return
   c) The EIP is an advanced credit that must be reconciled on the 2020 return
   d) Taxpayers must repay any advanced credit if their income in 2020 is higher than in 2019

2. What charitable contribution incentives are provided under the CARES Act, applicable to the 2020 year?

   a) There has been a temporary suspension of charitable contribution limits for purposes of the deduction for both cash and property contributions
   b) For individuals who do not itemize their deductions, there is a maximum $300 above-the-line deduction for 2020 cash contributions
   c) The only contributions that do not qualify for the temporary suspension of charitable contribution limits are those to donor advised funds
   d) The percentage for certain food inventory donations made in 2020 for taxpayers other than C corporations is increased from 10% to 15% of the taxpayer's aggregate net income

3. Which choice correctly describes issues surrounding unemployment compensation related to the COVID-19 pandemic?

   a) Unemployment benefits are taxed as ordinary income and are subject to Social Security and Medicare taxes
   b) Pandemic Unemployment Assistance under the CARES Act provided $600 per week for up to 12 weeks
   c) In California, for example, the maximum number of weeks a taxpayer can receive unemployment benefits is 26
   d) Claimants are able to request withholding from their weekly unemployment, but not the PUA at a federal rate of 10%

4. Many colleges have been issuing refunds to parents or students due to campus closures as a result of COVID-19. Which statement best reflects what happens if education expenses were paid from §529 plan funds?

   a) The IRS has extended the time for recontribution to a plan, which means that if the 60-day recontribution period falls after April 1, 2020, and before July 15, 2020, the recontribution may be any time prior to the later of July 15, 2020, or 60 days from receipt of the funds
   b) Funds distributed from a §529 plan may not be recontributed
   c) Distributions may be recontributed, but all such distributions are subject to taxes and penalties
   d) The SECURE Act allows for distributions to be made after 2018 from §529 plans for payments for student loans up to $10,000 per taxable year without being subject to tax, so returned payments may be so applied

SOLUTIONS TO REVIEW QUESTIONS

1. Which of these statements regarding economic impact payments (EIPs) is correct? **(Page 1-1)**
   a) Incorrect. EIPs are nontaxable.
   b) Incorrect. If a 2019 return wasn't filed, the IRS will use the taxpayer's 2018 AGI.
   c) Correct. The reconciliation uses the taxpayer's 2020 income, but no repayment is required.
   d) Incorrect. Although the credit is reconciled similar to the premium tax credit, there is no repayment necessary even with increased income in 2020.
2. What charitable contribution incentives are provided under the CARES Act? **(Page 1-6)**
   a) Incorrect. The suspension of limits applies to cash contributions only.
   b) Correct. Taxpayers must still follow the customary substantiation requirements.
   c) Incorrect. Other contributions that don't qualify are those made to a 509(a)(3) private foundation or carryover contributions from a pre-2020 tax year.
   d) Incorrect. The increase is from 15% to 25% for 2020.
3. Which choice correctly describes issues surrounding unemployment compensation related to the COVID-19 pandemic? **(Page 1-11)**
   a) Incorrect. Social Security and Medicare taxes do not apply.
   b) Incorrect. PUA was provided for 16 weeks maximum.
   c) Incorrect. Taxpayers are allowed $450 a week of regular unemployment compensation for up to 46 weeks.
   d) Correct. This rate applies to the regular weekly unemployment compensation, not the additional payment under Pandemic Unemployment Assistance.
4. Many colleges have been issuing refunds to parents or students due to campus closures as a result of COVID-19. Which statement best reflects what happens if education expenses were paid from §529 plan funds? **(Page 1-54)**
   a) Correct. This is true per Notice 2020-23, whereby plan owners can avoid tax and any early withdrawal penalty.
   b) Incorrect. They may be recontributed, and due to COVID-19, there is an extension on the deadline for recontribution, which is usually 60 days from receipt of the funds.
   c) Incorrect. If the distributions are used for qualified educational expenses in 2020, the distributions are not subject to tax and penalties.
   d) Incorrect. The $10,000 limit applies over the lifetime of the student, not the taxable year.

SPIDELL

TAX • ANALYSIS • EDUCATION

Chapter 2

Practice and Procedures

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PRACTICE AND PROCEDURES

PTINs AND ITINs

PTIN RENEWAL

The IRS is processing PTIN renewals for the 2021 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 this year is $21 (plus a $14.95 service fee to the program administrator). (IR-2020-159; Treas. Regs. §300.13)

Remember new data security question on PTIN renewal

Starting last year, as part of the PTIN renewal process, the IRS added a new question that requires tax professionals to affirmatively declare that they are aware of their data security responsibilities. The question states:

"I am aware that paid tax return preparers must have a data security plan to provide data and system security protections for all taxpayer information."

See page 12-39 for a sample data security plan.

EXPIRING ITINs

ITINs that have not been used on a federal tax return at least once in the last three consecutive tax years (2017, 2018, or 2019) and those issued before 2013 will expire on December 31, 2020. (IR-2020-181) Additionally, ITINs with middle digits of 90, 91, 92, 94, 95, 96, 97, 98, or 99 (example: XXX-95-XXXX) will also expire at the end of 2020. Use IRS Form W-7 to renew.

For more information, see the IRS's ITIN FAQ page at:

Website
www.irs.gov/individuals/itin-expiration-faqs

FORMS AND FILING UPDATE

DON'T USE 1099-MISC FOR NONEMPLOYEE COMPENSATION

Nonemployee compensation is no longer reported on Form 1099-MISC.

The IRS has brought back Form 1099-NEC, Nonemployee Compensation, starting with the 2020 tax year. The Form 1099-NEC was last used for the 1982 tax year.

Form 1099-NEC must be filed with the IRS and mailed to the recipient on or before January 31 each year — the same due date as Form W-2.

Now that Form 1099-MISC is no longer used to report nonemployee compensation, all Forms 1099-MISC are due to the recipient by January 31 and due to the IRS on February 28.

Website
www.irs.gov/pub/irs-pdf/f1099nec.pdf

1099-NEC is not included in the IRS combined federal/state filing program

The IRS will not forward Form 1099-NEC to the states as part of its combined federal/state filing program. Each state will have to provide rules for payers to independently report Form 1099-NEC information to the state. (IRS Publication 1220)

California conformity

For the latest information on California's treatment for payers to independently report 1099-NEC information to the state, see page 7-31.

Practice Pointer

Advise your clients that they must obtain a completed copy of Form W-9 from payees before any payment is made. By requiring the Form W-9 before issuing any payment to a potential 1099 recipient, clients can avoid a headache at the end of the year, as well as problems associated with required backup withholding.

Backup withholding

Nonemployee compensation is subject to backup withholding if a payee has not provided a taxpayer identification number (TIN) to the payer or the IRS notifies the payer that the TIN provided was incorrect. (IRC §3406) A TIN can be a:

- Social Security Number (SSN);
- Employer Identification Number (EIN);
- Individual Taxpayer Identification Number (ITIN); or
- Adoption Taxpayer Identification Number.

The backup withholding rate is 24% (it was 28% for tax years beginning before January 1, 2018) and must be reported on Form 945, Annual Return of Withheld Federal Income Tax. Federal income taxes withheld on nonemployee compensation must be paid over to the IRS based on the payer's payroll tax deposit schedule, which can be daily, semiweekly, monthly, quarterly, or annually, depending on the amount of the payer's payroll tax liabilities.

✐ **Practice Pointer**

If a payee neglects or refuses to provide a taxpayer identification number, then the payer must leave the recipient's TIN blank and attach an affidavit to the information returns (W-2, 1099-MISC, 1099-NEC, etc.) when filed with the IRS. (Treas. Regs. §301.6109-1(c)) The affidavit must list the names of all payees from whom the payer requested, and was not able to obtain, a TIN. As an additional precaution, the payer may attach a copy of the affidavit to its payroll tax returns (Forms 941, 945, etc.).

Taxpayer's failure to do backup withholding is costly mistake

A contractor was found liable for over $1.2 million in backup withholding, penalties, and interest for the 2005−2008 tax years when he consistently filed 1099s to report payments to subcontractors even after the IRS notified him he must start backup withholding because he failed to provide TINs for the subcontractors. (***Quezada v. IRS*** (August 31, 2018) U.S. Bankruptcy Ct., W.D. Texas, Austin Div., Case Nos. 16-10467-TMD, 16-01101-TMD)

The taxpayer argued that the IRS's assessment, which was issued in 2014, was beyond the three-year statute of limitations period because he timely filed the 1099-MISCs and 1040s for the tax years at issue. However, because he never filed the Form 945, Annual Return of Withholding Federal Income, to report and pay the backup withholding on the payments, the IRS argued, and the court agreed, that the statute of limitations never began to run.

Backup withholding notices

The IRS sends out CP2100 and CP2100A notices to let payers know they may be responsible for backup withholding when TINs are missing from IRS records or have incorrect name/TIN combinations. The notices list payees identified as having TIN matching issues. The CP2100 and CP2100A are the same notice; the only substantive difference is that the CP2100A is sent to smaller employers.

For missing TINs: If the payer has not started backup withholding, then it must begin to do so immediately (within 30 days of receiving the CP2100 or CP2100A) and continue withholding until the payer receives a TIN. (IRS Publication 1281) The payer should immediately send the payee a First "B" Notice with an accompanying Form W-9 soliciting a TIN from the payee.

For incorrect TINs: The payer must compare the CP2100/CP2100A to the payer's records. If the CP2100/CP2100A and payer's records agree, then the payer must send a First "B" Notice to the payee. If the CP2100/CP2100A do not agree with the payer's records, then the payer must simply update their records with the correct information contained in the CP2100/CP2100A.

There are two "B" notices:

- The First "B" Notice, which must be sent along with a copy of Form W-9 to a payee after the first CP2100 or CP2100A, indicates a missing or incorrect TIN for the payee; and
- The Second "B" Notice, which must be sent after the payer receives a second CP2100 or CP2100A within a three-calendar year period for the same payee.

The Second "B" Notice is different from the First "B" Notice. The Second "B" Notice tells the payee to contact the IRS or SSA to obtain the correct name/TIN combination. The mailing of the Second "B" Notice should not include a Form W-9.

Sample copies of the "B" notices along with flowcharts detailing a payer's required actions are contained within IRS Publication 1281.

EXTENSION OF TIME TO FURNISH RECIPIENT COPIES OF INFORMATION RETURNS

Taxpayers who are required to file information returns (such as 1099s, W-2s, etc.) generally must provide a copy to the recipient by January 31 of the year following the calendar year of payment. Taxpayers are subject to penalties for failure to provide recipient statements on time. (Treas. Regs. §301.6722-1)

The IRS has announced that taxpayers requesting an extension of time to furnish recipient statements must fax their written request to Internal Revenue Service Technical Services Operation Attn: Extension of Time Coordinator:

Fax
(866) 477-0572

According to the General Instructions for Certain Information Returns (2020), the extension request is made by letter (not using any specific form). The extension request must include the following information:

- Payer's name, tax ID, and address;
- Type of information return (e.g., W-2, 1099-NEC, etc.);
- A statement that an extension is requested for providing recipient statements;
- The reason for the delay in furnishing recipient statements; and
- The payer or payer's authorized agent's signature. (www.irs.gov/forms-pubs/faxing-request-for-extension-of-time-to-furnish-statements-to-recipients)

The IRS must approve the extension request. Payers will generally be granted a maximum 30-day extension of time to furnish recipient statements (15 days for Forms W-2).

E-FILE UPDATE

E-filing Form 1040-X

On August 17, 2020, the IRS announced that taxpayers can now e-file Form 1040-X, Amended U.S. Individual Income Tax Return. (IR-2020-182) As of the date of the announcement, only tax year 2019 Forms 1040 and 1040-SR can be amended electronically. The option to paper-file is still available.

The amended return may not be e-filed if the original return was done on paper.

Tool to check on amended returns

The IRS has provided a tool to check the status of an individual amended return (Form 1040-X). Amended returns will take up to three weeks to appear in the tool, and processing can take up to 16 weeks. Taxpayers will need their Social Security number, date of birth, and zip code to access information. This tool is available for paper-filed and electronically filed amended returns.

The tool can be found at:

Website
www.irs.gov/filing/wheres-my-amended-return

E-filed 1040-X FAQs

The IRS released a new FAQ page dedicated to e-filed amended returns, which can be found at:

Website
www.irs.gov/filing/amended-return-frequently-asked-questions

E-file mandate for tax-exempt organizations

The Taxpayer First Act requires tax-exempt organizations to e-file their returns for tax years beginning after July 1, 2019. (P.L. 116-25) Transition relief was extended to organizations that would suffer hardship due to these new filing requirements, and these organizations will need to e-file for tax years beginning after July 1, 2021.

The forms affected by the e-file mandate are:

- **Form 990, Return of Organization Exempt from Income Tax:** This form must be e-filed beginning after July 1, 2019. The IRS will continue to accept paper forms for short-year returns and other specific circumstances where the IRS system is not able to receive the form electronically (as outlined in the form instructions).
- **Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation:** This form must be e-filed beginning after July 1, 2019. The IRS will continue to accept paper forms for short-year returns and other specific circumstances where the IRS system is not able to receive the form electronically (as outlined in the form instructions).
- **Form 990-EZ, Short Form Return of Organization Exempt from Income Tax:** This form is not required to be e-filed, and optional e-filing is available. Mandatory e-filing will begin for this form for tax years ending on or after August 31, 2020.
- **Form 8872, Political Organization Report of Contributions and Expenditures:** This form must be filed electronically starting January 1, 2020; the IRS will not accept paper returns after this date.
  (IR-2019-206)

Form 990-T, Exempt Organization Business Tax Return, and Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the IRC, will continue to be accepted on paper, pending the conversion of these forms into an electronic format. The IRS anticipates these forms will be ready for e-filing by 2021 (for the 2020 tax year).

FORM 1040 NOW AVAILABLE IN SPANISH

For the 2020 tax year, the IRS is offering Form 1040 in Spanish for the first time. (IR-2020-204) The new Spanish Form 1040 is part of the IRS's effort to reach more taxpayers and includes offering Publication 1, Your Rights as a Taxpayer, in 20 languages. Publication 17, Your Federal Income Tax, will be available in seven languages starting next year.

FBAR FILING DEADLINE EXTENDED

FinCEN announced a further extension of time for certain individuals to file an FBAR in response to ongoing questions regarding the filing requirement and its application to individuals with signature authority over, but no financial interest in, certain types of accounts. (FinCEN Notice 2019-1) The filing due date is extended to April 15, 2021, for reporting of signature authority held during the 2019 calendar year and for individuals whose filing due date for reporting signature authority was previously extended by FinCEN Notice 2018-1 and earlier notices. The filing date remains unchanged for all other individuals with an FBAR filing obligation. The FBAR filing date is the same as the taxpayer's personal income tax return (April 15 original due date and October 15 extended due date).

EXTENDED DEADLINE AND PENALTY RELIEF FOR ACA FORMS

The deadline for issuers of 2020 Forms 1095-B, Health Coverage, and Form 1095-C, Employer-Provided Health Insurance Offer and Coverage, is extended from January 31, 2021, to March 2, 2021. (Notice 2020-76)

The individual shared responsibility payment is zero in 2020. Therefore, an individual taxpayer does not need Form 1095-B to compute his or her federal tax liability. Because of this, reporting entities will not be subject to penalties for failure to furnish 2020 Forms 1095-B if two conditions are met:

- The reporting entity must post a notice prominently on its website stating that responsible individuals may receive a copy of their 2020 Form 1095-B upon request, along with contact information necessary for a responsible individual to make such a request; and
- The reporting entity must furnish a 2020 Form 1095-B to any responsible individual upon request within 30 days of the date the request is received.
(Notice 2020-76)

CLIENT ISSUES

WORKER CLASSIFICATION

Court finds cleaning service workers to be independent contractors

A taxpayer who owned a cleaning service was able to get the Tax Court to reverse the IRS's determination that her independent contractors were employees, which would have meant she was liable for $125,000 in employment tax. (***Santos v. Comm.***, TCM 2020-88) The Tax Court looks at common law principles to make a determination of whether a worker is an employee. (IRC §3121(d); Treas. Regs. §31.3121(d)-1(c)(2); ***Weber v. Comm.*** (1994) 103 TC 378, 386)

A clean record

The taxpayer's business involved cleaning apartment buildings, including "unit turnover" cleaning to prepare a unit for a new tenant. The taxpayer was hired unit-by-unit by the complex to do unit turnover cleaning. The contracts specified the days and hours for cleaning the common areas but did not include any specification for unit turnover cleaning.

As her business grew, the taxpayer recruited other workers to help her clean. She only hired people who had previous cleaning experience, and she never provided any training. Most of the workers she used also worked for other cleaning companies, they used their own supplies, they provided their own transportation to the job sites, and they were allowed to hire their own assistants as they saw fit. The taxpayer never supervised her workers' work, and she didn't do a post-cleaning inspection when they were finished.

The taxpayer did not provide paid leave for sickness or vacation and did not offer health insurance, retirement benefits, or any other employee benefits. However, she did carry commercial general liability insurance and workers' compensation insurance, as obligated by the apartment complexes.

The IRS initiated an employment tax audit, and they classified the workers as employees, saying that the taxpayer had the requisite control over the workers to warrant that classification because she managed the day-to-day operations of the cleaning business. The contracts with the apartment complexes specified that she was responsible for all labor, supervision, and equipment; the IRS focused on that contract language as evidence that she was the employer of the workers.

The taxpayer simply argued that she didn't have the right to control the way the workers did their jobs and so there was no employer–employee relationship.

Court bursts IRS bubble

The court looked at the following factors to make the determination:

- The degree of control exercised by the principal over the worker;
- Which party invests in the work facilities used by the worker;
- The worker's opportunity for profit or loss;
- Whether the principal can discharge the worker;
- Whether the work is part of the principal's regular business;
- The permanency of the relationship; and
- The relationship the parties believed they were creating.

The "crucial" test is the first one regarding control. The Tax Court found that the taxpayer was more of a dispatcher or an intermediary between the workers and the job sites. The court also found that the contracts only controlled the relationship between the apartment complexes and the taxpayer, not the relationship between the taxpayer and her workers.

The taxpayer did not guarantee a specific amount of work for the workers. She also had fairly limited and transitory relationships with them; of the 14 workers she had during the audit period of 2008–2010, only three of them worked for her during the entire audit period, and the rest only worked during any one of those years.

She also believed she was creating an independent contractor relationship with the workers, given that she prepared Forms 1099-MISC and no W-2s or Forms 941.

The Tax Court agreed with the taxpayer that there was no employer–employee relationship and the workers were properly classified as independent contractors.

California nonconformity

California does not conform to the federal worker classification rules. Instead, California applies an ABC test pursuant to California Assembly Bill 5 (AB 5). California worker classification rules will be discussed at page 7-4.

PRACTITIONER ISSUES

OUTSOURCING TAX PREPARATION SERVICES

Tax preparers who make unauthorized disclosures of their clients' tax return information face the following federal penalties:

- Civil penalties equal to $250 per disclosure up to $10,000 maximum ($50,000 if the disclosure results in identity theft (IRC §6713); and/or
- Misdemeanor criminal penalties of up to $1,000 per disclosure ($100,000 if identity theft results) and imprisonment of up to one year. (IRC §7216)

The criminal penalty requires a showing that the preparer “knowingly or recklessly” disclosed the information, whereas there is no such requirement for imposition of the civil penalty.

Who is a tax preparer?

For purposes of these disclosure requirements, a preparer is not limited to those who actually sign the return, but also includes those who assist in preparing the return or who provide auxiliary services in connection with the preparation of returns. (Treas. Regs. §301.7216-1) The IRS has stated that auxiliary services are those services provided by persons who:

- Conduct client interviews to elicit information for the return or who otherwise solicit necessary tax information;
- Actually prepare the return on the basis of information that is provided;
- Type information on the returns into a computer; and
- Use a computer to e-file returns.

Outsourcing preparation processing services

A client’s prior written consent is not required if a tax preparer outsources tax preparation work to a third party as long as the third party is located in the U.S. and does not make any substantive determinations or provide advice affecting the client’s tax liability. A substantive determination involves an analysis, interpretation, or application of the law. (Treas. Regs. §301.7216-2(d))

Authorized disclosures not requiring prior client written consent include disclosing tax return information to:

- Another U.S. tax return preparer to have the other preparer transfer that information to and compute the tax liability on a tax return (essentially just performing data entry); and
- An authorized IRS e-file provider for e-filing purposes.

Example of using a third party

Tax Pro, Inc. is owned by Mark, who enters into a contract with Tax Prep, Inc. to enter data to complete the tax returns. Both companies are in California. Mark interviews his clients and makes all substantive determinations as to exclusions, deductions, etc., prior to forwarding on his clients’ information to Tax Prep to process the return. Tax Prep enters all the information on the return, computes the tax liability, and sends the completed returns back to Mark. Mark undertakes a final review prior to e-filing the return.

For those of you who have been around, remember the old data sheets we’d send to Lacerte, CCH, Compucraft, etc.?

If Tax Prep were to provide any substantive determinations or advice regarding any item on the return, then Mark must obtain his client’s prior written consent prior to contacting Tax Prep regarding the issue(s).

Foreign outsourcing

If a tax preparer outsources tax preparation services to a foreign person or company, then different rules apply. The preparer must obtain his or her client’s written consent prior to disclosing the client’s tax information. However, the preparer may not disclose the taxpayer’s Social Security number, even if the preparer has obtained the client’s prior written consent. The preparer must redact or otherwise mask the taxpayer's SSN before the tax return information is disclosed outside the U.S. (Treas. Regs. §301.7216-2(d)(3))

However, there is an exception to this prohibition against disclosing the taxpayer's Social Security number if the Social Security number is disclosed to a tax preparer outside the U.S. through the use of an "adequate data protection safeguard" maintained by both the sending and receiving tax preparers. (Treas. Regs. §301.7216-3(b)(4)(ii)) See Rev. Proc. 2013-14, Section 5.07 for a list of what is considered adequate data protection safeguards and Section 5.04(e)(ii) for specific language that must be included in the consent signed by the taxpayer.

Outsourcing IT services

No consent is required if a tax preparer hires a third party contractor to provide information technology (IT) services in connection with tax preparation programming, maintenance, repair, testing, or procurement of equipment or software. However, the preparer must "ensure that all individuals who are to receive disclosures of tax return information receive a written notice of the applicability of the penalties to the contractors." As previously discussed, IT contractors are considered tax return preparers under IRC §7216 because they are providing auxiliary services in connection with tax preparation.

TAX PREPARER LIABLE FOR FRAUD PENALTY

Taxpayers were liable for fraud penalties for failing to cooperate with their audit by withholding documentation pertaining to their multiple ventures: a marijuana cigarette container business ("Doobtubes"), rental properties, and a Colorado dispensary. (***Chico v. Comm.***, TCM 2019-123)

Besides being uncooperative, the taxpayer-husband was also a tax professional, and the court found that the continuing education courses he took on personal and corporate tax constituted circumstantial evidence that he was aware of his tax reporting obligations and that by consistently underreporting his income, he did so with fraudulent intent.

IRS ACCEPTING DIGITAL SIGNATURES FOR A LIMITED TIME

The IRS once again extended through December 31, 2020, the period during which it will accept digital signatures and e-mailed documents. It will now accept digital signatures on select documents through June 30, 2021. (IRS Internal Memo to Employees, available at: www.irs.gov/pub/irs-utl/dcse-wet-signature-compliance-morandum.pdf)

No specific technology is required for the e-signatures. The IRS will accept images of signatures (scanned or photographed), including, but not limited to, the common file types supported by Microsoft 365 (TIFF, JPG, JPEG, PDF, Microsoft Office suite, or Zip). The IRS will also accept digital signatures that use encryption techniques (e.g., DocuSign) to provide proof of original and unmodified documentation on common file types supported by Microsoft 365.

IRS employees may use all existing and previously allowable means of receiving documents such as eFax or established secured messaging systems. An IRS employee may, with the taxpayer's consent, e-mail the documents to the taxpayer as an attachment encrypted using SecureZip or one of the other encryption methods described in the memo.

Only the following forms may be filed with e-signatures:

- Form 3115, Application for Change in Accounting Method;
- Form 8832, Entity Classification Election;
- Form 8802, Application for U.S. Residency Certification;
- Form 1066, U.S. Income Tax Return for Real Estate Mortgage Investment Conduit;
- Form 706 (and Form 706-NA), U.S. Estate (and Generation-Skipping Transfer) Tax Return;
- Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return;
- Form 1120-ND, Return for Nuclear Decommissioning Funds and Certain Related Persons;
- Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies;
- Form 1120-C, U.S. Income Tax Return for Cooperative Association;
- Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts;
- Form 1120-L, U.S. Life Insurance Company Tax Return;
- Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return;
- Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts;
- Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner; and
- Form 8453 series, Form 8878 series, and Form 8879 series regarding IRS e-file Signature Authorization Forms.
  (IR-2020-194)

SUPERSEDING RETURNS

The word "supersede" simply means to replace or take the position of another. A superseding tax return replaces a previously filed original return and is treated as the original. It incorporates new or corrected information. The superseding return is filed subsequent to the original return yet still within the filing period including extensions.

An amended return is also filed to correct errors on a previously filed return, but it is commonly filed after the original due date including extensions once the filing period has expired.

Why should a superseding return be filed?

There are many reasons to file a superseding return. By filing a corrected original return before the deadline, certain penalties — for example, an accuracy-related penalty for underreporting income — may be avoided or reduced.

Most recently, the IRS recommended that taxpayers affected by the COVID-19 pandemic could use a superseding return to request that a 2019 overpayment, which had originally been applied to 2020, be refunded instead. (https://taxpayeradvocate.irs.gov/news/NTA_Blog_The_Value_of_a_Superseding_Tax_Return?category=Tax%20News)

Taxpayers may also use a superseding return to make an election that was missed on the originally filed return. Certain restrictions apply to some elections.

Also, a superseding return is the only way to change a return from married filing joint to married filing separate.

Practice Pointer

The prospect of filing a superseding return is a good reason to file an extension even if the return was previously filed. Filing the extension keeps the filing deadline open until the extended due date of the return.

How is a superseding return filed?

A superseding individual tax return is paper-filed using Form 1040. It is a complete return and must contain all of the forms, schedules, and attachments that were part of the original return. It is strongly recommended to write "Superseding Return" on the top of each page.

Businesses electronically filing superseding returns on Forms 1120, 1120S, 1120-F, and 1065 will have a checkbox in the software. The rules applicable for electronically filed returns do not change with superseding returns. It is recommended that businesses paper-filing superseding returns should write "Superseding Return" on the top of each page. Superseding returns must contain all of the forms, schedules, and attachments that were previously filed.

CPAR partnerships

For those partnerships that have not elected out of the centralized partnership audit regime (CPAR), amended returns can no longer be filed to report a change to a partnership item, starting with the 2018 tax year. These changes are considered administrative adjustment requests (AAR) and must be reported on Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request. This also means that amended K-1s can no longer be filed. (IRC §6031(b); Instructions to Form 1065)

However, the amended return prohibition does not prevent a partnership from filing a superseding original return, which is essentially an amended return filed prior to the return due date (including extensions, but only if an extension was requested). For this reason, CPAR partnerships should consider filing an extension every year, in case an adjustment must be made to the return.

CPAR GENERALLY PROHIBITS AMENDED RETURNS

The centralized partnership audit regime (CPAR) provisions generally prohibit partnerships that have not elected out of CPAR from amending their partnership returns to report a change to a partnership-related item beginning with the 2018 taxable year. Instead of filing an amended return, the partnership must file an administrative adjustment request (AAR).

Comment

To assist partnerships that wanted to claim the retroactive tax benefits enacted by the CARES Act, the IRS temporarily allowed all partnerships to file amended 2018 and 2019 returns *before* September 30, 2020, whether or not the amendment relates to CARES Act provisions, as long as certain conditions were satisfied. (Rev. Proc. 2020-23)

Comment

The definition of "partnership-related item" is very broad. It includes any item or amount with respect to the partnership that is relevant in determining the income tax liability of any person. (IRC §6241(2)(B)) It does not matter whether the item or amount appears on the partnership's return, including an imputed underpayment, or is an item or amount relating to any transaction with, basis in, or liability of, the partnership. (IRC §6241(2)(B))

Partnership adjustments

When an AAR is filed by a CPAR partnership, unless a push-out election is made, the partnership pays any imputed underpayment of tax in the year the AAR is filed (referred to as the reporting year).

However, if the partnership makes a push-out election, the partners will carry the adjustments to their personal income tax returns and pay the resulting tax in the year the partnership provides them with Form 8986, Partner's Share of Adjustment(s) to Partnership-Related Item(s) (Required Under Sections 6226 and 6227). Because CPAR partnerships don't file amended returns, they don't issue amended K-1s to their partners, which is why the new Form 8986 is used to report the partnership's share of adjustments to the partners.

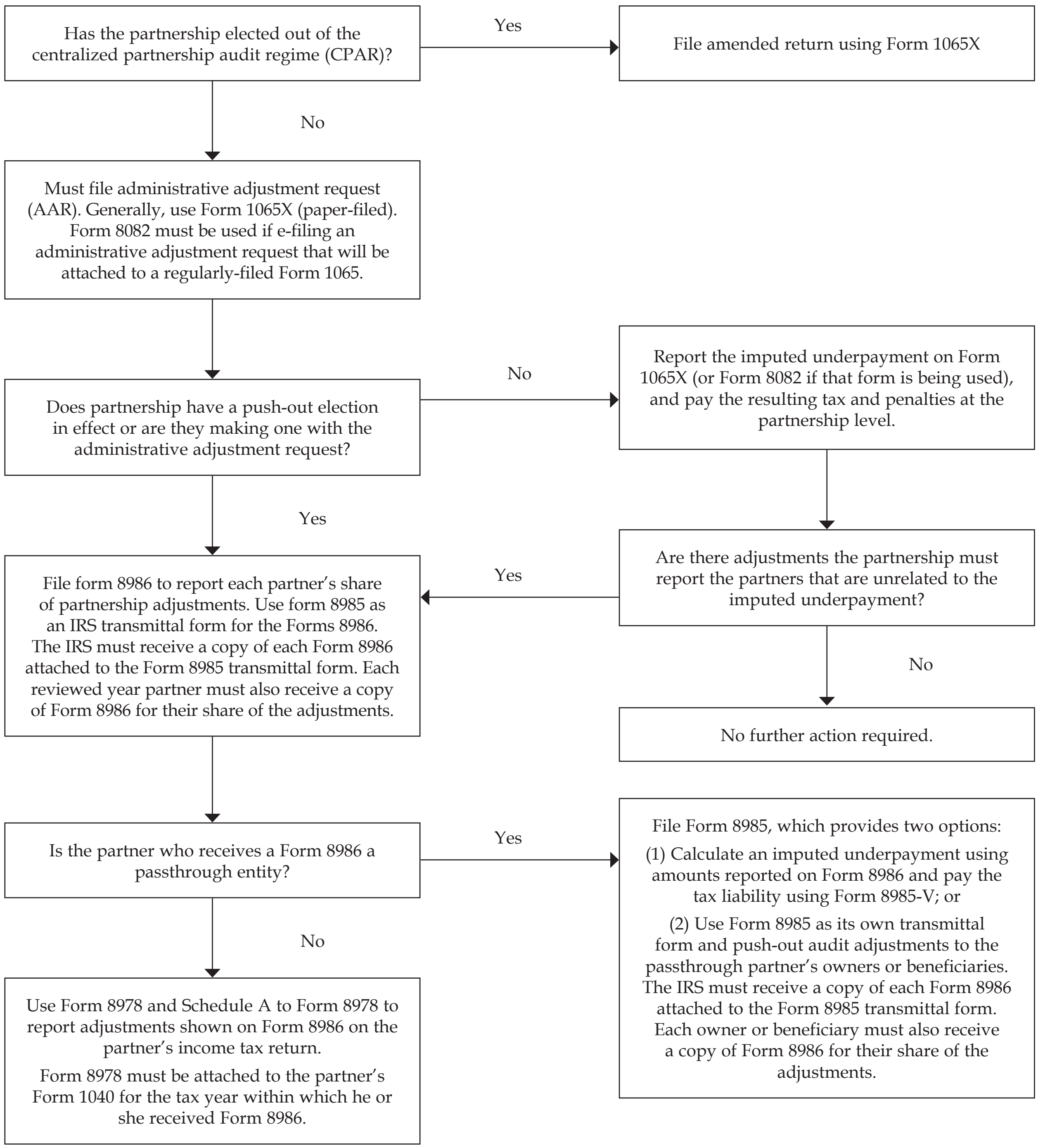
The partners will not file amended returns for the year to which the adjustment relates (referred to as the reviewed year). Instead, the partners will take the adjustments reported to them on Form 8986 and report them on new Form 8978, Partner's Additional Reporting Year Tax. The Form 8978 is used to calculate the additional tax liability (or credit) based on the tax rates in effect for the reviewed year.

Example of partners reporting adjustments

XYZ Partnership files an AAR for the 2018 taxable year in 2020 and makes a push-out election when filing its AAR. As a result, the partnership will provide each of the partners with Form 8986, showing the adjustments that must be made on their 2020 returns.

The partners will not amend their 2018 returns; they will report the adjustments on their 2020 returns, but will calculate any additional tax liability (or credit) using the tax rates in effect for the 2018 tax year (the reviewed year).

Administrative adjustment request process flowchart



Other centralized partnership audit regime forms that may be necessary, but are not part of the ordinary administrative adjustment request process:

- Form 8979, Partnership Representative Revocation, Designation and Resignation
- Form 8980, Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)
- Form 8982, Affidavit for Partner Modification Amended Return Under IRC Section 6225(c)(2)(A) or Partner Alternative Procedure Under IRC Section 6225(c)(2)(B)
- Form 8983, Certification of Partner Tax-Exempt Status for Modification Under IRC Section 6225(c)(3)
- Form 8984, Extension of the Taxpayer Modification Submission Period Under Section 6225(c)(7)
- Form 8988, Election for Alternative to Payment of the Imputed Underpayment – IRC Section 6226
- Form 8989, Request to Revoke the Election for Alternative to Payment of the Imputed Underpayment

California nonconformity

California still allows partnerships to file amended returns, and partnerships must report any federal changes from a CPAR audit or an AAR within six months of the date of each final federal determination from a CPAR audit. (R&TC §18622.5)

IRS LAUNCHES CPAR WEBPAGE

The IRS has launches a new webpage that is intended to be a one-stop location for anything related to the centralized partnership audit regime, including regulations and other guidance and instructions related to:

- Partnership representatives;
- Electing out of CPAR;
- Administrative adjustment requests; and
- What to expect during a CPAR audit.
(IR-2020-199)

The CPAR webpage can be found at:

Website
www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime

IP PIN AND STATUTE OF LIMITATIONS

Husband and wife taxpayers attempted to e-file a tax return, but it was rejected because they failed to provide an identity protection personal identification number (IP PIN). (***RJ Fowler v. Comm.*** 155 TC 7) On the third attempt to e-file, the return was accepted. Other than the IP PIN, each of the three attempted return filings were identical with respect to income, deductions, etc.

The IRS issued a notice of deficiency within three years of the taxpayers' successful tax return filing (their third attempt), but more than three years after their first failed e-file attempt. The taxpayers argued that the statute of limitations began to run when their first filing attempt was rejected. The court agreed with the taxpayers and ruled that the attempted filing of the return started the statute of limitations because the IRS received and rejected the return and that an IP PIN is not required to start the limitations period.

IRS ISSUES

IRS ATTORNEYS ALLOWED TO E-MAIL TAX INFORMATION

The IRS has released guidance for its attorneys to begin e-mailing personally identifiable information to taxpayers or their representatives. (IRS Chief Counsel Notice 2020-002) Generally, Chief Counsel employees have not been allowed to send e-mail messages to taxpayers or their representatives that contain sensitive information. (IRM 10.5.1.6.8.1(1)) Now, Chief Counsel employees may e-mail sensitive information to taxpayers or their representatives during Tax Court litigation and regarding letter ruling requests or closing agreements. When exchanging sensitive information with taxpayers or their representatives, Chief Counsel employees must use one of two e-mail encryption methods outlined in the notice.

Practice Pointer

If e-mailing information to the IRS, tax professionals should consider sending the e-mails with delivery and read receipts. If there is a question later about whether the e-mail was actually received by the IRS, the tax professional will have proof of electronic delivery and proof that the recipient actually opened the e-mail.

IRS LAUNCHES GIG ECONOMY WEBPAGE

The IRS has released the "Gig Economy Tax Center," which streamlines information for businesses and workers in the gig economy. (IR-2020-4) There is information on estimated taxes, FICA taxes, filing requirements, special reporting rules, and more at:

Website
www.irs.gov/businesses/gig-economy-tax-center

California conformity

California has also launched its own gig economy webpage, which can be found at:

Website
www.ftb.ca.gov/file/business/industries/gig-economy.html

NEW IRS AND FTB WEBSITES COMBAT IDENTITY THEFT

The IRS launched Identity Theft Central, a webpage that provides information on identity theft and data security for taxpayers, businesses, and tax professionals. (IR-2020-27) The webpage contains information on how to prevent identity theft and steps to take after theft has occurred, including how to report theft to the IRS.

The IRS's Identity Theft Central webpage can be accessed at:

Website
www.irs.gov/identity-theft-central

The FTB's identity theft webpage can be accessed at:

Website
www.ftb.ca.gov/help/scams/identity-theft.html

FAQs on identity theft personal identification number (IP PIN)

The IRS has issued a series of FAQs concerning Identity Protection Personal Identification Numbers (IP PINs). You can see the FAQs at:

Website
www.irs.gov/identity-theft-fraud-scams/
frequently-asked-questions-about-the-identity-protection-personal-identification-number-ip-pin

IRS CONDUCTING UNANNOUNCED VISITS TO TAXPAYERS

IRS revenue officers are conducting unannounced face-to-face meetings with certain taxpayers as part of an effort to resolve compliance issues, including missing tax returns and taxes owed, with an emphasis on payroll taxes. (IRS Fact Sheet 2019-15) By the time the visit occurs, taxpayers will be aware that they have a tax issue because the IRS will have reached out through the usual channels. But because these visits will be unannounced, taxpayers should know what to look for to verify the identity of a legitimate IRS revenue officer. (TAS Tax Tip, available at: https://taxpayeradvocate.irs.gov/news/tas-tax-tip-how-to-confirm-the-identity-of-a-field-revenue-officer-if-they-come-knocking-at-your-door)

Practice Pointer

The Taxpayer Bill of Rights, item #9, provides taxpayers with the right to representation. If a taxpayer has a power of attorney on file and the IRS conducts a visit to the taxpayer's residence or place of work without first contacting the taxpayer's designated representative, then the IRS has violated the Taxpayer Bill of Rights.

Look for official IRS credentials

When a revenue officer visits a taxpayer, they will always provide two forms of official credentials:

- A pocket commission; and
- An HSPD-12 card.

A pocket commission is a form of government identification that certain IRS employees are required to use when conducting business with taxpayers.

The HSPD-12 card is a government-wide standard for secure and reliable forms of identification for federal employees and contractors.

Both forms include a serial number and photo of the IRS employee. Taxpayers have the right to see each of these credentials. Taxpayers can request the name and telephone number of the manager of the revenue officer if they have any concerns.

You can see a sample of what the HSPD-12 card looks like at:

Website
www.fedidcard.gov/credential-features

Taxpayers who receive these visits should also expect that if there is an outstanding federal tax debt, the visiting officer will request payment. The taxpayer will have a number of payment options, including a check payable to the U.S. Treasury.

IRS INCREASES OIC FEE

On March 13, 2020, the IRS issued final regulations increasing the OIC application fee to $205. This fee increase is effective April 27, 2020. (TD 9894; Treas. Regs. §300.3)

REPETITIVE AUDIT

Finding in favor of the taxpayer, the IRS's Office of Chief Counsel issued an opinion stating that a second audit of an NOL carryforward was a repetitive audit prohibited by IRC §7605(b). (Field Attorney Advice 20202501F (June 24, 2020))

The IRS disallowed the NOL deduction for a taxpayer because the auditor determined that the activity generating the NOL in an earlier year was a hobby loss and therefore not deductible. However, the taxpayer had already been audited on the hobby loss issue, and won, for the year generating the loss.

What if?

If the NOL carryforward was disallowed for other reasons, the second audit would not be considered a repetitive audit, for example, if the NOL carryover was not properly computed or used in a previous year. Or, if the auditor found evidence of fraud in the later year's audit, he may disallow the NOL and request documentation so he could confirm there was no fraud in the original audit year.

In applying the restrictions set forth in IRC §7605(b), the courts have been hesitant in restricting the IRS's legitimate investigations. The code section was not meant to prevent a revenue agent from diligently executing their duty to collect taxes. (***Benjamin v. Comm.*** (1976) 66 TC 1084, 1098; ***DeMasters v. Arend*** (1963) 313 F.2d 79, 87)

The IRS is not able to reopen a case closed after audit to make an unfavorable adjustment unless:

- There is evidence of fraud, collusion, concealment, or misrepresentation of material fact;
- The closed case involved a clearly defined, substantial error based on an established IRS position existing at the time of the examination; and
- Other circumstances exist indicating that a failure to reopen the case would be a serious administrative omission.
  (Rev. Proc. 2005-32)

CASH PAYMENTS FOR FEDERAL TAXES

The IRS is expanding its list of retail partners that will accept cash payments from taxpayers to satisfy their federal tax liabilities. Participating retailers include:

- 7-Eleven;
- Ace Cash Express; and
- Casey's General Stores.

Taxpayers wishing to take advantage of the cash payment option should visit www.IRS.gov/payments, select the cash option in the "Other Ways You Can Pay" section, and follow the instructions. There is a $1,000 payment limit per day and a $3.99 fee per payment.

IRS FAQs ARE NOT LEGAL AUTHORITY

The IRS Taxpayer Advocate Service has expressed concern over taxpayers relying on IRS FAQs as legal authority. (https://taxpayeradvocate.irs.gov/news/nta-blog-protecting-taxpayer-rights-FAQ) The Advocate's main complaint was that FAQs are updated and removed frequently, and there is no archive of older versions of FAQs. This statement came after the IRS released a huge number of FAQs to help taxpayers and tax pros cope with the massive changes stemming from the FFCRA and CARES Act following the COVID-19 pandemic.

The Advocate opined that a taxpayer would likely be subject to the accuracy-related penalty in the event they followed an FAQ and then subsequently the IRS took the opposite position on audit. The Advocate stated that the IRS should never assess a penalty against a taxpayer for taking a position consistent with an FAQ posted on the IRS website at the end of a taxpayer's taxable year or at the time of return filing unless the IRS has convincing evidence the taxpayer knew the FAQ had been changed. They also recommended that the IRS create an FAQ archive.

According to the Internal Revenue Manual, "FAQs that appear on IRS.gov but that have not been published in the Bulletin are not legal authority and should not be used to sustain a position unless the items (e.g., FAQs) explicitly indicate otherwise or the IRS indicates otherwise by press release or by notice or announcement published in the Bulletin." (IRM 4.10.7.2.4)

The Internal Revenue Bulletin is the authoritative instrument for announcing official rulings and procedures of the IRS and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.

Practice Pointer

In light of the Advocate statement, we suggest you print out and save any FAQs you rely on when taking a position regarding a taxpayer's return, in case the client is audited and the FAQs were later changed.

IRS ADDS QR CODES TO CP14 NOTICES

Starting in October, 2020, CP14 and CP14 IA notices sent by the IRS will have QR codes that taxpayers can scan with their smartphones. (IR-2020-233) By scanning the QR code on their notice, taxpayers can securely access their IRS account, set up a payment plan or contact the Taxpayer Advocate.

The IRS has not released detailed information on their QR code program, so we don't know how a taxpayer's smartphone will direct them to set up an account or what security measures are in place to ensure that only the taxpayer can gain access to their account by scanning the QR code on their notice.

Notices CP14 and CP14 IA are the first legal notices informing a taxpayer that they have a balance due with the IRS.

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 filing details for tax-exempt organizations?

   a) Tax-exempt organizations that would suffer hardship because of the new e-filing requirements do not need to e-file until after July 1, 2020
   b) Form 990-EZ, Short Form Return of Organization Exempt from Income Tax, must be paper-filed
   c) The IRS will not accept paper returns for Form 8872, Political Organization Report of Contributions and Expenditures, after January 1, 2020
   d) Form 990-T, Exempt Organization Business Tax Return, must be e-filed beginning after July 1, 2019

6. For outsourcing tax preparation services, which of the following applies?

   a) The tax preparer will automatically face both civil and criminal penalties if they disclose a client's information without the client's knowledge
   b) For purposes of the disclosure requirements, the tax preparer is the person who signs the return
   c) A tax preparer will be penalized if they do not obtain prior written consent when they outsource any tax preparation work to a third party
   d) A tax preparer is not allowed to disclose a taxpayer's Social Security number to a foreign person or company even if the preparer has the client's prior written consent

7. What is true about superseding returns?

   a) A superseding 1040 must be paper-filed
   b) All superseding business and personal income tax returns must be filed electronically
   c) They should not include any attachments
   d) For partnerships that have not elected out of CPAR, they cannot be used to report a change in a partnership item

8. Which of the following is true regarding the centralized partnership audit regime provisions?

    a) Partnerships that wanted to claim retroactive benefits under the CARES Act were allowed to file amended 2018 or 2019 returns before September 30, 2020, but the amendment had to relate to the CARES Act provisions
    b) For purposes of reporting a change to a "partnership-related item," the item must have appeared on the partnership's return
    c) If an administrative adjustment request is filed by a CPAR partnership, the partnership pays an imputed underpayment of tax in the year the AAA is filed unless a push-out election is made
    d) CPAR partnerships must issue amended K-1s to their partners reflecting a change in a partnership-related item

SOLUTIONS TO REVIEW QUESTIONS

5. What are among the filing details for tax-exempt organizations? **(Page 2-5)**
   a) Incorrect. Transition relief is available, and required e-filing will not begin until after July 1, 2021.
   b) Incorrect. Optional e-filing is available for this form. Mandatory e-filing will begin for tax years ending on or after August 31, 2020.
   c) Correct. Form 8872 must be filed electronically starting January 1, 2020.
   d) Incorrect. This form may still be paper-filed as they are being converted to an electronic format, which should be ready for the 2020 tax year.

6. For outsourcing tax preparation services, which of the following applies? **(Page 2-8)**
   a) Incorrect. The criminal penalties are not automatic but require that the preparer knowingly or recklessly disclosed a taxpayer's information.
   b) Incorrect. Anyone who assists in the return preparation is also bound under the disclosure requirements, including the person who uses the computer to e-file the return.
   c) Incorrect. Not necessarily. As long as the third party is in the U.S. and doesn't give advice regarding the taxpayer's tax liability or make any "substantive determinations," the client's prior written consent is not required.
   d) Correct. An SSN sent outside the U.S. must be redacted.

7. What is true about superseding returns? **(Page 2-11)**
   a) Correct. It must contain all forms, schedules, and attachments that were part of the original return.
   b) Incorrect. Business superseding returns may be filed electronically.
   c) Incorrect. They are considered complete returns and must include all schedules and attachments.
   d) Incorrect. An amended return can no longer be used to report a change to a partnership item, but the use of a superseding return is not prohibited.

8. Which of the following is true regarding the centralized partnership audit regime provisions? **(Page 2-12)**
   a) Incorrect. The reason for the amendment did not need to be related to the CARES Act, provided certain conditions were met.
   b) Incorrect. The item need not have been on the partnership's return.
   c) Correct. If a push-out election is made, the partners carry the adjustments to their person income tax returns.
   d) Incorrect. The partnership will not file an amended return, so no amended K-1s are issued.

Chapter 3

Paycheck Protection Program

PAYCHECK PROTECTION PROGRAM

PPP LOANS

The CARES Act authorized $349 billion for the Paycheck Protection Program, which provided loans to businesses with fewer than 500 employees impacted by the COVID-19 pandemic. (CARES Act §1102)

Key benefits of the program include:

- The loans may be forgiven for amounts used to cover specific operating expenses such as payroll costs, rent and mortgage, and utilities for earlier of 24 weeks or December 31, 2020, (eight weeks under specified circumstances described later) from the date the loan was funded, if the business retains its workforce at specified salary levels;
- Loan payment deferral until the bank receives the loan forgiveness amount from the SBA (10 months if no loan forgiveness application is submitted);
- No personal guarantees or collateral requirements; and
- Waiver of Small Business Administration fees.

The PPP program was put together quickly, and since the original enactment, there have been numerous interim final rules and FAQs issued by the Treasury and the SBA.

FOLLOW-UP LEGISLATION

The Paycheck Protection Program and Health Care Enhancement Act (H.R. 266; P.L. 116-139), signed by the President on April 24, 2020, added an additional $320 billion to the Paycheck Protection Program.

The Paycheck Protection Program Flexibility Act of 2020 (PPPFA; H.R. 7010; P.L. 116-142) was signed by the President on June 5, and it made significant changes to the PPP loan program. While the PPPFA offered a longer period to use loan proceeds and qualify for forgiveness, borrowers should be aware of new rules regarding full-time equivalent employees (FTEEs).

The Paycheck Protection Program Extension Act was signed by the President on July 4. (P.L. 116-147) It extended the deadline to apply for a loan under the Paycheck Protection Program through August 8, 2020.

For a full listing of program rules and FAQs, go to:

Website
https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses

THE ORIGINAL LOANS

The maximum loan amount is equal to the lesser of:

- 2.5 times the average monthly payroll costs (with a $100,000 annual limit on wages per worker or annual owner compensation) during the one year before the date on which the loan is made, plus any refinanced Economic Injury Disaster Loans (EIDL); or
- $10 million.
  (CARES ACT §1102)

CONSOLIDATED APPROPRIATIONS ACT OF 2021

The Additional Coronavirus Response and Relief Act (ACRRA), which is contained in the Consolidated Appropriations Act of 2021 (H.R. 133), reopens the Paycheck Protection Program (PPP) loan program. The program is now extended to March 31, 2021, with an additional $284.45 billion in funding for PPP loans, with set-asides for certain businesses.

The bill also clarifies the deductibility of expenses paid with forgiven PPP loan amounts, and revises the eligibility requirements for the loans. (ACRRA §323)

This new round of PPP funding makes the following new PPP funds available to borrowers:

- New "second draw loans" for smaller businesses whose gross receipts have dropped; and
- Supplemental funding for original PPP loans where the loan amount would have changed due to new rules that have been released.

The bill also makes changes to the existing PPP loan provisions adopted under the CARES Act, including allowing a simplified loan forgiveness application process and expanding the expenses that are qualified and eligible for loan forgiveness.

SECOND DRAW LOANS

The ACRRA creates a second loan from the Paycheck Protection Program, called a "PPP second draw" loan for smaller and harder-hit businesses, with a maximum loan amount of $2 million per eligible entity. These are loans for businesses that can show significant losses in 2020 over 2019.

In order to receive a second draw PPP loan, eligible entities must:

- Employ not more than 300 employees (including part-time and seasonal employees); and
- Demonstrate at least a 25% reduction in gross receipts in the first, second, or third quarter of 2020 relative to the same 2019 quarter. (If the entity was not in business during all of 2019, then the business must show a 25% reduction in gross receipts during any quarter in 2020 from the 2019 calendar quarters it was in operation. If the application is submitted on or after January 1, 2021, then the fourth quarter of 2020 may be used as well.)
  (ACRRA §311)

Comment

Borrowers must have used, or will use, the first loan prior to the disbursement of a second draw loan.

There is nothing in the law addressing forgiveness or use of original PPP loans before a second draw loan may be taken. So it appears borrowers may take these loans regardless of the status of their original loans as long as the loans were used prior to disbursement.

The same waiver of affiliation rules that applied to the initial PPP loans will apply to the second draw PPP loans. Similarly, the rule covering hotels and restaurants with more than one physical location that applied for the first PPP loans applies to the second draw loans, except the employee limit per location is 300 employees.

Comment

The CARES Act provided loans to businesses with fewer than 500 employees that were "impacted by the COVID-19 pandemic," but did not require that the borrower demonstrate a specified decline in revenues in order to qualify.

✐ **Practice Pointer**

Practitioners should notify clients that qualify for these new loans to contact their bank about applying as soon as possible.

Eligible businesses

Eligible entities include businesses, certain nonprofit organizations, housing cooperatives, veterans' organizations, tribal businesses, self-employed individuals, sole proprietors, independent contractors, and small agricultural co-operatives.

Ineligible businesses

The following businesses are ineligible for the second round of PPP loans:

- Businesses that weren't in operation on February 15, 2020 (this also applied to the first round of loans);
- Businesses listed in §120.110 of Title 13 of the Code of Federal Regulations, which includes businesses located in a foreign country, businesses involving gambling or activities of a "prurient sexual nature," and private clubs;
- Persons or entities that receive a shuttered venue operator grant under the Economic Aid to Hard-Hit Small Businesses, Nonprofits and Venues Act;
- Entities involved in political and lobbying activities;
- Entities affiliated with entities in the People's Republic of China; and
- Registrants under the Foreign Agents Registration Act.
  (ACRRA §§310, 311)

Loan terms

The loans will again be based on 2.5 times the borrower's average monthly payroll costs for the one-year period prior to the loan, or calendar-year 2019, with a maximum of $2 million. (ACRRA §311)

Comment

Entities in industries assigned to NAICS code 72 (Accommodation and Food Services) may receive loans of up to 3.5 times average monthly payroll costs. This is welcome relief to hotels and restaurants.

Seasonal employers may calculate their maximum loan amount based on a 12-week period beginning February 15, 2019, through February 15, 2020, and new entities may receive loans of up to 2.5 times the sum of average monthly payroll costs for the months they existed if the entity was not in existence for less than 12 months.

Comment

The ACRRA defines seasonal employers as eligible borrowers that do not operate for more than seven months in any calendar year, or during the preceding calendar year had gross receipts for any six months of that year that were not more than 33.33% of the other six months of that year. (ACRRA §315) This definition applies for all PPP purposes, as if it were originally included in the CARES Act.

The rules regarding allowable expenses (including new allowable expenses discussed on page 3-5), loan forgiveness, and COD exclusions for existing PPP loans, apply to these loans as well.

SUPPLEMENTAL FUNDING REQUESTS

Borrowers can also submit supplemental PPP loan requests in all cases where their original PPP loan amount would have changed due to new rules that have been released. This applies to partnerships where the original loan did not include the self-employment earning of the partners. But it also applies to borrowers that returned their original loans or took reduced loans to qualify for other benefits that are no longer limited for PPP recipients, such as the Employee Retention Credit. (ACRRA §312)

Comment

Businesses that never applied for a PPP loan may now apply under the original PPP program. However, as stated above, it is possible that they qualify for a second draw loan.

An interim final rule was issued in May 2020, allowing a borrower to request a supplemental loan if, subsequent to the time of application, regulations were issued that would have increased the loan amount it could have received. However, this only applied if the lender had not yet submitted what's known as SBA Form 1502 for the original loan. This meant that many borrowers were out of luck and did not receive the additional PPP funds they were entitled to. The ACRRA removes this restriction and allows supplemental requests in all cases where the loan amount would have changed due to the new rules.

✎ **Practice Pointer**

Borrowers must request this additional funding before forgiveness is granted on their original PPP loan. (ACRRA §312(a)(2)) So borrowers that may want to borrow additional funds should wait to apply for forgiveness and attempt to withdraw forgiveness applications that have already been submitted.

The SBA has until January 13, 2021, (17 days from the date of enactment) to release guidance on this additional funding.

The loan amount for certain farmers and ranchers is now based on gross income, not net profit shown on the 2019 Schedule F, but is still limited to 2.5 months with a $100,000 annual gross income cap. The ACRRA specifically allows a supplemental application for these borrowers as long as they have not received any loan forgiveness on the original loan. (ACRRA §313)

Comment

These amounts would be considered supplemental funding for original PPP loans, so these borrowers will not be required to meet the requirements for second draw loans.

✐ Practice Pointer

Taxpayers applying for bankruptcy must receive approval from the bankruptcy court to receive additional PPP funds or a new PPP loan. (ACRRA §320)

EXPANDED ELIGIBILITY

Most §501(c)(6) organizations, i.e., trade groups, chamber of commerce groups, and certain destination marketing companies, are eligible to apply for PPP loans, provided:

- The organization doesn't receive more than 10% of receipts from lobbying activities;
- The lobbying activities of the organization do not comprise more than 10% of its total activities; and
- The organization has 150 employees or fewer.

In addition, housing cooperatives, newspapers, broadcasters, and radio stations now potentially qualify. (ACRRA §§311, 316, 317, 318, 319)

Comment

The ACRRA also provides further clarification that churches and religious organizations are eligible PPP loan recipients and prohibits the application of regulations otherwise rendering ineligible businesses principally engaged in teaching, instructing, counseling, or indoctrinating religion or religious beliefs. It also codifies that the prohibition on eligibility for nonprofit and certain other businesses for SBA loans shall not apply for PPP loans.

Self-employed borrowers

Schedule C filers

For Schedule C filers, the maximum loan amount (and loan forgiveness) is based on the taxpayer's 2019 Schedule C. Self-employed individuals with no employees determined their monthly payroll costs by dividing their Schedule C, line 31 net profit amount, up to a $100,000 maximum, by 12. If the line 31 net profit amount is zero, the individual was ineligible for a loan. (Treasury PPP FAQs, How to Calculate Loan Amounts, Question 1)

If the self-employed individual had employees in 2019, the monthly employee payroll costs were added to the amount just determined. These payroll costs were based on the 2019 IRS Form 941 taxable Medicare wages and tips (line 5c, column 1), plus any excluded pretax employee contributions for health insurance or other fringe benefits, up to a $100,000 maximum per employee.

Comment

The maximum loan for a self-employed "individual" is "across all of that individual's businesses." (SBA 2020-0038) Therefore, an individual with two or more Schedule Cs was ineligible for separate loans for each Schedule C. The individual had to total the net incomes from the Schedule Cs.

As the limit applied per "individual," husbands and wives with separate self-employment income could each get separate loans.

What happens if PPP loan funds are misused?

In SBA PPP FAQ #46, the SBA states it will not audit companies on the necessity (hardship) certification if the PPP loan amount is under $2 million, though loan funds must still be used properly. However, this is not necessarily true.

PPP loan recipients may face scrutiny from a variety of government agencies looking to ensure PPP loan funds were properly obtained and used. In addition to the borrower's bank, the SBA, and the Department of Justice — federal, state, and local — it is possible that the IRS may play a hand in auditing the loans and whether they were fraudulently taken or used.

Regardless of who is doing the investigating, companies need to be careful to respond truthfully and that they have vetted any and all information provided to an investigator. A company that was entitled to a PPP loan and made good faith certifications can still get in trouble — even years later — by not responding appropriately to an investigator's inquiries.

Interim Final Rule 1 (SBA 2020-0015), Part III, paragraph 2 provides this warning (emphasis added): "If you use PPP funds for unauthorized purposes, SBA will direct you to repay those amounts. **If you knowingly use the funds for unauthorized purposes**, you will be subject to additional liability such as charges for fraud. If one of your shareholders, members, or partners uses PPP funds for unauthorized purposes, SBA will have recourse against the shareholder, member, or partner for the unauthorized use."

The subsequent paragraph requires borrowers to certify that the PPP loan funds would be used for authorized purposes only. Knowingly making a false statement to get a guaranteed loan from the SBA is punishable by:

- Imprisonment of not more than five years and/or a fine of up to $250,000 (18 USC §§1001, 3571);
- Imprisonment of not more than two years and/or a fine of up to $5,000 (15 USC §645); and/or
- Imprisonment of not more than 30 years and/or a fine of not more than $1 million. (18 USC §1014)

Fraudsters already getting caught

In the first fraud case in early May, two East Coast men created dozens of fictitious employees for four restaurants that were not in operation prior to the start of the COVID-19 pandemic, and they used this information to get almost $550,000 in PPP loans. One of the restaurants had never existed at all, and one was a restaurant that neither of the men owned. They also left an e-mail trail of their discussions on how to create fraudulent documentation to support their loan applications. They're both charged with conspiracy to make false statements and conspiracy to commit bank fraud.

In another case, an engineer in Texas applied for $13 million in PPP loans, using a nonexistent LLC. On his application, he claimed the company employed 250 people with a monthly payroll of between $1.2 million and $4 million. He was charged after the Texas Workforce Commission let investigators know that payroll records for the LLC did not exist.

One case stands out not so much in the way the fraud was perpetrated, but in what happened next. A man in Georgia is being prosecuted for fraudulently obtaining a $2 million PPP loan. He created a trucking company and fabricated employees to calculate an inflated loan amount, the same tactic used in the other cases. Once he had the funds, he spent them on a 2019 Rolls Royce Wraith, child support payments, a Rolex Presidential watch, a diamond bracelet, and a 5.73 carat diamond ring that was for himself. As the DOJ carried off the spoils (the Wraith still had the temporary dealer tag on it), they also confiscated $80,000 cash, $9,400 of which was in the accused's pockets.

SBA questioning "loan necessity" for loans over $2 million

The SBA created two forms that will be sent to borrowers with loans totaling more than $2 million. The forms are:

- Form 3509, Paycheck Protection Program Loan Necessity Questionnaire (For-Profit Borrowers); and
- Form 3510, Paycheck Protection Program Loan Necessity Questionnaire (Non-Profit Borrowers).

The forms ask a number of questions to establish the borrower's need for the PPP funds. The questions address the following information:

- Gross revenue amounts from 2019 and 2020;
- Whether the business was subject to a government shutdown;
- Whether any owners were paid compensation in excess of $250,000 on an annualized basis during the covered forgiveness period; and
- What the borrower's liquidity was immediately prior to receiving the PPP funds, and during the covered forgiveness period.

The questionnaires are due to the lender within 10 days of receipt by the PPP borrower.

To view the memo issued by the SBA, go to:

Website
www.federalregister.gov/documents/2020/10/26/2020-23594/reporting-and-recordkeeping-requirements-under-omb-review

PPP LOAN FORGIVENESS

Eligible loan recipients may have all or a portion of their loan forgiven if the loan proceeds are used for specified purposes.

The borrower must apply for loan forgiveness within 10 months after the last day of the "covered period" (discussed later). (SBA 2020-0038) For most borrowers, the end of the covered period will be near the end of 2020. However, there was much confusion because the loan forgiveness forms display an expiration date of October 31, 2020.

In General PPP Loan Forgiveness FAQ #4, the SBA clarified that the expiration date in the upper right corner of the posted PPP loan forgiveness application forms is displayed for purposes of the SBA's compliance with the Paperwork Reduction Act, and reflects the temporary expiration date for approved use of the forms. This date will be extended, and when approved, the same forms with the new expiration date will be posted.

Furthermore, borrowers may submit a loan forgiveness application any time before the maturity date of the loan, which is either two or five years from loan origination. However, if a borrower does not apply for loan forgiveness within 10 months after the last day of the borrower's loan forgiveness covered period, loan payments are no longer deferred, and the borrower must begin making payments on the loan. For example, a borrower whose covered period ends on October 30, 2020, has until August 30, 2021, to apply for forgiveness before loan repayment begins.

Caution

This means that many, if not most, borrowers will be applying for loan forgiveness in 2021, and your client might ask for help in completing the forgiveness application in the middle of the coming tax season.

Keep in mind that this work is outside the scope of tax engagements and calls for a separate engagement letter. The following engagement letters are reprinted with permission from CAMICO. ©2020. All rights reserved.

Website
Agreed-Upon Procedures: PPP Loan Forgiveness Calculations:
www.caltax.com/files/2020/cl-ppploan1.doc
Consulting Services: Assistance with PPP Loan Forgiveness:
www.caltax.com/files/2020/cl-ppploan2.doc

AMOUNT ELIGIBLE FOR FORGIVENESS

The amount that may be forgiven is equal to the following costs incurred and payments made during the *covered* forgiveness period beginning on the date their loan is funded:

- Payroll costs;
- Mortgage interest on a mortgage taken out by the borrower for real or personal property that was in place prior to February 15, 2020 (not including prepayments);
- Rent on a real or personal property lease taken out before February 15, 2020; and
- Utilities for service established before February 15, 2020.
  (CARES Act §1106)

To qualify for full forgiveness, at least 60% of the loan proceeds must be used for payroll costs. However, because the purpose of the program is to help employers maintain the employment of their employees (to protect paychecks), loan forgiveness may be reduced if:

- The employer reduces its number of full-time equivalent employees (FTEEs); or
- The employer reduces any of its employee's rate of pay.

Eligible expenses expanded

The following expenses are now considered allowable and forgivable uses for PPP loan funds:

- **Covered operations expenditures:** Payment for any business software or cloud computing service that facilitates any of the following:
  - Business operations;
  - Product or service delivery;
  - The processing, payment, or tracking of payroll expenses;
  - Human resources;
  - Sales and billing functions; or
  - Accounting or tracking of supplies, inventory, records, and expenses;
- **Covered property damage costs:** Costs related to property damage due to public disturbances that occurred during 2020 that are not covered by insurance or other compensation;
- **Covered supplier costs:** Amounts paid to a supplier for goods essential to operations of the entity that are made pursuant to a contract, purchase order, or order for goods in effect prior to taking out the loan (before or during the loan covered period for perishable goods); and
- **Covered worker protection expenditures:** Expenses to help a loan recipient comply with federal health and safety guidelines or any equivalent state and local guidance related to COVID-19 during the period between March 1, 2020, and the end of the national emergency declaration. These include, but are not limited to, the purchase, maintenance, or renovation of assets that create or expand:
  - A drive-through window facility;
  - An indoor, outdoor, or combined air or air pressure ventilation or filtration system;
  - A physical barrier such as a sneeze guard;
  - An expansion of additional indoor, outdoor, or combined business space;
  - An onsite or offsite health screening capability; or
  - Other assets necessary to comply with various regulatory agency requirements.

Costs related to residential real property or intangible property are not eligible costs. (ACRRA §304(a))

These provisions are effective as if they were originally included in the CARES Act. As a result, they apply to all PPP loans, except for loans where borrowers have already received forgiveness.

FORGIVENESS COVERED PERIOD

Under the PPPFA, the loan forgiveness covered period was extended from eight weeks (beginning on the date the loan was funded) to a period ending the earlier of:

- 24 weeks; or
- December 31, 2020.
  (PPPFA §3)

Because loans are based on 2.5 months of payroll costs, spending the full amount during the original eight-week covered period was basically mathematically impossible. However, spending that amount in 24 weeks should be no problem for many borrowers.

New covered period choice

The ACRRA allows a borrower to choose a covered period for purposes of the loan forgiveness provisions that begins on the loan origination date and ends on any date selected by the borrower that is between eight weeks and 24 weeks after the loan origination date. (ACRRA §306) This provision applies to all PPP loans and basically codifies what banks and the SBA had been allowing. However, the flexibility to choose a covered period can benefit borrowers that have forgiveness reductions based on reductions in full-time equivalent employees (FTEEs), or reductions in salaries or wages.

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Example of longer forgiveness period

Critical Co. applied for a PPP loan on April 3, 2020. For 2019, the company had average monthly payroll costs of $400,000. As a result, Critical qualified for a loan of $1 million ($400,000 × 2.5).

During the eight-week period starting with the date their loan was funded, Critical Co. used their loan funds for:

Employee compensation	$544,000
Health insurance costs	30,000
State payroll taxes	6,000
Rent	60,000
Equipment leases	80,000
Utilities	12,000
Total	$732,000

For the eight-week period, Critical would qualify for loan forgiveness of $732,000.

Assume that, using the 24-week period, Critical has payroll costs of $1.4 million. Not considering any reductions in FTEEs or salary reductions, Critical would qualify for forgiveness of the full $1 million loan based on payroll costs alone.

The one consideration that borrowers must keep in mind with this longer forgiveness period is that their average FTEEs and salary and wage amounts are also measured over a longer period, which is a factor for the forgiveness reductions discussed on page 3-11. Because of this, borrowers who received their loan prior to June 5, 2020, may still want to use the eight-week period.

COUNTING PAYROLL COSTS

Payroll costs

"Payroll costs" means the sum of the following payments:

- Salary, wages, or other compensation paid to an employee or sole proprietor, or employee-owners (up to $100,000 annual limit per worker). Note that payments made to independent contractors are not eligible. Independent contractors could apply for their own loans as sole proprietors, so payments to independent contractors do not count for loan calculation or forgiveness purposes;
- Payment of cash tips or equivalents;
- Vacation, parental, family, medical or sick leave;
- Termination allowances;
- Group health care benefits, including insurance premiums;
- Retirement benefit payments; and
- State or local payroll taxes (limited to state taxes imposed on employee payroll paid by the employer (such as unemployment insurance premiums)).
  (SBA 2020-0015)

The following payroll costs are excluded:

- Compensation to employees whose principal place of residence is outside the U.S.; and
- The employer-provided sick leave benefits and paid family leave benefits mandated by the Families First Coronavirus Response Act (FFCRA).
  (SBA 2020-0015)

Group insurance benefits expanded

The ACRRA expands the types of group insurance benefits that are included in payroll costs for purposes of both loan eligibility and forgiveness. In addition to group health insurance provided under the CARES Act, as originally passed, eligible group insurance benefits now also include group life, disability, vision, and dental. (ACRRA §308)

This provision applies retroactively to loans made before, on, or after December 27, 2020, (the date of the ACRRA's enactment) including loan forgiveness.

Period counted

In general, payroll costs paid or incurred during the covered period are eligible for forgiveness. (SBA 2020-0038) The "paid or incurred" rule means that loan recipients will get the best of both worlds. Employers can count the full amount of paychecks issued during the first pay day of the covered period, even if those payroll costs were incurred prior to the start of the covered period.

Example of wages earned prior to covered period

Rescue Me, Inc. received loan proceeds on Monday, April 21, 2020. The covered period for loan forgiveness is April 21, through June 15, 2020, assuming they don't elect to use the 24-week period.

Rescue Me has a biweekly payroll and pays employees every other Wednesday for the two weeks that ended on the previous Friday. Their first payroll period that ends after April 20 ends on Friday, April 24, and the employees are paid on Wednesday, April 29.

The last payroll payment date that includes the covered period ends on June 19. Employees are paid on June 24.

Rescue Me may include wages included in its April 29 payroll, even those amounts that are attributable to wages earned on April 18, 19, and 20, or prior to those dates.

Rescue Me may also include wages earned through June 15 from the paycheck issued on June 24.

Payroll costs incurred but not paid during the borrower's last pay period of the covered forgiveness period are eligible for forgiveness if paid on or before the next regular payroll date.

Alternative payroll covered period

To make things a little less complicated, borrowers with a biweekly (or more frequent) payroll schedule may elect to calculate eligible payroll costs using the eight-week or 24-week period that begins on either:

- The date of funding of the borrower's PPP loan proceeds from the lender; or
- The first day of the first full payroll cycle in the covered period (the "alternative payroll covered period").
  (SBA 2020-0038)

Comment

This alternative period may only be used for payroll costs and not for other eligible expenses.

Maximum compensation

The maximum compensation eligible for loan forgiveness is:

- For employees:
  - For borrowers using an eight-week forgiveness period: $15,385 (8 ÷ 52 × $100,000) per employee, plus covered benefits such as health care, retirement contributions, and state payroll taxes; and
  - For borrowers using a 24-week forgiveness period: $46,154 (24 ÷ 52 × $100,000) plus covered benefits such as health care, retirement contributions, and state payroll taxes. (SBA 2020-0037)
- For owners, even if the borrower uses a 24-week period, compensation is capped at 2.5 months of 2019 compensation, with a maximum of $20,833 (2.5 ÷ 12 × $100,000). (PPP Loan Forgiveness FAQ #8)

Comment

Owner-employees with less than a 5% ownership interest in a C or S corporation are not subject to the owner-employee compensation rules. (SBA 2020-0044)

For Schedule C borrowers, using 2.5 months of 2019 compensation will allow them to qualify for 100% forgiveness.

Example of difference for Schedule C borrower

Bay Antiques is a sole proprietorship with 2019 net profit of $100,000 and no employees. The owner received a PPP loan of $20,833 ((2.5 ÷ 12) × $100,000). Prior to the PPPFA, with the eight-week forgiveness period, their forgiveness would have been limited to $15,385 ((8 ÷ 52) × $100,000), plus amounts paid for interest, rent, lease payments, or utilities.

The increased forgiveness period under the PPPFA means Bay's owner will be able have the loan fully forgiven without having to utilize their nonpayroll expenses. This is true, even though their maximum compensation is limited as owners.

	Eight-week period	24-week period
Net income	$15,385[1]	$20,833[2]
Rent	2,000	12,000
Utilities	1,000	6,000
Potential forgiveness	$18,385	(maximum) $38,833
Total forgiveness	**$18,385**	**$20,833**[3]

[1] (8 ÷ 52) × $100,000
[2] (2.5 ÷ 12) × $100,000; for forgiveness purposes, owner compensation is capped at 2.5 months of 2019 compensation, with a maximum of $20,833
[3] The lesser of the original loan amount or the expenses that qualify for forgiveness

If Bay uses the 24-week period, their loan will be fully forgiven.

Retirement and health care benefits

Because many companies make annual contributions to retirement plans or pay annual health insurance premiums, there were questions about how much of those annual amounts would qualify for forgiveness if they were paid during the covered period.

The interim final rules issued by the SBA explained that forgiveness does not apply to retirement or health care benefits "accelerated" into the covered period. Only the amount of benefits proportional to the covered period qualify for forgiveness. (PPP Loan Forgiveness FAQs #6)

Example of pension contribution

Employers, Inc. has elected to use the 24-week covered period to maximize their loan forgiveness. Employers received their loan proceeds on May 1, 2020. On August 3, 2020, Employers makes their annual pension contribution of $300,000.

Although the pension contribution is a covered expense, and it was made during the covered period, Employers may only include $144,231 ($300,000 × (24 ÷ 52)) in their forgiveness amount.

If Employers had elected to use an eight-week covered period, they would only be able to include $46,154 ($300,000 × (8 ÷ 52)).

Reminder: Pension and health insurance costs for 5% or greater owners are not allowed.

Other payroll cost guidance

The forgiveness application instructions and SBA-issued FAQs state that:

- Payroll costs include all forms of cash compensation paid to employees, including tips, commissions, bonuses, and hazard pay. However, there is still no clarification as to caps on these amounts, other than the overall payroll cap of $100,000 on an annualized basis per employee;
- Eligible payroll costs do not include any employer health insurance contributions made on behalf of self-employed individuals, general partners, or S corporation owner-employees;
- Employer retirement contributions made on behalf of a self-employed individual or general partner are also excluded from payroll costs; and
- Employer retirement contributions on behalf of owner-employees (including S corporation shareholder/employees) are capped at 2.5 months' worth of the 2019 contribution amount.

NONPAYROLL COSTS

Nonpayroll costs are eligible for forgiveness if:

- Paid during the covered period; or
- Incurred during the covered period and paid on or before the next regular billing date, even if the billing date is after the covered period.
(SBA 2020-038)

Note: Nonpayroll costs cannot account for more than 40% of the loan forgiveness (see upcoming discussion).

Example of nonpayroll costs

Reader's Books received a PPP loan with a covered period of April 16 through June 10.

Its electric bill for the month of April is $100, and they pay the bill on May 11. They can count the entire $100 because it was paid in the covered period.

Its electric bill for the month of June is also $100, and they pay the bill on July 11. They can count one-third of that payment because one-third of it was incurred in the covered period even though they didn't pay the bill until after the end of the covered period.

Home office expenses and self-rentals

The SBA's interim rules also clarified that:

- Deductible home office expenses are qualified expenses, but only to the extent they were deductible on 2019 tax filings (or if a new business, the borrower's expected 2020 tax filings);
- Rent or lease payments to related parties (defined as any ownership in common between the business and property owner) are eligible for forgiveness if:
  - The amount of loan forgiveness requested for rent or lease payments to a related party is no more than the amount of mortgage interest owed on the property during the covered period that is attributable to the space being rented by the party; and
  - The lease and the mortgage were entered into prior to February 15, 2020.
- Amounts attributable to a tenant or subtenant of the PPP borrower are ineligible for loan forgiveness (e.g., a tenant with a monthly rent of $10,000 who subleases a portion of the space for $2,500 will only be eligible for $7,500 of forgiveness).
  (SBA 2020-0044)

Example of rent to related party

Jessica owns a building that her corporation rents from her. The mortgage interest paid on the loan for the building during the covered period was $5,000. The corporation paid Jessica rent of $8,000 during the covered period, but they are limited to the $5,000 interest amount for forgiveness purposes.

Other nonpayroll cost guidance

Nonpayroll costs incurred prior to the forgiveness period but paid during the forgiveness period will also qualify for forgiveness.

In addition, the SBA-issued FAQs clarified the following issues:

- If a lease that existed prior to February 15, 2020, expires on or after February 15, 2020, and is renewed, the lease payments made pursuant to the renewed lease during the covered period are eligible for loan forgiveness;
- If a loan on real or personal property that existed prior to February 15, 2020, is refinanced on or after February 15, 2020, the interest payments on the refinanced loan during the covered period are eligible for loan forgiveness;
- Interest on unsecured credit is not eligible for loan forgiveness because the loan is not secured by real or personal property; and
- Utility expenses for the "distribution of transportation" refers to transportation utility fees assessed by state and local governments. Payment of these fees by the borrower is eligible for loan forgiveness. For more information on these fees, go to:

Website
www.fhwa.dot.gov/ipd/value_capture/defined/transportation_utility_fees.aspx

Comment

This guidance on utility expenses clarifies that fuel and other expenses for business use vehicles will not qualify as utility expenses.

REDUCTIONS OF FORGIVENESS

One step in determining how much of a taxpayer's PPP loan will be forgiven is determining if the employer has a reduction in either of the following, which can result in a decrease in the amount that may be forgiven.

- Full-time equivalent employees (FTEEs); or
- Reductions in salaries or wages for individual employees.

Reduction of full-time equivalents

In general, a reduction in FTEEs during the covered period reduces the loan forgiveness amount by the same percentage as the percentage reduction in FTEEs. (SBA 2020-0032; instructions to loan forgiveness form) However, as discussed below, businesses may be exempted from this reduction if they meet certain requirements.

The FTEE reference period

A reduction occurs if the average number of FTEEs during the "reference" period was greater than the average number of FTEEs during the covered period. Borrowers who are not seasonal employers have the choice to use one of two reference periods:

- February 15, 2019, to June 30, 2019; or
- January 1, 2020, to February 29, 2020.

Comment

A seasonal employer that elects to use a 12-week period between May 1, 2019, and September 15, 2019, to calculate its maximum PPP loan amount must use the same 12-week period as the reference period for calculation of any reduction in the amount of loan forgiveness.

Computing the number of FTEEs

The SBA is using a 40-hour full-time equivalency standard. If an employee works more than 40 hours in a week, only count 40 hours for that employee.

However, borrowers may use a simplified method that assigns a 1.0 for employees who work 40 hours or more per week and 0.5 for employees who work fewer hours. This is most advantageous for businesses that have many employees who work fewer than 20 hours per week.

Comment

Some borrowers counted employees using the 30-hour standard (which is the traditional standard for SBE purposes) when they applied for their loan. While using the 40-hour standard will likely reduce their number of FTEEs, this calculation is done on the forgiveness application. The number of employees reported on the original loan application is not relevant for this purpose.

Example of simplified FTEE method

Red Meat Restaurant pays its employees weekly. During a week in the covered period, Red Meat Restaurant had five employees. Their hours were:

Employee	**Hours**	**Simplified FTEE**
Chief cook	52*	1.0
Junior cook	10	0.5
Waiter 1	40	1.0
Waiter 2	16	0.5
Waiter 3	10	0.5
Dishwasher	24	0.5
Total countable hours	140*	4.0

* The total countable hours are 140 because you can only count a maximum of 40 hours for each employee

Using the standard method, the restaurant has 3.5 FTEEs (140 ÷ 40).

Using the simplified method, it has 4 FTEEs.

Red Meat must compute the number of FTEEs in each payroll period during the covered period and compare the average number of FTEEs during that period to the number of FTEEs during its chosen reference period.

Assume that its average FTEEs during the reference period was five. Red Meat will use the simplified method from above because it results in a smaller reduction of FTEEs, and its average FTEEs during the covered period is four. It would have a reduction of FTEES of one. Therefore, Red Meat must reduce its loan forgiveness amount by 20% (a reduction of one-fifth FTEEs in the reference period).

Note: It's likely that Red Meat will qualify for an exemption from the FTEE reduction rules (see the upcoming discussion).

> ***Comment***
>
> Neither the instructions to the forgiveness application nor the SBA in any of its pronouncements state that a borrower is required to use the same method from week-to-week. However, it seems likely that a borrower must do so.

FTEE reduction exemption

The PPPFA gives employers until December 31, 2020, to replace their reduced FTEEs without having to reduce their loan forgiveness amounts.

The act also contains provisions eliminating the FTEE reduction if the business can document that they were unable to rehire employees, or where the business has not been able to return to the same level of business activity.

Inability to rehire employees

A reduction in FTEEs will not occur for any employee where:

- The borrower made a good-faith, written offer to rehire an individual who was an employee on February 15, 2020, and was unable to hire similarly qualified employees for unfilled positions on or before December 31, 2020;
- Any positions for which the borrower made a good-faith, written offer to restore any reduction in hours, at the same salary or wages, during the covered forgiveness period, and the employee rejected the offer (this would also include an employee who was laid off); or
- Any employees who during the covered forgiveness period were fired for cause, voluntarily resigned, or voluntarily requested and received a reduction of their hours.

Business activity

The forgiveness amount will not be reduced if the business cannot return to the same level of business activity the business was operating at before February 15, 2020, (by the end of the covered forgiveness period) due to compliance with requirements or guidance issued between March 1, 2020, and December 31, 2020, by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration, related to worker or customer safety requirements related to COVID–19. (PPPFA §3(b)(2))

> ***Comment***
>
> The provision allowing borrowers to disregard a reduction in FTEEs if they were unable to operate at their same level of business activity appears to be a fairly broad standard. The interim final rules interpret this exemption to include both direct and indirect compliance with COVID-19 requirements or guidance, including state and local government shutdown orders that are based in part on guidance from the three federal agencies previously mentioned.
>
> For example, even if a restaurant is able to continue operating through take-out and delivery, it would qualify for the exemption if it can't operate at the same level of business because it's not allowed to have customers in the restaurant.

Reductions in salaries or wages

The forgiveness is also reduced by any reduction of total salary or wages of an employee during the covered forgiveness period of any employee earning less than $100,000 (on an annualized basis) by more than 25% when compared to the total salary or wages in the prior quarter. The reduction calculation is done on a per-employee basis, not in the aggregate. (PPP Loan Forgiveness FAQ #4)

To determine if, and by how much, an employee's salary was reduced, compare:

- The average annual salary or hourly wage during the covered period; to
- The average annual salary or hourly wage between January 1, 2020 and March 31, 2020.

The good news is that the formula used for these reductions on the application only reduces the forgiveness by the reduction in pay during the covered forgiveness period, and only reduces the forgiveness to the extent the reduction is more than 25% of the original wage or salary.

Example of salary reduction

Prior to the COVID-19 pandemic, We Need Help, Inc. paid Josh an annual salary of $80,000. We Need Help received a PPP loan, but they still had to cut Josh's salary to $50,000, and they did not increase his wages by December 31, 2020. We Need Help uses an eight-week forgiveness period.

Here is how We Need Help will calculate their forgiveness reduction:

Josh's salary during the eight weeks	$ 50,000
Josh's salary 1/1/20–3/31/20	80,000
Multiply this amount by 0.75	60,000
Subtract his new salary	(50,000)
Reduction in excess of 25%	10,000
8/52 of this amount is	**$1,538.46**

We Need Help will reduce their potential PPP forgiveness by $1,538.46.

The formula also provides one calculation for salaried workers and one for hourly workers. The calculation is based on the worker's hourly wage and applies that reduction based on the average weekly hours worked between January 1, 2020, and March 31, 2020.

Based on the calculation in the application, if an employer reduces a worker's hours but keeps the worker's hourly wage the same, there will be no reduction in forgiveness based on reduction in salary. However, the reduction in hours will be reflected in the FTEE calculation.

Example of hourly wage reduction

We Need Help also reduced Jessica's hourly wage from $40 per hour to $25 per hour. During the previous quarter, Jessica worked 40 hours per week.

Here is how We Need Help will calculate their forgiveness reduction:

Jessica's hourly wage during the eight weeks	$ 25.00
Jessica's hourly wage 1/1/20–3/31/20	40.00
Multiply this amount by 0.75	30.00
Subtract her new hourly wage	(25.00)
Reduction in excess of 25%	$ 5.00
Average hours worked 1/1/20–3/31/20	40.00
Average weekly wage difference ($5.00 × 40)	$ 200.00
Multiplied by eight weeks	**$1,600.00**

We Need Help will reduce their potential PPP forgiveness by $1,600.

Salary/wage reduction safe harbor

The instructions also contain a safe harbor that allows businesses to claim the full loan forgiveness amount if the wages or salaries paid to employees are restored to the amount paid in the borrower's pay period that included February 15, 2020, by the earlier of:

- December 31, 2020; or
- The date the loan forgiveness application is submitted.

However, if an employee's average salary or wages paid during the period of February 15, 2020, through April 26, 2020, are greater than the amount paid during the pay period that included February 15, 2020, that employee's wages do not qualify for the safe harbor. As we discussed, this calculation is based on base salaries and wages, so a reduction in overtime or commissions would not be considered a reduction for purposes of loan forgiveness.

Note: The instructions do not specify how long those restored amounts must be paid.

Example of reduced commissions

Gyms, Inc. pays their sales staff base salaries and commissions based on the number of new gym memberships they sell. During Gym's covered period, they were able to use the PPP funds to pay the sales staff their base salaries. However, because the gyms were closed, there were no commissions for new memberships.

Although the sales staff's total pay was reduced by more than 25%, the reductions were all due to reduced commissions, not reduced salaries or wages. These reductions would not be considered for purposes of the loan forgiveness calculations.

Even if they had reduced the employee's wages, they would likely qualify for the exemption based on reduced operations.

Safe harbors extended

For new PPP loan distributions, the ACRRA extends the safe harbors for restoring FTEEs and salaries and wages to the end of the borrower's covered period. (ACRRA §311)

Avoidance of double penalties

To ensure that borrowers are not doubly penalized, the salary/wage reduction applies only to the portion of the decline in employee salary and wages that is not attributable to the reduction of FTEEs. (SBA 2020-0032)

Example of double penalty

An employee had been working 40 hours per week during the borrower-selected reference period. The employee's hours were reduced to 20 hours per week during the covered period. Therefore, the employee's FTEE status was reduced from 1.0 to 0.5.

There was no change in the employee's hourly rate during this period. Because the hourly rate did not change, the reduction in the employee's total wages is entirely attributable to the FTEE reduction, and the borrower is not required to conduct a salary/wage reduction calculation with respect to this employee.

If the employee had both a reduction in hours and a reduction in pay rate, both reductions could apply.

THRESHOLD FOR PAYROLL COSTS

The PPPFA states that borrowers are only allowed full loan forgiveness if at least 60% of the total loan proceeds are used for payroll costs. The 60% payroll cost threshold isn't a "cliff" test, but rather a cap (that is, a cap on the relative amount of nonpayroll costs that can be used in calculating forgiveness).

The calculation on the forgiveness application does limit the forgiveness, so that 60% of the forgiven amount must be used to cover payroll costs. It applies this limitation after reducing the forgiveness amount for reductions in FTEEs and salaries or wages.

Example of 60% limit

Pottery Farm got a PPP loan of $120,000. During the covered period, it had qualifying wages of $60,000. As a result, its maximum forgiveness is $100,000 ($60,000 qualifying wages ÷ 60%).

If it had $20,000 of nonpayroll costs, its forgiveness would be $80,000 ($60,000 payroll plus $20,000 nonpayroll).

If it had $50,000 of nonpayroll costs, its forgiveness would be limited to $100,000.

EIDL GRANTS

PPP forgiveness amounts will no longer be reduced by Economic Injury Disaster Loan (EIDL) advances the borrowers received. (ACRRA §333) The SBA is also directed to issue rules ensuring that borrowers that received forgiveness reduced by their EIDL advance be "made whole."

FORGIVENESS CALCULATORS

Spidell is offering a Loan Forgiveness Calculator. The results of the calculations will closely mimic the items on the forgiveness application form, and the amounts can be easily transferred to the application.

Website
www.caltax.com/files/2020/8weekworksheet.xlsx
www.caltax.com/files/2020/24weekworksheet.xlsx

APPLYING FOR FORGIVENESS

Borrowers will apply for loan forgiveness from their lender, and lenders have up to 60 days to issue a decision. See the following checklist for details. You may download a copy at:

> **Website**
> www.caltax.com/files/2020/ppploanforgiveness.pdf

Checklist for Applying for PPP Loan Forgiveness

The applicant must submit the following documents with their forgiveness application.

- ☐ Payroll records
  - ☐ Bank account statements or third-party payroll service provider reports documenting the amount of cash compensation paid to employees
  - ☐ Payroll tax returns (or equivalent third-party payroll service provider reports) for the periods that overlap with the covered forgiveness period, including 941s and state quarterly wage reporting and unemployment insurance tax filings
  - ☐ Payment receipts, cancelled checks, or account statements documenting the amount of any employer contributions to employee health insurance and retirement plans that the borrower included in the forgiveness amount
- ☐ For FTEEs, federal or state payroll tax filings showing the number of FTEEs during the measuring period selected by the borrower
- ☐ Nonpayroll costs
  - ☐ Mortgage interest: copy of lender amortization schedule and receipts or cancelled checks verifying eligible payments from the covered forgiveness period; or lender account statements from February 2020 and the months of the covered forgiveness period through one month after the end of the covered forgiveness period verifying interest amounts and eligible payments
  - ☐ Rent or lease payments: copy of current lease agreement and receipts or cancelled checks verifying eligible payments from the covered forgiveness period; or lessor account statements from February 2020 and from the covered forgiveness period through one month after the end of the covered forgiveness period verifying eligible payments
  - ☐ Business utility payments: copy of invoices from February 2020 and those paid during the covered forgiveness period and receipts, cancelled checks, or account statements verifying those eligible payments
- ☐ A certified statement from an authorized representative of the business attesting the following:
  - ☐ The documentation submitted is true and correct
  - ☐ The amount of the loan sought to be forgiven was used to cover qualified expenses

(continued)

Checklist for Applying for PPP Loan Forgiveness (continued)	
In case of a future audit, the following documents must be maintained but not submitted	
☐	PPP Schedule A Worksheet or its equivalent
☐	Documentation supporting the listing of each individual employee in PPP Schedule A Worksheet Table 1, including the “Salary/Hourly Wage Reduction” calculation, if necessary
☐	Documentation supporting the listing of each individual employee in PPP Schedule A Worksheet Table 2; specifically, that each listed employee received during any single pay period in 2019 compensation at an annualized rate of more than $100,000
☐	Documentation regarding any employee job offers and refusals, refusals to accept restoration of reductions in hours, firings for cause, voluntary resignations, written requests by any employee for reductions in work schedule, and any inability to hire similarly qualified employees for unfilled positions on or before December 31, 2020
☐	Documentation supporting the certification, if applicable, that the borrower was unable to operate between February 15, 2020, and the end of the covered period at the same level of business activity as before February 15, 2020, due to compliance with requirements established or guidance issued between March 1, 2020, and December 31, 2020, by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration, related to the maintenance of standards of sanitation, social distancing, or any other work or customer safety requirement related to COVID-19. This documentation must include copies of the applicable requirements for each borrower location and relevant borrower financial records
☐	Documentation supporting the PPP Schedule A Worksheet “FTE Reduction Safe Harbor 2”
Note: The borrower must maintain these records for six years after the date the loan is forgiven or repaid in full **Comment:** The bank may request additional information to process the forgiveness	

Example of forgiveness application

Events R Us applied for a PPP loan on April 3, 2020. For 2019, the company had average monthly payroll costs of $500,000. As a result, Events qualified for a loan of $1.25 million ($500,000 × 2.5).

Events is an S corporation, has one owner, and averaged 40 employees prior to the COVID-19 pandemic.

Eight-week covered period

Events is able to use the PPP funds to maintain 35 of their employees at their full rate of pay for the eight-weeks after they receive the loan except for the CFO, whose annual salary was reduced from $75,000 to $40,000 during the covered period.

During the eight-week period starting with the date their loan was disbursed, Events used their loan funds for:

Cash compensation to 29 employees earning less than $100,000	$707,306
Cash compensation to six employees earning more than $100,000[1]	92,310
Employee health insurance contributions[2]	20,000
Employer contributions to employee retirement plans	33,333
State payroll taxes	6,666
Owner compensation[3]	15,385
Total payroll costs	$875,000
Rent	20,000
Utilities	8,000
Total	$903,000
Less: reduced salary	2,500
	$900,500

[1] Limited to 8/52 of $100,000

[2] Excluding shareholder/employee contributions

[3] Limited to 8/52 of $100,000

For the eight-week period, Events would qualify for loan forgiveness of $787,937.50 ($900,500 × (35 ÷ 40)).

Comment: The FTEE reduction will not apply if Events is unable to return to the same level of business they had on February 15, 2020 (discussed on page 3-11).

PPP Loan Forgiveness Calculation Form

Business Legal Name ("Borrower")	DBA or Tradename, if applicable	
EVENTS R US		
Business Address	**Business TIN (EIN, SSN)**	**Business Phone**
		( ) -
	Primary Contact	**E-mail Address**

SBA PPP Loan Number:__________ **Lender PPP Loan Number:** __________

PPP Loan Amount:__________ **PPP Loan Disbursement Date:** __________

Employees at Time of Loan Application: _____ **Employees at Time of Forgiveness Application:** _____

EIDL Advance Amount:__________ **EIDL Application Number:** __________

Payroll Schedule: The frequency with which payroll is paid to employees is:

☐ **Weekly** ☐ **Biweekly** (every other week) ☐ **Twice a month** ☐ **Monthly** ☐ **Other** ________

Covered Period:__________to __________

Alternative Payroll Covered Period, if applicable:__________to __________

If Borrower (together with affiliates, if applicable) received PPP loans in excess of $2 million, check here: ☐

Forgiveness Amount Calculation:

Payroll and Nonpayroll Costs

Line 1. Payroll Costs (enter the amount from PPP Schedule A, line 10): 875,000.00

Line 2. Business Mortgage Interest Payments: __________

Line 3. Business Rent or Lease Payments: 20,000.00

Line 4. Business Utility Payments: 8,000.00

Adjustments for Full-Time Equivalency (FTE) and Salary/Hourly Wage Reductions

Line 5. Total Salary/Hourly Wage Reduction (enter the amount from PPP Schedule A, line 3): 2,500.00

Line 6. Add the amounts on lines 1, 2, 3, and 4, then subtract the amount entered in line 5: 900,500.00

Line 7. FTE Reduction Quotient (enter the number from PPP Schedule A, line 13): .875

Potential Forgiveness Amounts

Line 8. Modified Total (multiply line 6 by line 7): 787,937.50

Line 9. PPP Loan Amount: 1,250,000.00

Line 10. Payroll Cost 60% Requirement (divide line 1 by 0.60): 1,458,333.33

Forgiveness Amount

Line 11. Forgiveness Amount (enter the smallest of lines 8, 9, and 10): 787,937.50

PPP Schedule A

PPP Schedule A Worksheet, Table 1 Totals

Line 1. Enter Cash Compensation (Box 1) from PPP Schedule A Worksheet, Table 1: 707,306.00

Line 2. Enter Average FTE (Box 2) from PPP Schedule A Worksheet, Table 1: 29.00

Line 3. Enter Salary/Hourly Wage Reduction (Box 3) from PPP Schedule A Worksheet, Table 1: 2,500.00
If the average annual salary or hourly wage for each employee listed on the PPP Schedule A Worksheet, Table 1 during the Covered Period or the Alternative Payroll Covered Period was at least 75% of such employee's average annual salary or hourly wage between January 1, 2020 and March 31, 2020, check here ☐ and enter **0** on line 3.

PPP Schedule A Worksheet, Table 2 Totals

Line 4. Enter Cash Compensation (Box 4) from PPP Schedule A Worksheet, Table 2: 92,310.00

Line 5. Enter Average FTE (Box 5) from PPP Schedule A Worksheet, Table 2: 6.00

Non-Cash Compensation Payroll Costs During the Covered Period or the Alternative Payroll Covered Period

Line 6. Total amount paid or incurred by Borrower for employer contributions for employee health insurance: 20,000.00

Line 7. Total amount paid or incurred by Borrower for employer contributions to employee retirement plans: 33,333.00

Line 8. Total amount paid or incurred by Borrower for employer state and local taxes assessed on employee compensation: 6,666.00

Compensation to Owners

Line 9. Total amount paid to owner-employees/self-employed individual/general partners: 15,385.00
This amount may not be included in PPP Schedule A Worksheet, Table 1 or 2. If there is more than one individual included, attach a separate table that lists the names of and payments to each.

Total Payroll Costs

Line 10. Payroll Costs (add lines 1, 4, 6, 7, 8, and 9): 875,000.00

Full-Time Equivalency (FTE) Reduction Calculation

If you satisfy **any** of the following three criteria, check the appropriate box, skip lines 11 and 12, and enter **1.0** on line 13; otherwise, complete lines 11, 12, and 13:

No reduction in employees or average paid hours: If you have not reduced the number of employees or the average paid hours of your employees between January 1, 2020 and the end of the Covered Period, check here ☐.

FTE Reduction Safe Harbor 1: If you were unable to operate between February 15, 2020, and the end of the Covered Period at the same level of business activity as before February 15, 2020 due to compliance with requirements established or guidance issued between March 1, 2020 and December 31, 2020, by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID-19, check here ☐.

FTE Reduction Safe Harbor 2: If you satisfy FTE Reduction Safe Harbor 2 (see PPP Schedule A Worksheet), check here ☐.

Line 11. Average FTE during the Borrower's chosen reference period: 40.00

Line 12. Total Average FTE (add lines 2 and 5): 35.00

Line 13. FTE Reduction Quotient (divide line 12 by line 11) or enter 1.0 if any of the above criteria are met: .875

PPP Schedule A Worksheet

Table 1: List employees who:

- Were employed by the Borrower at any point during the Covered Period or the Alternative Payroll Covered Period whose principal place of residence is in the United States; and
- Received compensation from the Borrower at an annualized rate of less than or equal to $100,000 for all pay periods in 2019 or were not employed by the Borrower at any point in 2019.

Employee's Name	Employee Identifier	Cash Compensation	Average FTE	Salary / Hourly Wage Reduction
LIST EMPLOYEES				
FTE Reduction Exceptions:				
Totals:		**Box 1** 707,306.00	**Box 2** 29.00	**Box 3** 2,500.00

Table 2: List employees who:

- Were employed by the Borrower at any point during the Covered Period or the Alternative Payroll Covered Period whose principal place of residence is in the United States; and
- Received compensation from the Borrower at an annualized rate of more than $100,000 for any pay period in 2019.

Employee's Name	Employee Identifier	Cash Compensation	Average FTE
LIST EMPLOYEES			
Totals:		**Box 4** 92,310.00	**Box 5** 6.00

Attach additional tables if additional rows are needed.

FTE Reduction Safe Harbor 2:

Step 1. Enter the borrower's total average FTE between February 15, 2020 and April 26, 2020. Follow the same method that was used to calculate Average FTE in the PPP Schedule A Worksheet Tables. Sum across all employees and enter: ______________.

Step 2. Enter the borrower's total FTE in the Borrower's pay period inclusive of February 15, 2020. Follow the same method that was used in step 1:_______________.

Step 3. If the entry for step 2 is greater than step 1, proceed to step 4. Otherwise, FTE Reduction Safe Harbor 2 is not applicable and the Borrower must complete line 13 of PPP Schedule A by dividing line 12 by line 11 of that schedule.

Step 4. Enter the borrower's total FTE as of the earlier of December 31, 2020, and the date this application is submitted:______.

Step 5. If the entry for step 4 is greater than or equal to step 2, enter 1.0 on line 13 of PPP Schedule A; the FTE Reduction Safe Harbor 2 has been satisfied. Otherwise, FTE Reduction Safe Harbor 2 does not apply and the Borrower must complete line 13 of PPP Schedule A by dividing line 12 by line 11 of that schedule.

Instructions for PPP Schedule A Worksheet

Complete the PPP Schedule A Worksheet or obtain an equivalent report from the Borrower's payroll system or payroll processor.

Table Instructions

Employee's Name: Separately list each employee. Do not include any independent contractors, owner-employees, self-employed individuals, or partners.

Employee Identifier: Enter the last four digits of each employee's Social Security Number.

Cash Compensation: Enter the sum of gross salary, gross wages, gross tips, gross commissions, paid leave (vacation, family, medical or sick leave, not including leave covered by the Families First Coronavirus Response Act), and allowances for dismissal or separation paid or incurred during the Covered Period or the Alternative Payroll Covered Period. For each individual employee, the total amount of cash compensation eligible for forgiveness may not exceed an annual salary of $100,000, as prorated for the Covered Period. For an 8-week Covered Period, that total is $15,385. For a 24-week Covered Period, that total is $46,154.

Average FTE: This calculates the average full-time equivalency (FTE) during the Covered Period or the Alternative Payroll Covered Period. For each employee, enter the average number of hours paid per week, divide by 40, and round the total to the nearest tenth. The maximum for each employee is capped at 1.0. A simplified method that assigns a 1.0 for employees who work 40 hours or more per week and 0.5 for employees who work fewer hours may be used at the election of the Borrower.

This calculation will be used to determine whether the Borrower's loan forgiveness amount must be reduced due to a statutory requirement concerning reductions in full-time equivalent employees. Borrowers are eligible for loan forgiveness for certain expenditures during the Covered Period or the Alternative Payroll Covered Period. However, the actual loan forgiveness amount that the Borrower will receive may be less, depending on whether the Borrower's average weekly number of FTE employees during the Covered Period or the Alternative Payroll Covered Period was less than during the Borrower's chosen reference period (*see* Instructions to PPP Schedule A, Line 11). The Borrower is exempt from such a reduction if either of the FTE Reduction Safe Harbors applies. See the FTE Reduction Safe Harbor instructions below.

Salary/Hourly Wage Reduction: This calculation will be used to determine whether the Borrower's loan forgiveness amount must be reduced due to a statutory requirement concerning reductions in employee salary and wages. Borrowers are eligible for loan forgiveness for certain expenditures during the Covered Period or the Alternative Payroll Covered Period. However, the actual amount of loan forgiveness the Borrower will receive may be less, depending on whether the salary or hourly wages of certain employees during the Covered Period or the Alternative Payroll Covered Period was less than during the period from January 1, 2020 to March 31, 2020. If the Borrower restored salary/hourly wage levels, the Borrower may be eligible for elimination of the Salary/Hourly Wage Reduction amount. Borrowers must complete this worksheet to determine whether to reduce the amount of loan forgiveness for which they are eligible. Complete the Salary/Hour Wage Reduction column only for employees whose salaries or hourly wages were reduced by more than 25% during the Covered Period or the Alternative Payroll Covered Period as compared to the period of January 1, 2020 through March 31, 2020. For each employee listed in Table 1, complete the following (using salary for salaried employees and hourly wage for hourly employees):

Step 1. Determine if pay was reduced more than 25%.

a. Enter average annual salary or hourly wage during Covered Period or Alternative Payroll Covered Period: 40,000.00.
b. Enter average annual salary or hourly wage between January 1, 2020 and March 31, 2020: 75,000.00.
c. Divide the value entered in 1.a. by 1.b.: .53.
   If 1.c. is 0.75 or more, enter zero in the column above box 3 for that employee; otherwise proceed to Step 2.

Step 2. Determine if the Salary/Hourly Wage Reduction Safe Harbor is met.

a. Enter the annual salary or hourly wage as of February 15, 2020: 75,000.00.
b. Enter the average annual salary or hourly wage between February 15, 2020 and April 26, 2020: 75,000.00.
   If 2.b. is equal to or greater than 2.a., skip to Step 3. Otherwise, proceed to 2.c.
c. Enter the average annual salary or hourly wage as of the earlier of December 31, 2020 and the date this application is submitted: 40,000.00.
   If 2.c. is equal to or greater than 2.a., the Salary/Hourly Wage Reduction Safe Harbor has been met – enter zero in the column above box 3 for that employee. Otherwise proceed to Step 3.

Step 3. Determine the Salary/Hourly Wage Reduction.

a. Multiply the amount entered in 1.b. by 0.75: 56,250.00.
b. Subtract the amount entered in 1.a. from 3.a.: 16,250.00.

If the employee is an hourly worker, compute the total dollar amount of the reduction that exceeds 25% as follows:

c. Enter the average number of hours worked per week between January 1, 2020 and March 31, 2020: ______________.

d. Multiply the amount entered in 3.b. by the amount entered in 3.c.______________. Multiply this amount by 24 (if Borrower is using a 24-week Covered Period) or 8 (if Borrower is using an 8-week Covered Period):______________. Enter this value in the column above box 3 for that employee.

If the employee is a salaried worker, compute the total dollar amount of the reduction that exceeds 25% as follows:

e. Multiply the amount entered in 3.b. by 24 (if Borrower is using a 24-week Covered Period) or 8 (if Borrower is using an 8-week Covered Period): 130,000 . Divide this amount by 52: 2,500.00 . Enter this value in the column above box 3 for that employee.

FTE Reduction Exceptions: Indicate the FTE of (1) any positions for which the Borrower made a good-faith, written offer to rehire an individual who was an employee on February 15, 2020 and the Borrower was unable to hire similarly qualified employees for unfilled positions on or before December 31, 2020; (2) any positions for which the Borrower made a good-faith, written offer to restore any reduction in hours, at the same salary or wages, during the Covered Period or the Alternative Covered Period and the employee rejected the offer, and (3) any employees who during the Covered Period or the Alternative Payroll Covered Period (a) were fired for cause, (b) voluntarily resigned, or (c) voluntarily requested and received a reduction of their hours. In all of these cases, include these FTEs on this line only if the position was not filled by a new employee. Any FTE reductions in these cases do not reduce the Borrower's loan forgiveness.

Boxes 1 through 5: Enter the sums of the amounts in each of the columns.

FTE Reduction Safe Harbors

Two separate safe harbors exempt certain borrowers from any loan forgiveness reduction based on a reduction in FTE employee levels:

1. The Borrower is exempt from the reduction in loan forgiveness based on a reduction in FTE employees described above if the Borrower, in good faith, is able to document that it was unable to operate between February 15, 2020, and the end of the Covered Period at the same level of business activity as before February 15, 2020, due to compliance with requirements established or guidance issued between March 1, 2020 and December 31, 2020, by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration, related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID-19.

2. The Borrower is exempt from the reduction in loan forgiveness based on a reduction in FTE employees described above if both of the following conditions are met: (a) the Borrower reduced its FTE employee levels in the period beginning February 15, 2020, and ending April 26, 2020; and (b) the Borrower then restored its FTE employee levels by not later than December 31, 2020 to its FTE employee levels in the Borrower's pay period that included February 15, 2020.

Simplified forgiveness for loans of $150,000 or less

The ACRRA provides simplified loan forgiveness provisions for borrowers with PPP loans of $150,000 or less and expands the types of expenses that may be forgiven.

A simplified loan forgiveness procedure will be available to borrowers with loans of up to $150,000. (ACRRA §307) The simplified forgiveness application for these borrowers applies to both original PPP loans under the CARES Act and second draw PPP loans under the ACRRA. These borrowers will submit a one-page application that only requires them to provide:

- A description of the number of employees the borrower was able to retain because of the covered loan;
- An estimated amount of the loan amount spent on payroll costs;
- The total loan amount; and
- An attestation that the borrower accurately provided the required certification for the loan and complied with the PPP loan requirements.

The borrower must retain records to support the application in case of an audit but will not be required to submit them with the application. Employment records related to the loan must be retained for four years from the date of the loan forgiveness application submission. All other records must be retained for three years.

Comment

A new application will be required for this simplified forgiveness process. The ACRRA states the application form must be made available by January 20, 2021, (24 days after the December 27, 2020, date of enactment).

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EZ FORGIVENESS APPLICATION

A simplified EZ application is available to be used by borrowers who:

- Are self-employed and did not list any employees on their original loan application; or
- Have employees, but are not subject to any loan forgiveness reduction due to salary or full-time equivalent employee reductions.

The form does not deal with the complicated calculations for forgiveness reduction based on FTEEs or salaries and wages. This makes it a much shorter, more straightforward form.

Comment

In Announcement 2020-12, the IRS notified PPP lenders that they should not file information returns or furnish payee statements to report PPP loan forgiveness. This means your clients will not receive 1099-Cs reporting the forgiven debt.

BORROWERS OF $50,000 OR LESS

The Treasury and SBA have released PPP Loan Forgiveness Form 3508S and interim final rules that ease the forgiveness rules for borrowers of $50,000 or less. These borrowers are no longer required to reduce forgiveness amounts based on reductions in full-time equivalent employees or reductions in salaries and wages.

This is great news for many small businesses. However, this is not automatic forgiveness. All of the other rules regarding qualified forgiveness expenses still apply, including the requirement that at least 60% of the forgiveness amount must be from payroll expenses.

The new forgiveness form is available at:

Website
www.sba.gov/document/sba-form-3508s-ppp-loan-forgiveness-form-3508s

Instructions for the form are available at:

Website
www.sba.gov/document/support-ppp-loan-forgiveness-form-3508s-instructions

New interim final rules are available at:

Website
https://home.treasury.gov/system/files/136/PPP--IFR--Additional-Revisions-Loan-Forgiveness-Loan-Review-Procedures-Interim-Final-Rules.pdf

SUBMITTING FORGIVENESS APPLICATIONS EARLY

Borrowers are not required to submit their forgiveness applications until 10 months after the end of their covered period, but they are not required to wait until after their covered forgiveness period to apply for forgiveness. Some borrowers chose to apply for forgiveness before the end of their covered period if they had used all of the loan proceeds. If the borrower qualifies for full forgiveness, we don't see any problems with the early applications.

However, for borrowers with forgiveness reductions there are some drawbacks to those early applications:

- First, applying for forgiveness early does not reduce forgiveness reductions. The interim rules clearly state that if the borrower applies for forgiveness before the end of the covered period and has reduced any employee's salaries or wages in excess of 25%, the borrower must account for the excess salary reduction for the full eight-week or 24-week covered period;
- Second, if the borrower has reductions to their forgiveness for reduced full-time equivalent employees or reductions in salary, they will most likely benefit from waiting until the end of their covered period to apply for forgiveness. This is because the reduction applies to all qualified expenses during the covered period, even those in excess of the loan amount; and
- Finally, borrowers who have potential forgiveness reductions may also benefit from waiting until after December 31, 2020, to see if they have restored any of their full-time employees, and or salaries, meaning they qualify for the safe harbor and are not required to reduce their forgiveness amounts. It is possible they could lose the benefit of these safe harbors if they apply for forgiveness before December 31.

Practice Pointer

Because loan forgiveness doesn't have to be applied for until 10 months after the covered period, a borrower eligible to use either the eight- or 24-week period can wait to see which period provides the most forgiveness.

DEDUCTIBILITY OF EXPENSES

The ACRRA makes it clear that no deduction may be denied, no tax attribute reduced, and no basis increase denied by reason of any PPP loan forgiveness under the CARES Act or the ACRRA. (ACRRA §276) This reverses the IRS's position taken in IRS Notice 2020-32 that taxpayers could not deduct expenses that were paid with forgiven PPP loans.

California conformity

For taxable years beginning on or after January 1, 2020, California does not treat the forgiveness as COD income but disallows deductions for any of the amounts paid with forgiven PPP debt. (AB 1577 (Ch. 20-39); R&TC §§17131.8, 24308.6) Because California passed a law that specifically disallows deductions for expenses paid with PPP loan amounts that were forgiven, absent subsequent legislation enacted in 2021, these expenses will not be deductible on the California return. See page 8-1 for additional information.

Basis issues

The ACRRA also clarifies that tax basis and other attributes of the borrower's assets will not be affected as a result of the loan forgiveness. (ACRRA §276) This means that for PPP loan forgiveness excluded on a partnership or S corporation return, the amount excluded is treated as tax-exempt income for purposes of IRC §§705 and 1366. Unless otherwise provided by the IRS, any increase in a partner's adjusted basis in the partner's partnership interest is equal to the partner's distributive share of deductions resulting from costs giving rise to the loan forgiveness.

These provisions are applicable to taxable years ending after March 27, 2020 (the date of the enactment of the CARES Act).

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What happens if the business is sold?

We have received a number of questions from practitioners asking what happens when their clients buy or sell a business that has taken out a Paycheck Protection Program loan. Recent guidance clarifies the rules that apply in these situations. (SBA Procedural Notice 5000-20057)

The guidance clarifies when a "change of ownership" has occurred, who is responsible for the PPP debt after that change, and what notification must be provided to the bank servicing the PPP loan. The notification process is important because some sales require SBA approval, which could cause delays in your clients' transactions.

Change in ownership

For purposes of the PPP loans, a change of ownership occurs when:

- At least 20% of the common stock or other ownership interest of a PPP borrower (including a publicly traded entity) is sold or otherwise transferred, whether in one or more transactions, including to an affiliate or an existing owner of the entity;
- The PPP borrower sells or otherwise transfers at least 50% of its assets (measured by fair market value), whether in one or more transactions; or
- A PPP borrower is merged with or into another entity.

Regardless of any change of ownership, the original PPP borrower remains responsible for all obligations under the loan. Additionally, if the new owners use PPP funds for unauthorized purposes, the SBA will have recourse against them for the unauthorized use.

Notice to the lender

Prior to the closing of any change of ownership transaction, the PPP borrower must notify the bank servicing their PPP loan in writing of the contemplated transaction. The borrower must provide a copy of the proposed agreements or other documents that would carry out the proposed transaction.

If the PPP debt has not been forgiven or paid off, the borrower must get approval from the bank (and in some cases the SBA) prior to completing the sale.

Approval required

If the sale is a sale of stock or other ownership interest, the bank may approve the sale without SBA approval if the following requirements are met:

- 50% or less of the original ownership is transferred; or
- The borrower has completed a forgiveness application with all supporting documents, and an interest bearing escrow account has been set up with the PPP lender holding funds equal to the outstanding balance of the PPP loan. After the forgiveness determination is made by the SBA, any outstanding debt will be paid from the escrow account with the remainder being disbursed to the borrower under the new ownership.

If the sale is structured as an asset sale, the bank may approve the sale without SBA approval only if:

- The borrower is not selling more than 50% of its assets (based on FMV); and
- The borrower has completed a forgiveness application with all supporting documents, and an interest bearing escrow account has been set up with the PPP lender holding funds equal to the outstanding balance of the PPP loan. After the forgiveness determination is made by the SBA, any outstanding debt will be paid from the escrow account with the remainder being disbursed to the borrower.

If a sale of ownership or assets does not meet the requirements listed above, the SBA must approve the sale. The SBA has 60 calendar days to issue this approval and may require that the new owners take steps to assume liability for any unpaid debt.

The full text of the change in ownership guidance can be found here:

Website
https://home.treasury.gov/system/files/136/PPP-Procedural-Notice-PPP-Loans-and-Changes-of-Ownership.pdf

Paycheck Protection Program Loan Overview	
Maximum loan amount	Equal to lesser of: • 2.5 times the average total monthly payroll costs (maximum $100,000 annual salary per employee) during the 2019 calendar year, or during the one year before the date on which the loan is made (between January 1, 2020, and February 29, 2020, for newer businesses); plus any refinanced Economic Injury Disaster Loans; or • $10 million
Payroll costs defined	"Payroll costs" means the sum of the following payments: • Salary, wages, or other compensation paid to an employee, sole proprietor, or partner, or employer-owner; • Payment of cash tips or equivalents; • Vacation, parental, family, medical or sick leave (other than the paid leave benefits required under the FFRCA); • Termination allowances; (**Note:** Costs listed have a maximum of $100,000 annual limit per worker/owner) • Group health care benefits, including insurance premiums; • Retirement benefit payments; and • State or local payroll taxes
Who's eligible	Businesses, including nonprofits, that: • Were in operation on February 15, 2020; and • Have fewer than 500 employees (exceptions for certain industries) Includes corporations, partnerships, LLCs, sole proprietorships, self-employed individuals, and independent contractors (including gig workers); however, partners do not qualify for their own PPP loan Business only needs to self-certify that loan is necessary due to economic uncertainty caused by COVID-19 (loans of $2 million or more will be reviewed to determine eligibility)
	(continued)

Paycheck Protection Program Loan Overview (continued)	
Loan forgiveness	Forgiveness is available for the portion of the loan proceeds used for payroll costs, mortgage interest, rent, and utilities for up to 24 weeks, provided at least 60% of the loan proceeds are used for payroll costs Borrowers must apply for loan forgiveness through their lender — forgiveness is not automatic
Use of loans	Loans can be used to pay: • Payroll costs; • Group health care benefits; • Retirement benefits; • Rent/lease payments*; • Utilities*; and • Mortgage interest* (* These agreements must have been in place prior to February 15, 2020)
Payment deferral	Defer payments of principal, interest, and fees until the SBA remits the borrower's loan forgiveness amount to the bank
Loan conditions	• Two-year maturity date (five years for loans made on or after June 5, 2020 (or earlier if borrower/lender mutually agree); • No personal guarantees or collateral (although owner(s) liable for amounts used for nonqualified purposes); • 1.0% interest rate; • Borrower and lender fees waived; • No prepayment penalties; and • One loan per business Only available until August 8, 2020 (unless extended by subsequent legislation)
Effect on other benefits	• Wages paid with forgiven PPP debt are not included in payroll costs taken into account in computing the Employee Retention Credit; and • PPP loan forgiveness amounts cannot include FFCRA employer-mandated paid sick leave and paid family leave benefits

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. Guidance from the IRS provided in 2020 on PPP loan forgiveness includes which of the following?

    a) Payroll costs incurred prior to the covered period do not qualify for forgiveness
    b) Forgiveness applies to health care benefits accelerated into the covered period
    c) Interest on unsecured credit is eligible for loan forgiveness
    d) Nonpayroll costs, which may be eligible for forgiveness, cannot account for more than 40% of the loan forgiveness

SOLUTIONS TO REVIEW QUESTIONS

9. Guidance from the IRS on PPP loan forgiveness includes which of the following? **(Page 3-9)**
   a) Incorrect. Such payroll costs, if paid during the covered period, will qualify.
   b) Incorrect. It also will not apply to accelerated retirement benefits, all of which must be proportional to the covered period in order to qualify.
   c) Incorrect. The loan is not secured by real property, so it is not eligible.
   d) Correct. The nonpayroll costs must be paid during the covered period or incurred during the covered period and pain on or before the next regular billing date if that date is after the covered period.

SPIDELL

TAX • ANALYSIS • EDUCATION

Chapter 4

Business

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BUSINESS

EMPLOYMENT TAX BENEFITS RELATED TO COVID-19

The Families First Coronavirus Response Act (FFCRA) and the Coronavirus Aid, Relief, and Economic Security (CARES) Act work together to provide multiple tax benefits that are, generally, administered through employment taxes and claimed on Form 941, Employer's Quarterly Federal Tax Return.

Such benefits include credits for:

- Mandatory paid sick leave;
- Mandatory paid family leave; and
- Employee Retention Credit.

In addition, employers are permitted to delay deposits of certain employment taxes.

DELAY OF EMPLOYER PAYROLL TAX PAYMENTS

Businesses may defer the employer's share of OASDI (Social Security tax) at 6.2% (but not Medicare at 1.45% or the employee's share of either OASDI or Medicare), for the period March 27, 2020, through December 31, 2020, as follows:

- 50% due on December 31, 2021; and
- 50% due on December 31, 2022.

The deferral applies to deposits or payments of the employer's share of Social Security tax that would otherwise be due after December 31, 2020, as long as the deposits relate to the tax imposed on wages paid during the quarter ending on December 31, 2020.

FAQs on deferral of employer's share of Social Security tax

The IRS has provided some frequently asked questions on its website regarding the CARES Act's deferral of the employer's share of Social Security tax.

Website
www.irs.gov/newsroom/
deferral-of-employment-tax-deposits-and-payments-through-december-31-2020

Eligible employers

All employers (including government entities) may defer the deposit and payment of the employer's share of Social Security tax.

Comment

Taxpayers who receive PPP loan forgiveness are eligible. Originally, under the CARES Act, taxpayers that received PPP loan forgiveness were ineligible for deferral. However, the prohibition was repealed by the Paycheck Protection Program Flexibility Act of 2020.

Reporting and taking the deferral

The deferral is reported and taken on each quarterly Form 941, Employer's Quarterly Federal Tax Return.

Repaying the deferred amount

The employer may pay the amount it owes electronically using the Electronic Federal Tax Payment System® (EFTPS), by credit or debit card, or by a check or money order. The preferred method of payment is EFTPS. If an employer is using EFTPS, in order to pay the deferred amount, an employer that files Form 941 should select Form 941, the calendar quarter in 2020 to which its payment relates, and payment due on an IRS notice in EFTPS. (FAQ #29)

The IRS intends to issue a reminder notice to employers before each applicable due date. (FAQ #20)

If an employer pays any amount before the applicable dates, any such payment is first applied to reduce the employer's liability for an amount due on December 31, 2021, and then to the amount due on December 31, 2022. (FAQ #18)

Failure to timely repay

If the taxpayer fails to timely pay a deferred amount, the taxpayer will be subject to penalties.

Income tax deduction

It's the employer's portion of Social Security tax that is eligible for deferral, and it's also the employer's portion that is deductible for income tax purposes.

For cash basis taxpayers, it appears that no deduction is allowed in the year of deferral. The amount can only be deducted in the year paid.

For most accrual basis taxpayers, the tax will also only be deductible when paid. For a payroll tax liability, Treas. Regs. §1.461-4(g)(6) provides that economic performance occurs as the tax is paid to the governmental authority that imposed it. This rule leaves open only a narrow window for the recurring item exception (see Treas. Regs. §1.461-5(b)).

Self-employed taxpayers

Self-employed individuals may similarly defer their employer-share (50%) of their Social Security taxes. (CARES Act §2302) The deferral does not apply to the employer-share of Medicare taxes.

Self-employed individuals may use any reasonable method to allocate 50% of the Social Security portion of self-employment tax attributable to net earnings from self-employment earned during March 27, 2020, through December 31, 2020. For example, an individual may allocate 22.5% of the individual's annual earnings from self-employment to the period from January 1, 2020, through March 26, 2020, and 77.5% of the individual's annual earnings to the period from March 27, 2020, through December 31, 2020. (FAQ #24)

Practice Pointer

The deferral of the employer-share of Social Security taxes will be handled on new page 2 of Schedule SE, reproduced here:

Schedule SE (Form 1040) 2020 Attachment Sequence No. **17** Page **2**

Part III Maximum Deferral of Self-Employment Tax Payments

If line 4c is zero, skip lines 18 through 20, and enter -0- on line 21.

18	Enter the portion of line 3 that can be attributed to March 27, 2020, through December 31, 2020	**18**	
19	If line 18 is more than zero, multiply line 18 by 92.35% (0.9235); otherwise, enter the amount from line 18	**19**	
20	Enter the portion of lines 15 and 17 that can be attributed to March 27, 2020, through December 31, 2020	**20**	
21	Combine lines 19 and 20	**21**	

If line 5b is zero, skip line 22 and enter -0- on line 23.

22	Enter the portion of line 5a that can be attributed to March 27, 2020, through December 31, 2020	**22**	
23	Multiply line 22 by 92.35% (0.9235)	**23**	
24	Add lines 21 and 23	**24**	
25	Enter the smaller of line 9 or line 24	**25**	
26	Multiply line 25 by 6.2% (0.062). Enter here and see the instructions for line 12e of Schedule 3 (Form 1040)	**26**	

Schedule SE (Form 1040) 2020

Method of repayment

The IRS has not stated how a self-employed individual will repay the deferred self-employment tax.

Comment

This would seem to be of some importance.

With due dates of December 31, 2021, and December 31, 2022, it would seem that the taxpayer cannot wait until filing their 2021 and 2022 return to make the payments.

Taxpayers should consider the repayments when calculating their estimated tax payments for 2021 and 2022.

Household employers

Household employers that file Schedule H may defer payment of the amount of the employer's share of Social Security tax imposed on wages paid during the payroll tax deferral period. (FAQ #25)

EMPLOYEE SOCIAL SECURITY DEFERRAL

In a notice issued on August 28, 2020, the IRS permitted employers to defer the withholding, deposit, and payment of the *employee's* portion of Social Security taxes paid from September 1, 2020, through December 31, 2020. (IRS Notice 2020-65) Notice 2020-65 implements the Presidential Memorandum signed on August 8, 2020, that authorizes employers to defer the withholding and payment of these taxes.

Employers are not required to withhold the employee's portion of Social Security taxes even if the employee requests the deferral. However, if the taxes are deferred, employers must withhold and pay the deferred tax ratably from wages and compensation paid to the employees between January 1, 2021, and April 30, 2021. So, the employees will repay the deferral through double withholding during that period.

These dates have now been extended as follows:

- **Deferral period:** September 1, 2020 through April 30, 2021;
- **Repayment period:** May 1, 2021 through December 31, 2021.
  (ACRRA §274)

The deferral is only available to employees with wages or compensation of less than $4,000 paid during a biweekly pay period, or the equivalent threshold amount with respect to other pay periods. Biweekly wages of $4,000 is the equivalent of an annual salary of $104,000.

The liability for the amounts that are not withheld stays with the employees. However, the ultimate liability for the taxes remains with the employer under Notice 2020-65.

✐ Practice Pointer

What if the employee no longer works for the employer during the repayment period (May 1, 2021, through December 31, 2021)? The notice states that the employer may "make arrangements to otherwise collect the total Applicable Taxes from the employee." Any amounts still owed by the employer on December 31, 2021, will be subject to penalties, interest, and additions to tax.

The Presidential Memorandum does require the Secretary of the Treasury to explore avenues, including legislation, to eliminate the obligation to pay the taxes deferred, but at this time there is no forgiveness for the deferred taxes.

For California employers, California labor laws do not allow an employer to withhold from an employee's final paycheck any unpaid debt to the employer, which we believe could include unwithheld taxes that would be due in the following year.

We do not encourage employers to participate in this offer. It's additional work and risk to the employer should the employee quit before the repayment is made.

What about payroll services?

Confusion abounds on this issue. Some payroll services are not offering this tax deferral to their clients. Others are offering it, but employers must opt in to the program. Still others, like the federal government, stopped withholding payroll tax from all employees.

The federal government has implemented the deferral in all federal agencies.

The Presidential Memorandum is available at:

Website
www.whitehouse.gov/presidential-actions/
memorandum-deferring-payroll-tax-obligations-light-ongoing-covid-19-disaster/

W-2 reporting guidance where employee Social Security tax is deferred

Employers who deferred the employee portion of Social Security tax under Notice 2020-65 must include all Social Security wages on Form W-2, box 3, but box 4 should not reflect deferred Social Security tax. (www.irs.gov/forms-pubs/form-w-2-reporting-of-employee-social-security-tax-deferred-under-notice-2020-65)

MANDATORY PAID LEAVE UNDER THE FFCRA

The FFCRA requires that certain employers provide:

- Mandatory paid sick leave; and
- Mandatory paid family leave.

Comment

The mandatory paid sick leave and family leave under the FFCRA expired on December 31, 2020. Under the ACRRA, employers are no longer required to pay these FFCRA benefits, though if they do, they are entitled to the credits. It is not clear how the limits on the amount of leave available to employees would apply to employees taking leave in both 2020 and 2021.

Paid sick leave

From April 1, 2020, through December 31, 2020, employers with fewer than 500 employees (including some government employers) must provide up to 80 hours of paid sick leave to each employee unable to work (or telework) as follows:

- For an employee who is unable to work because of coronavirus quarantine or self-quarantine or who has coronavirus symptoms and is seeking a medical diagnosis, the eligible employee receives their regular rate of pay, up to $511 per day and $5,110 in the aggregate, for a total of 10 days;
- For an employee who is caring for someone with coronavirus or is caring for a child because the child's school or child care facility is closed, or the child care provider is unavailable due to the coronavirus, the eligible employee receives two-thirds of their regular rate of pay, up to $200 per day and $2,000 in the aggregate, for up to 10 days; and
- Employers will receive a refundable credit for the amounts paid to employees and an additional credit determined based on costs to maintain health insurance for the eligible employee during the leave period, plus the employer's share of Medicare tax.

All employees are eligible:

- New hires (there is no minimum threshold of days the employee must have worked); and
- Part-time employees (see later discussion).

Paid family leave

Until December 31, 2020, the FFCRA (as extended by the ACRRA) allowed employees who have worked more than 30 days for an employer who employs fewer than 500 employees to take up to 10 weeks of employer-paid family leave. An employee only qualifies if they are unable to work (or telework) because they need to take care of their child, under 18 years of age (age 18 or older if mentally or physically disabled and incapable of self-care), due to school or child care closures related to a COVID-19 emergency declared by a governmental authority. (29 U.S.C. §2611 et seq.; FFCRA §3102; ACCRA §286)

There is a 10-day waiting period during which the employee may use employer sick pay or vacation pay, including the paid sick leave benefits provided under the FFCRA.

Employers

Mandatory leave must be provided by employers with fewer than 500 employees. For this purpose you must count both full-time and part-time employees within the United States (see DOL Q&A at: www.dol.gov/agencies/whd/pandemic/ffcra-questions).

California conformity

California has enacted its own COVID-19 supplemental paid sick leave benefit under Governor Newsom's Executive Order N-51-20. (Labor Code §248) The executive order required hiring entities with 500 or more nationwide food service network employees to provide up to 80 hours of paid sick leave to qualified California employees. We will discuss California's paid sick leave benefits in more detail at page 8-10.

Small employers and health workers may have an exemption

Employers with fewer than 50 employees may claim an exemption from paying family leave benefits, but only if:

- Their employee is taking paid family leave to take care of a child due to school/child care closures; and
- The business can demonstrate that paying the paid leave benefits would jeopardize the viability of the business as a going concern.

Employers may not claim an exemption from paying paid sick leave benefits claimed for any of the other reasons listed (see upcoming, e.g., quarantine, diagnosed COVID-19, etc.). Employers do not apply to the Department of Labor for an exemption. They simply deny the employee the benefit.

Payments are employee wages

These payments are considered "wages" and are includable in the employee's taxable income for federal and state purposes, and are subject to withholding for income and the employee payroll taxes.

Not subject to employer Social Security tax

Another benefit to the employer is that payments made as either mandatory paid sick leave or mandatory family leave are not subject to the employer's portion of Social Security tax. (Instructions to Form 941)

<table>
<tr><th colspan="2">Paid Sick Benefits: Up to 80 Hours Maximum</th></tr>
<tr><th>Reason for leave</th><th>Amount of benefit</th></tr>
<tr><td>The worker:
• Is subject to a federal, state, or local quarantine or isolation order related to COVID-19;
• Has been advised by a health care provider to self-quarantine due to concerns related to COVID-19; or
• Is experiencing symptoms of COVID-19 and is seeking a medical diagnosis</td><td>100% of the employee's regular rate of pay (not less than the applicable minimum wage rate) up to a maximum of $511 per day and $5,110 in aggregate in paid sick leave benefits. Paid sick leave benefits are capped at 80 hours for full-time workers (proportional amount for part-time workers) total
(Small business exemption does not apply)</td></tr>
<tr><td>The worker is:
• Caring for an individual who is subject to governmental quarantine, or an isolation order has been advised by a health care provider to self-quarantine;
• Caring for his or her child or if the child's school or place of care has been closed, or the child care provider is unavailable due to COVID-19 precautions; or
• Experiencing any other substantially similar condition specified by the Secretary of Health and Human Services in consultation with the Secretary of the Treasury and the Secretary of Labor</td><td>Two-thirds of the regular rate of pay up to a maximum of $200 per day and $2,000 in aggregate in paid sick leave benefits. Paid sick leave capped at 80 hours for full-time workers (proportional amount for part-time workers) total
(Small business exemption applies only if worker is staying home to take care of child due to child care/school closure)</td></tr>
<tr><th colspan="2">Paid Family Leave Benefits: Up to 10 Weeks Paid Maximum</th></tr>
<tr><th>Reason for leave</th><th>Amount of benefit</th></tr>
<tr><td>The worker is:
• Caring for his or her child or if the child's school or place of care has been closed, or the child care provider is unavailable due to COVID-19 precautions</td><td>If the employee is staying home to care for his or her child due to school closure or unavailability of child care provider due to COVID precautions, the employee is entitled to an additional 12 weeks of emergency family and medical leave (paid family leave benefits). Two weeks of this may be unpaid, but the remaining 10 weeks must be paid at two-thirds of the regular rate of pay up to a maximum of $200 per day and $10,000 in aggregate
(Small business exemption applies)</td></tr>
</table>

PAYROLL TAX CREDITS UNDER THE FFCRA

Employers who pay mandatory sick or paid family leave benefits under the FFCRA can claim a dollar-for-dollar refundable credit against their payroll taxes. (FFCRA §§7001, 7002)

The credits are claimed on Form 941, Employer's Quarterly Federal Tax Return, beginning with the second quarter 2020, and any excess amount is refunded.

The FFCRA paid sick and family leave is mandated through December 31, 2020, but employers can choose to pay these benefits through March 31, 2021, and claim the credit for it.

IRS FAQs

The IRS has provided a list of FAQs which are referred to throughout the following discussion. The FAQs are available at:

Website
www.irs.gov/newsroom/covid-19-related-tax-credits-general-information-faqs

The DOL has provided a list of FAQs regarding when an employee is eligible for the paid leave, for which the credits may be claimed:

Website
www.dol.gov/agencies/whd/pandemic/ffcra-questions

Amount of credit

The credit may be claimed for 100% of the paid sick leave and paid family leave benefits paid under the FFCRA:

- Increased by:
  - o The amount of the employer's qualified health plan expenses allocable to the paid sick leave wages if these expenses are excluded from the employee's gross income; and
  - o The employer's 1.45% Medicare tax paid on such benefits; and
- Reduced by any credits claimed for the employment of qualified veterans or for research expenditures of qualified small business employees claimed by the employer.

The amount of qualified health plan expenses taken into account in determining the credits generally includes both the portion of the cost paid by the eligible employer and the portion of the cost paid by the employee with pretax salary reduction contributions. However, the qualified health plan expenses should not include amounts that the employee paid with after-tax contributions. The employer must allocate health plan expenses on a *pro rata* basis for the period of leave (see FAQs #31–36).

Example of calculating credit

Tape Measures, Inc. has one employee out on paid family leave. Tape Measures pays that employee's salary of $6,000 during the employee's leave period.

The company also pays for the employee's health plan premiums, which are $400 per month. The employee was out for 1½ months, so Tape Measures allocates $600 to health plan premiums.

In addition, the company allocates $87 to its share of Medicare taxes (1.45 % × $6,000).

Tape Measures can take a credit on its Form 941 of $6,687 ($6,000 + $600 + $87). If the credit exceeds the total amount of taxes required to be deposited by the employer, the excess is refundable to Tape Measures.

Form 7200, Advance Payment of Employer Credits Due to COVID-19

An employer may file Form 7200, Advance Payment of Employer Credits Due to COVID-19, to expedite a refund of the paid sick leave credit, the paid family leave credit, and the Employee Retention Credit (discussed on page 4-14) due in excess of the amount of previously retained employment taxes.

No double benefit

The gross income of the employer must be increased by the amount of payroll tax credit for paid sick leave and paid family leave. The IRS has provided reporting guidance for this additional gross income in its form instructions. For example, the draft Form 1065 instructions released on October 21, 2020, state that the amount of the FFCRA credits claimed by a partnership should be reported as other income on page 1, line 7 of the Form 1065.

In addition, any wages taken into account in determining the payroll tax credit for paid sick or family leave cannot be taken into account for purposes of determining the employer credit for paid family and medical leave allowed under IRC §45S. (FFCRA §§7001(e)(1), 7003(e)(1))

Example of gross income

Veinte, Inc. claims a credit of $5,000 for qualified sick leave wages paid during the year. Veinte must include $5,000 in its gross income. It can still deduct the $5,000 of wages paid.

Note: It is not clear at this time how this amount of gross income will be reported on the tax return. For example, on a Form 1120, will it be reported on line 10, Other Income?

Equivalent credit for self-employed taxpayers

Self-employed individuals may claim refundable credits similar to the FFCRA's paid sick leave and family leave for leave taken by the self-employed individual between March 18, 2020, and March 31, 2021. (FFCRA §§7002, 7004; ACCRA §287) The credit may only be claimed by an individual who:

- Regularly carries on any trade or business; and
- Would be entitled to receive paid sick leave benefits or paid family leave benefits if the individual were an employee.

The amount of the paid sick leave and paid family leave credit for self-employed individuals is based on the average daily self-employment income, up to the applicable $511 and $200 daily caps. The daily caps are discussed on page 4-5. "Average daily self-employment income" is determined by taking the net earnings from self-employment of the individual for the taxable year divided by 260.

Election to use 2019 self-employment income

Self-employed individuals claiming the FFCRA credit may elect to use their average daily self-employment income from 2019 rather than 2020 to compute the credit, applicable retroactively as if included in the FFCRA. (ACRRA §287)

Example of electing to use 2019 average self-employment income

Jan is a self-employed physical therapist who works part-time as an independent contractor while her children are in school. In 2019, her net income from self-employment was $80,000. In 2020, Jan had to quarantine in April for two weeks due to COVID-19 exposure, then she was forced to stop working immediately thereafter due to her children's school closures and could not work for the remainder of 2020. Jan's 2020 net income from self-employment was only $15,000.

The following calculation compares Jan's 2020 FFCRA credits based on her 2019 or her 2020 net income from self-employment:

	FFCRA sick leave credit	**2019 SE income**	**2020 SE income**
	Net earnings from self-employment	$80,000	$15,000
÷	Divisor (see Form 7202, line 8)	260	260
=	Average daily self-employment income (cannot exceed $511)	307	58
×	Days unable to work due because of coronavirus-related care required (10 day maximum) (Jan's quarantine period)	10	10
=	**FFCRA sick leave credit**	**$ 3,070**	**$ 580**

	FFCRA family leave credit	**2019 SE income**	**2020 SE income**
	Net earnings from self-employment	$80,000	$15,000
÷	Divisor (see Form 7202, line 27)	260	260
=	Average daily self-employment income	307	58
×	Percentage of average daily self-employment income eligible for family leave credit	67%	67%
=	Eligible daily credit (cannot exceed $200)	$ 200	$ 39
×	Days unable to work to care for children under the age of 18 (50 day maximum)	50	50
=	**FFCRA family leave credit**	**$10,000**	**$ 1,950**

Jan will be able to claim total FFCRA equivalent credits as a self-employed person of $13,070 ($3,070 sick leave + $10,000 family leave) by using her 2019 net income from self-employment. The FFCRA as originally enacted would have forced Jan to use her 2020 net income from self-employment, which would have only generated FFCRA equivalent credits of $2,530 ($580 sick leave + $1,950 family leave).

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Self-employed taxpayers with employees

Self-employed taxpayers with employees may get credits under both the employer rules and the self-employed rules.

Refund only available at time of filing

Self-employed taxpayers don't claim the credits until they file their Form 1040.

However, self-employed taxpayers can still benefit during 2020 by factoring in their expected credits under the FFCRA when calculating their quarterly estimated tax payments.

Example of self-employed taxpayer taking sick leave credit

Rose is a self-employed dress shop owner with no employees. Due to health conditions, she has been advised by her physician to self-quarantine. She is quarantined for 14 days.

Upon completing her 2020 Schedule C, her net income is $104,000. Therefore, her average daily income is $400 ($104,000 ÷ 260). She is entitled to a credit of $4,000 ($400 per day × 10 days).

Method of reporting

Form 7202, Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals, has been released in draft form. It indicates that the amount of the FFCRA credits are carried to Schedule 3 of Form 1040, then carried to line 12b of Form 1040. This treatment indicates that the credits are refundable credits against income tax and not against self-employment tax.

As of publication, the instructions to Form 7202 had not yet been released.

Form **7202**

Department of the Treasury
Internal Revenue Service

Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals

▶ Attach to Form 1040 or 1040-SR.

▶ Go to *www.irs.gov/Form7202* for instructions and the latest information.

OMB No. 1545-0074

2020

Attachment Sequence No. 202

Name of person with self-employment income (as shown on Form 1040 or 1040-SR)	Social security number of person with self-employment income

Part I Credit for Sick Leave for Certain Self-Employed Individuals

1	Number of days you were unable to perform services as a self-employed individual because of certain coronavirus-related care you required. See instructions	1	
2	Number of days you were unable to perform services as a self-employed individual because of certain coronavirus-related care you provided to another. (Do not include days you included in line 1.) See instructions	2	
3	If you are filing a fiscal year return, see instructions; otherwise enter 10	3	
4	Enter the smaller of line 1 or line 3	4	
5	Subtract line 4 from line 3	5	
6	Enter the smaller of line 2 or line 5	6	
7	Net earnings from self-employment (see instructions)	7	
8	Divide line 7 by 260 (round to nearest whole number)	8	
9	Enter the smaller of line 8 or $511	9	
10	Multiply line 4 by line 9	10	
11	Multiply line 8 by 67% (0.67)	11	
12	Enter the smaller of line 11 or $200	12	
13	Multiply line 6 by line 12	13	
14	Add lines 10 and 13	14	
15	Amount of emergency paid sick leave subject to the $511 per day limit you received from an employer (see instructions)	15	
16	Amount of emergency paid sick leave subject to the $200 per day limit you received from an employer (see instructions)	16	
	If line 15 and line 16 are both zero, skip to line 24 and enter the amount from line 14.		
17	Add line 13 and line 16	17	
18	Enter the smaller of line 17 or $2,000	18	
19	Subtract line 18 from line 17	19	
20	Add lines 10, 15, and 18	20	
21	Enter the smaller of line 20 or $5,110	21	
22	Subtract line 21 from line 20	22	
23	Add line 19 and line 22	23	
24	Subtract line 23 from line 14. If zero or less, enter -0-. Enter here and include on Schedule 3 (Form 1040), line 12b	24	

Part II Credit for Family Leave for Certain Self-Employed Individuals

25	Number of days you were unable to perform services as a self-employed individual because of certain coronavirus-related care you provided to a son or daughter under the age of 18. (Do not enter more than 50 days.) See instructions	25	
26	Net earnings from self-employment (see instructions)	26	
27	Divide line 26 by 260 (round to nearest whole number)	27	
28	Multiply line 27 by 67% (0.67)	28	
29	Enter the smaller of line 28 or $200	29	
30	Multiply line 25 by line 29	30	
31	Amount of emergency family leave wages you received from an employer (see instructions)	31	
	If line 31 is zero, skip to line 35 and enter the amount from line 30.		
32	Add line 30 and line 31	32	
33	Enter the smaller of line 32 or $10,000	33	
34	Subtract line 33 from line 32	34	
35	Subtract line 34 from line 30. If zero or less, enter -0-. Enter here and include on Schedule 3 (Form 1040), line 12b	35	

No double benefit for self-employed

If a self-employed individual is also an employee of another company and receives paid family leave benefits from his or her employer, the credit must be reduced to the extent the benefits paid by the employer exceed the aggregate amount the worker is entitled to (e.g., $10,000 for family leave benefits; $5,110 for paid sick leave benefits).

In other words, for a taxpayer who is both an employee and also has self-employment income, the maximum benefit they can receive through the FFCRA is $10,000 for family leave benefits and $5,110 for paid sick leave benefits, whether the benefits are paid by the employer or are claimed through the self-employment credits.

Comment

While there is no double benefit for self-employed taxpayers, the same does not appear to be true where an employee works two jobs. Each employer must provide paid leave to the employee.

Example of limitation on self-employment tax credits

Blue Co. has 75 full-time employees who are eligible for sick leave. One of those employees is Susan, who is a full-time employee and earns $480 per day ($60 per hour). She was advised by her physician to self-quarantine.

Blue Co. must pay Susan $480 per day times 10 days (or $4,800).

Susan is also self-employed. She has her own business that she operates as a Schedule C. Due to the sick leave she must take, she is unable to work her side job, and she is unable to work for Blue Co. Susan's maximum self-employed sick leave credit is calculated as follows:

Maximum eligible sick leave benefit	$5,110
Sick leave benefit paid by Blue Co.	(4,800)
Maximum sick leave credit eligible against SE tax	$ 310

No gross income add-back

Paid sick and family leave credits for employers are contained in different sections of the act than the credits for the self-employed (FFCRA §§7001 and 7003 for employers and §§7002 and 7004 for the self-employed). While the act requires employers to add the amounts of the credits to gross income for income tax purposes (see prior discussion), the act does not require self-employed individuals to add their credits to gross income.

Documentation

In FAQs, the IRS has provided the documentation and substantiation requirements for claiming the credits. (FAQs #44-46)

We have provided a checklist of those requirements that you can print and give to your clients:

💻 **Website**
www.caltax.com/files/2020/leavecredits.pdf

Checklist for Claiming Paid Sick Leave and Family Leave Credits	
☐	An eligible employer will substantiate eligibility for the sick leave or family leave credits if the employer receives a written request for such leave from the employee in which the employee provides: ☐ The employee's name; ☐ The date or dates for which leave is requested; ☐ A statement of the COVID-19-related reason the employee is requesting leave and written support for such reason; and ☐ A statement that the employee is unable to work, including by means of telework, for such reason.
☐	In the case of a leave request based on a quarantine order or self-quarantine advice, the statement from the employee should include the name of the governmental entity ordering quarantine or the name of the health care professional advising self-quarantine, and, if the person subject to quarantine or advised to self-quarantine is not the employee, that person's name and relation to the employee.
☐	In the case of a leave request based on a school closing or child care provider unavailability, the statement from the employee should include: ☐ The name and age of the child (or children) to be cared for; ☐ The name of the school that has closed or place of care that is unavailable; and ☐ A representation that no other person will be providing care for the child during the period for which the employee is receiving family medical leave.
☐	An eligible employer will also maintain records that include the following information: ☐ Documentation to show how the employer determined the amount of qualified sick and family leave wages paid to employees that are eligible for the credit, including records of work, telework, and qualified sick leave and qualified family leave; ☐ Documentation to show how the employer determined the amount of qualified health plan expenses that the employer allocated to wages; ☐ Copies of any completed Forms 7200, Advance of Employer Credits Due To COVID-19, that the employer submitted to the IRS; and ☐ Copies of the completed Forms 941, Employer's Quarterly Federal Tax Return.
☐	An eligible employer should keep all records of employment taxes for at least four years after the date the tax becomes due or is paid, whichever comes later. These should be available for IRS review.

Caution

Keep in mind that the credits and the deposit deferrals are reported on single lines on the Form 941. The IRS only provides a worksheet for computing the credits. Otherwise it is entirely up to the taxpayer to compute and report the credits and deferrals.

EMPLOYEE RETENTION CREDIT UNDER THE CARES ACT

The CARES Act provides a *refundable* credit against quarterly employment taxes equal to 50% of the qualified wages and compensation. Only wages paid after March 12, 2020, and before January 1, 2021, qualify for the credit. (CARES Act §2301(a) and (m))

Maximum credit

The maximum qualified wages per employee is $10,000, which equates to a maximum Employee Retention Credit of $5,000 per employee. (CARES Act §2301(c)(1)) There is no maximum number of employees who may lead to a credit.

The Employee Retention Credit is in addition to the payroll tax credits available under the Families First Coronavirus Response Act for paid sick leave and family leave (discussed beginning on page 4-7). However, the Employee Retention Credit may not be claimed for wages paid as paid sick leave or paid family leave benefits available under the FFCRA (no double benefit).

Employers who received a PPP loan are eligible for the credit. See the discussion beginning on page 4-20A.

The refundable credit is claimed on Form 941, Employer's Quarterly Federal Tax Return. Taxpayers can also use Form 7200 to claim an advanced Employee Retention Credit.

Caution

Self-employed individuals cannot claim the credit for their self-employment services or earnings. (IRS FAQs: Employee Retention Credit Under the CARES Act)

Comment

While the Employee Retention Credit is available for first quarter wages paid on March 13, 2020, through March 31, 2020, the IRS required employers to claim the Employee Retention Credit for first quarter wages on the employer's second quarter payroll tax returns.

IRS FAQs

The IRS has provided a list of FAQs which are referred to throughout the following discussion. The FAQs are available at:

Website
www.irs.gov/newsroom/faqs-employee-retention-credit-under-the-cares-act

No double benefit

Employers may not claim a deduction for the portion of wages paid for which a credit is claimed. (FAQ #85)

> ***Comment***
>
> This treatment differs from the treatment for credits taken for paying mandatory sick leave and mandatory family leave. For those credits, the taxpayer includes the credit amounts in gross income and is allowed a deduction for wages paid (see page 4-5).
>
> When it comes to the reduction of the deduction for wages paid, the question comes up: Must the taxpayer reduce wages for purposes of the qualified business income (QBI) deduction under IRC §199A? It is noteworthy that the language of IRC §199A(b)(4)(A) states that the wages limitation is based on wages "paid" not wages "deducted." This seems to indicate that even if a taxpayer reduces wages deducted on their income tax return due to the Employee Retention Credit, the taxpayer can still include all wages paid in their IRC §199A wage limitation.

Counting wages

Wages that are countable for purposes of the Employee Retention Credit are those items that are countable for Social Security purposes, defined in IRC §§3121(a) and 3231(e), including, but not limited to:

- Salaries and wages (including cash compensation and noncash compensation, such as wages paid using virtual currencies);
- Cash tips;
- Bonuses and commissions;
- Vacation pay; and
- Employer-provided sick pay (with exceptions).
  (CARES Act §2301(c)(5); IRC §§3121(a), 3231(e))

Health plan expenses

Additionally, qualified wages for purposes of the Employee Retention Credit specifically include health plan expenses paid on an employee's behalf that are excluded from the employee's gross income. (CARES Act §2301(c)(3)(C)) For employers with 100 or fewer employees, this includes health care expenses paid while an employee is laid off. Employers with more than 100 employees may only include the health care expenses paid that are allocable to the period that the employees are not working. (FAQs #64 and #65)

Employee salary reductions allocated to a health reimbursement arrangement (HRA) or a health flexible spending arrangement (health FSA) are included in qualified wages. However, employer contributions to an HSA, Archer MSA, or qualified small employer health reimbursement arrangement (QSEHRA) are not included in qualified wages. (FAQ #70)

Wages paid to relatives are not qualified

Wages paid to related individuals, as defined by IRC §51(i)(1), are not taken into account for purposes of the Employee Retention Credit. (FAQ #59)

A related individual is:

- A child or a descendant of a child;
- A brother, sister, stepbrother, or stepsister;
- The father or mother, or an ancestor of either;
- A stepfather or stepmother;
- A niece or nephew;
- An aunt or uncle;
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

In addition, if the employer is a corporation, then a related individual is any person that bears a relationship just described with an individual owning, directly or indirectly, more than 50% in value of the corporation's outstanding stock.

If the employer is a noncorporate entity, then a related individual is any person that bears a relationship just described with an individual owning, directly or indirectly, more than 50% of the entity's capital and profits interests.

If the employer is an estate or trust, then a related individual includes a grantor, beneficiary, or fiduciary of the estate or trust, or any person that bears a relationship just described with an individual who is a grantor, beneficiary, or fiduciary of the estate or trust.

Comment

This differs from credits taken for mandatory sick and family leave. For those, wages paid to an owner or related party do count, as there are no related-party rules for the leave programs.

Eligible employers

Employers eligible for the Employee Retention Credit are those that:

- Carried on a trade or business during the 2020 calendar year, including a tax-exempt organization, or a tribe that operates a trade or business; and
- With respect to any calendar quarter:
  - Fully or partially suspended their operations due to orders from any governmental authority limiting commerce, travel, or group meetings due to COVID-19; or
  - Experienced a significant decline in gross receipts for the calendar quarter (see the following discussion).

(CARES Act §2301(c)(2)(A) and (C))

Comment

Household employers are not eligible to claim the credit. (IRS FAQ #24)

Significant decline in gross receipts

A trade or business's significant decline in gross receipts applies to the first calendar quarter in 2020 for which gross receipts are less than 50% of gross receipts for the same calendar quarter in 2019. If gross receipts are less than 50% of gross receipts for the same calendar quarter in 2019, then the Employee Retention Credit is available for the entire quarter.

An employer can claim the Employee Retention Credit through the end of the first quarter for which its gross receipts are greater than 80% of the gross receipts for the same calendar quarter in 2019.

Example of decline in gross receipts

Blue Co. had the following quarterly gross receipts in 2019 and 2020:

Calendar quarter ending	2019	2020	% of prior-year gross receipts	Eligible quarter
March 31	$300,000	$375,000	125%	No
June 30	$400,000	$100,000	25%	Yes
September 30	$250,000	$225,000	90%	Yes
December 31	$225,000	$157,000	70%	No

Blue Co. can claim the Employee Retention Credit on wages paid during the second and third quarters of 2020. The third quarter is the first quarter for which gross receipts climbed back over 80% of the gross receipts for the same quarter in 2019. BlueCo. may not claim the credit in the fourth quarter.

Comment

An employer is not required to show that the significant decline in gross receipts is related to COVID-19.

Comment

For calendar quarters beginning after December 31, 2020, the TCDTRA amends the CARES Act and expands employer eligibility for the employee retention credit. See the discussion beginning on page 4-20A.

✐ **Practice Pointer**

If an employer does not realize that it had a significant decline in revenues in 2020 until after January 1, 2021, they may still claim the credit by filing a Form 941-X, Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund.

Example of amended payroll return

Shy Corp. has been your client for many years. You only hear from them once a year when they send the documents you need to do their Form 1120.

You notice that their revenues have dropped to $800,000 from their normal $1 million. You ask Shy Corp. to break out their revenues by quarter.

Calendar quarter ending	2019	2020	% of prior-year gross receipts	Eligible quarter
March 31	$250,000	$225,000	90%	No
June 30	$260,000	$104,000	40%	Yes
September 30	$240,000	$240,000	100%	Yes
December 31	$250,000	$231,000	92%	No

Shy Corp. did not take out a PPP loan. Shy Corp. was eligible for the credit for the second and third quarters but was unaware of it. Shy Corp. can still take the credit by filing Forms 941-X for the second and third quarters.

Shy Corp. has five employees including Owner (100% owner), Daughter (the owner's daughter), Paul, Paula, and Paulina (three unrelated individuals). No credit can be taken for Owner or Daughter. The computations for the other three employees are:

	Paul	Paula	Paulina	Total
Second quarter pay	$12,000	$8,000	$4,000	
50%	6,000	4,000	2,000	
Overall limit per employee	5,000	5,000	5,000	
Credit taken in previous quarters	0	0	0	
Credit limit for quarter	5,000	5,000	5,000	
Credit*	$5,000	$4,000	$2,000	**$11,000**
Third quarter pay	$12,000	$8,000	$4,000	
50%	6,000	4,000	2,000	
Overall limit per employee	5,000	5,000	5,000	
Credit taken in previous quarters	5,000	4,000	2,000	
Credit limit for quarter	0	1,000	3,000	
Credit*	0	$1,000	$2,000	**$3,000**

* Lesser of 50% or credit limit for quarter

Shy Corp. can file two Forms 941-X and claim an $11,000 refundable credit for the second quarter and a $3,000 refundable credit for the second quarter.

Special rules apply to:

- New businesses (see FAQ #44);
- Businesses purchasing another business (see FAQ #45); and
- Tax-exempt employers (see FAQ #46).

Refund advances

Form 7200, Advance Payment of Employer Credits Due to COVID-19, discussed at page 4-9, can also be used to expedite a refund of the Employee Retention Credit due in excess of the amount of previously retained employment taxes.

Limitations to the Employee Retention Credit

Limitation for larger employers

The Employee Retention Credit contains a further limitation for larger employers. For employers with an average of greater than 100 full-time employees (those who work on average at least 30 hours per week) during 2019, only those wages paid to employees who are not actually working are counted. (CARES Act §2301(c)(3)(A)(i); FAQ #51) In other words, the credit only applies if the employer furloughs the employee with pay.

Reduced hours

Employers may claim the credit if they continue to pay 100% of the wages to employees who are working reduced hours, but they may only claim the credit for the portion of the wages that are attributable to those reduced hours. (FAQ #54)

Example of qualified wages for employees working reduced hours

Wellmade Goods, Inc., a manufacturing company, averaged more than 100 full-time employees in 2019, and has several locations that are closed during the second quarter of 2020 due to a governmental order. Wellmade continues to pay hourly employees who are not working 50% of their normal hourly wage rates. Wellmade also reduced headquarters' administrative staff hours by 40% but continues to pay them at 100% of their normal hourly wage rates.

Wellmade may claim the credit for employees who are not working due to the closure of their location but are still receiving 50% of their normal hourly wages.

For the administrative staff whose hours were reduced by 40% but who are paid 100% of the normal wage rate for those hours, Wellmade may only claim the credit for 40% of the wages paid.

Salary increases

Additionally, wages paid by an employer with an average of greater than 100 full-time employees eligible for the Employee Retention Credit cannot exceed the amount of wages that would have been paid to the employee for working an equivalent duration during the 30 days of the immediately preceding pay period. (CARES Act §2301(c)(3)(B)) So any increase in wages paid after the prior day period may not be included in qualified wages.

Paid leave

Amounts paid to employees for paid time off for vacations, holidays, sick days, and other time off do not count as qualified wages for employers with more than 100 employees in 2019 (although they do count if the employer has 100 or fewer employees in 2019).

The same limitation does not apply to small employers

Employers with an average of 100 or fewer full-time employees count all wages paid, not just wages paid to employees who are not working. (CARES Act §2301(c)(3)(A)(ii))

> ***Comment***
>
> Remember, only wages paid during a quarter where the business was fully or partially suspended or experienced a significant decline in gross receipts are counted.

Aggregation rules

All entities that are treated as a single employer under IRC §52(a) or IRC §414(m) or (o) are treated as a single employer for purposes of the Employee Retention Credit.

These aggregation rules are used to determine whether the employer has:

- A trade or business operation that was fully or partially suspended due to COVID-19–related orders;
- A significant decline in gross receipts; or
- More than 100 full-time employees.
  (IRS FAQs #25–27, Employee Retention Credit under the CARES Act)

> **Caution**
>
> All members of an aggregated group are precluded from claiming the Employee Retention Credit if any member of the aggregated group received a Paycheck Protection Program loan.

The amount of the Employee Retention Credit must be apportioned among members of the aggregated group on the basis of each member's proportionate share of the qualified wages eligible for the credit.

Credit where PEO is used

If an employer uses a professional employer organization, otherwise known as a third-party payer, then the true, common law employer is the one who is entitled to claim the Employee Retention Credit, not the professional employer organization. (CARES Act §2301(h)(3)) These employers will claim their credits on Form 7200 and provide their PEO with copies so they can reconcile those amounts on the 941s filed for those employees' wages.

> ***Responses to common questions about these credits***
>
> Here are some questions and answers:
>
> 1. **Are payments made to independent contractors considered "qualified wages" for purposes of the credit?**
>   No.
> 2. **Is the $5,000 per-employee limit applied per quarter or per year?**
>   It is applied for total wages paid after March 12, 2020, and before January 1, 2021. It is not applied per quarter and is not available for wages paid after 2020.

See pages 4-20A through 4-20D.

COORDINATING THE PAYROLL TAX CREDITS AND DEFERRAL

It is possible that an employer may use more than one of the four payroll tax benefits; in fact, it's possible the employer may use all of them. See "Example of using multiple benefits" on page 4-21.

EMPLOYEE RETENTION CREDIT EXPANDED UNDER THE TCDTRA

The TCDTRA modifies, expands, and extends the Employee Retention Credit. (TCDTRA §207)

Coordination with PPP loans

Under the CARES Act, PPP loan recipients were ineligible to claim the Employee Retention Credit. The TCDTRA retroactively repeals this rule. Under the TCDTRA, PPP loan recipients may now claim the Employee Retention Credit.

No double benefit where PPP loans forgiven

Wages paid with forgiven PPP debt are not included in payroll costs taken into account in computing the Employee Retention Credit. (TCDTRA §206(c)) However, if the PPP loan is not forgiven, the wages may be used for purposes of computing the credit. The SBA and the IRS are directed to issue additional guidance in this area. (TCDTRA §206(c))

These amendments are effective retroactively as if included in the CARES Act.

Practice Pointer

A PPP borrower that filed their employment tax returns prior to the enactment of the TCDTRA, when they were ineligible to claim the Employee Retention Credit, may treat any applicable amount for which they are now going to claim the credit as an amount paid in the calendar quarter that includes the date of the TCDTRA enactment (therefore, fourth quarter, 2020).

"Applicable amount" is the wages or qualified wages paid in a calendar quarter beginning after December 31, 2019, and before October 1, 2020, and not taken into account by the taxpayer in calculating the Employee Retention Credit for such calendar quarter.

Example of claiming credit after PPP loan

XYZ, Inc. received a PPP loan in April 2020. If not for the PPP loan, XYZ, Inc. would have been eligible to claim the Employee Retention Credit on its second- and third-quarter payroll tax returns.

The TCDTRA amendments to the CARES Act permits XYZ, Inc. to retroactively calculate its eligible wages and claim the Employee Retention Credit on all eligible wages paid after March 12, 2020, through December 31, 2020, on its fourth-quarter payroll tax return for 2020, excluding those wages that were paid with PPP debt that qualifies for forgiveness.

No double benefit for other credits

Taxpayers may not claim the following credits for the wages used to determine the amount of the Employee Retention Credit:

- IRC §41 Credit for Increasing Research Activities;
- IRC §45A Indian Employment Credit;
- IRC §45P Employer Wage Credit for Employees Who are Active Duty Members of the Uniformed Services;
- IRC §45S Employer Credit for Paid Family and Medical Leave;
- IRC §51 Work Opportunity Credit; and
- IRC §1396 Empowerment Zone Employment Credit.
  (TCDTRA §207(f))

Comment

The CARES Act only precluded double benefits for the Employer Retention Credit for paid family and medical leave and the Work Opportunity Credit.

Credit extension and expansion

Under the CARES Act, employers may claim this refundable credit against quarterly employment taxes equal to 50% of the qualified wages and compensation paid to each employee. Only wages paid after March 12, 2020, and before January 1, 2021, qualify for the credit. The maximum qualified wages per employee is $10,000 *annually*, which equates to a maximum Employee Retention Credit of $5,000 per employee.

For calendar quarters beginning after December 31, 2020, the TCDTRA amends the CARES Act and:

- Extends the credit to apply to qualified wages paid prior to July 1, 2021, (so the credit now applies to wages paid after March 12, 2020, through July 1, 2021);
- Increases the credit rate from 50% of qualified wages to 70%; and
- Increases the $10,000 qualified wage limitation to apply per quarter, rather than on an annual basis.
  (TCDTRA §207(a)-(c))

Example of credit limit differences

ABC, Inc. has 10 employees. Assuming ABC, Inc. did not receive a PPP loan, then under the CARES Act, as originally passed on March 27, 2020, ABC, Inc. would be eligible for an Employee Retention Credit in 2020 of $50,000 calculated as follows:

	Qualifying wages per employee (capped at $10,000 annually)	$ 10,000
×	Number of employees	10
=	Maximum qualifying wages	$100,000
×	Credit percentage	50%
=	Maximum credit for 2020	$ 50,000

After the TCDTRA's amendments to the CARES Act, ABC's maximum Employee Retention Credit in 2021 is calculated as follows:

	Qualifying wages per employee (capped at $10,000 per quarter)	$20,000*
×	Number of employees	10
=	Maximum qualifying wages	$200,000
×	Credit percentage	70%
=	Maximum credit for 2021	$140,000

*Remember, the TCDTRA is expanded through June 30, 2021, so the credit is only available for the first two quarters of 2021.

Eligible employers expanded

In addition, under the CARES Act, an "eligible employer" was one that carried on a trade or business during the 2020 calendar year and with respect to any calendar quarter:

- Fully or partially suspended their operations due to governmental orders; or
- Experienced a significant decline in gross receipts for the calendar quarter.

A significant decline in gross receipts was defined as:

- A more than 50% decline in gross receipts for the calendar quarter compared to the comparable 2019 calendar quarter; and
- Continuing until the calendar quarter following a quarter in which its gross receipts are greater than 80% when compared to the corresponding 2019 calendar quarter.

For calendar quarters beginning after December 31, 2020, the TCDTRA amends the CARES Act, and a significant decline in gross receipts is revised to apply to any employer if the gross receipts:

- For such calendar quarter are less than 80% of the gross receipts of such employer for the same calendar quarter in 2019 (in other words, only a 20% decline in gross receipts); or
- At the election of the employer, for the immediately preceding calendar quarter, are less than 80% of the gross receipts for the corresponding calendar quarter in calendar year 2019. (TCDTRA §207(d))

At the election of the taxpayer, if the business wasn't in operation at the beginning of a calendar quarter in 2019, the taxpayer may use the 2020 comparable quarter.

> ***Comment***
>
> Even though the TCDTRA eased the definition of "significant decline in gross receipts," it left intact the Employee Retention Credit eligibility for employers whose operations were fully or partially suspended due to governmental orders.
>
> So, an employer that didn't experience a significant decline in gross receipts but was subject to shutdown orders can still claim the Employee Retention Credit for any quarter during which it was subject to governmental shutdown orders.

Government employers

The following governmental agencies or instrumentalities are now eligible for the credit:

- Government agencies or instrumentalities that are tax-exempt under IRC §501(a); or
- Colleges or universities whose primary purpose or function is providing medical or hospital care.
  (TCDTRA §207(d)(3))

Definition of small employer expanded

Under the CARES Act, employers with an average of more than 100 full-time employees may only count wages paid to employees who are not actually working in the calculation of the credit. In contrast, employers with an average of 100 or fewer full-time employees count all wages paid, including those paid to employees who are still working.

The TCDTRA allows employers with 500 or fewer full-time employees to count all wages paid to employees in calculating the credit, not just wages paid to those employees who are not working. (TCDTRA §207(e)) This is a huge boost in the credit amounts that medium- to large-size employers may now claim.

Advance payments

Under the TCDTRA, only employers with an average number of full-time employees (30 hours) of 500 or less during 2019 may elect to receive an advance payment of the credit in any calendar quarter. The amount of advance payment cannot exceed 70% of the average quarterly wages paid by the employer in calendar-year 2019. Seasonal employers can elect to pay 70% of the wages for the calendar quarter in 2019 which corresponds to the calendar quarter to which the election relates. Employers not in existence in 2019 may use the wages for 2020 rather than 2019. (TCDTRA §207(j))

> ***Example of advance payment limit***
>
> XYZ Corp. averaged $200,000 in wages per quarter in 2019. As a result, their advance credit is limited to $140,000 ($200,000 × 70%).

The employer's FICA or railroad retirement tax liabilities will be increased by any excess advance payments received.

> **Practice Pointer**
>
> Advance payments are claimed on IRS Form 7200, Advance Payment of Employer Credits Due to COVID-19.

Example of using multiple benefits

Jerry operates a Schedule C business and has one employee, Jenny. Jenny is paid $3,000 monthly. Her monthly paycheck is always the same:

Gross pay	$3,000
Federal tax withholding	$300
Social Security tax	$186
Medicare tax	$44

Jenny's hourly rate is considered to be $18.

Second quarter: In the second quarter, Jenny doesn't take any time off. However, Jerry elects to defer the employer's portion of Social Security tax. Jerry defers $558 (3 months × $186).

Third quarter: At the start of the third quarter, Jenny takes mandatory sick leave for ten days. Her normal pay is $1,440. The employer share of Medicare tax is $21. The total credit is $1,461.

Soon after returning, Jenny must stay home to care for her child. After the 10-day waiting period (in which she uses vacation pay), she stays home for six weeks. Jerry is only required to pay her two-thirds her normal rate, but he chooses to pay her full rate. Her normal pay for her period of absence is $4,500. The employer share of Medicare tax is $65. The total credit is $4,565.

The amount of payroll tax that would normally need to be deposited would be:

Federal tax withholding	3 × $300	$ 900
Social Security tax	12.4% × $9,000	1,116
Medicare tax	2.9% × $9,000	261
Total		$2,277

First, Jerry reduces the amount by the amount of employer Social Security tax on the paid leave. The total paid leave was $5,940 ($1,440 + $4,500). So, the employer Social Security amount on paid leave was $368 (6.2% × $5,940). Now the amount deposited is reduced to $1,909.

Initial deposit amount	$2,277
Employer Social Security tax on paid leave	(368)
Deposit after Social Security tax on paid leave	$1,909

Second, Jerry elects to defer the portion of Social Security taxes paid on regular wages. Total regular wages were $3,060 ($9,000 - $5,940). Employer Social Security tax on that amount was $190 (6.2% × $3,060).

Deposit after Social Security tax on paid leave	$1,909
Employer Social Security tax deferred	(190)
Deposit after deferred Social Security tax	$1,719

Third, Jerry reports the tax credits.

Deposit after deferred Social Security tax	$1,719
Credit for sick pay	(1,461)
Credit for family leave	(4,565)
Net refund	$4,307

(continued)

Example of using multiple benefits (continued)

Jerry is overpaid. He doesn't have to make any payroll deposits for the quarter, and he will receive a refund of $4,307.

Fourth quarter: Jerry's business tanks and his gross receipts for the fourth quarter of 2020 are only 40% of the gross receipts for fourth quarter 2019. He continues to pay Jenny her normal salary.

He may claim an Employee Retention Credit of $4,500 (50% × $9,000). He also elects to defer the employer portion of Social Security tax of $558 (see above).

Initial deposit amount	$2,277
Deferred employer Social Security tax	(558)
Employee Retention Credit	(4,500)
Net refund	$2,781

Note: Jerry is either lucky or unlucky according to how you look at it. Had his bad quarter been the third quarter, he would have been entitled to two quarters of the Employee Retention Credit instead of one.

However, suppose Jenny had waited until the fourth quarter to use leave. In that case, Jerry's credits over the two quarters would have been greatly reduced because he could not have claimed an Employee Retention Credit on amounts paid for leave.

Summary of Employment Tax Benefits

	Deferral	Sick leave	Family leave	Employee Retention
Employers	All (including government)	< 500 employees	< 500 employees	Any*
Self-employment income	Yes	Yes	Yes	No
Household employer	Yes	Yes	Yes	No
Owner or related party	Yes	Yes	Yes	No
PPP loan forgiven	Yes	Yes	Yes	No
Employee qualifications	None	Unable to work or caring for an individual	Unable to work caring for a child	None
Employer qualifications	None	None	None	Suspended operations or decline in gross receipts
Amount	Employer SS tax	100% of eligible wages	100% of eligible wages	50% of eligible wages

* Credit calculation depends on the number of employees. The credit is calculated differently if the employer has fewer than 100 employees or if the employer has 100 employees or more

Practice Pointer

Tax professionals should obtain all payroll tax returns for all quarters of 2020 in order to properly allocate credits and prepare business income tax returns.

QUALIFIED DISASTER AREA

The TCDTRA also provides various disaster relief provisions that apply to qualified disaster areas. As an initial matter, defining "qualified disaster area" and other key disaster-related terms is important to understanding many of the TCDTRA's disaster relief provisions. The COVID-19-related disaster is not considered a "qualified disaster" for purposes of these provisions.

Comment

Many of these provisions are similar to the CARES Act changes but only apply to taxpayers impacted by qualified disasters, and there are specific requirements that must be met for this disaster relief.

Qualified disaster area

A qualified disaster area is any geographic area designated as a Presidentially declared disaster from January 1, 2020, until February 25, 2021, (60 days after the date of the TCDTRA's date of enactment). (TCDTRA §301(1)(A))

Disaster areas

Many of the communities struck by California's wildfires during 2020 are qualified disaster areas. See page 11-17 for a list of the California wildfires that have been declared a major disaster area.

A full list of the 2020 major disasters can be found by searching FEMA's website for 2020 major disasters at:

Website
www.fema.gov/disasters/disaster-declarations

The COVID-19 declaration is not included as a qualified disaster.

Qualified disaster zone distinguished

A qualified disaster zone is a geographic area within the qualified disaster area that FEMA has designated as warranting individual or individual and public assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Some of the relief discussed below, such as the Disaster-Related Employment Retention Credit, is only available to individuals or businesses located in a qualified disaster zone. (TCDTRA §301(2))

Disaster incident period

The incident period is the period specified by FEMA as the period during which such disaster occurred (except such period is not treated as ending after the date which is 30 days after the date of the enactment of the TCDTRA). (TCDTRA §301(4))

DISASTER-RELATED EMPLOYEE RETENTION CREDIT

Eligible employers located in a qualified disaster zone whose trade or business was inoperable at any time during the beginning of a disaster incident period and ending on December 27, 2020, (the date of enactment of the TCDTRA) as a result of damage sustained by the qualified disaster may claim a 2020 disaster-related Employee Retention Credit. (TCDTRA §303)

CARES Act Employee Retention Credit vs.
TCDTRA Disaster-Related Employee Retention Credit

The disaster-related Employee Retention Credit is completely separate from, and not related to, the CARES Act's Employee Retention Credit, even though some of the provisions of the two credits appear similar.

The disaster-related Employee Retention Credit is part of the IRC §38 general business credit and is therefore:

- Subject to the limitations that apply to all other general business credits; and
- Is a nonrefundable income tax credit.

By contrast, the CARES Act's Employee Retention Credit is a refundable payroll tax credit.

Credit amount

The Disaster-Related Employee Retention Credit is equal to 40% of qualified wages paid to each employee. The qualified wages that may be taken into account is capped at $6,000 per year, per employee, meaning the maximum credit is equal to $2,400 per employee ($6,000 maximum annual wages per employee x 40%). The credit is reduced by the amount of qualified wages with respect to such employee taken into account for any prior taxable year.

Annual wages or total wages for the life of the credit?

The TCDTRA §303(a) contains directly conflicting language. It says, in part:

"The amount of qualified wages with respect to any employee which may be taken into account [for purposes of the disaster-related employee retention credit] by the employer for any taxable year shall not exceed $6,000 (reduced by the amount of qualified wages with respect to such employee taken into account for any prior taxable year.)"

So, if an employer claims the disaster-related Employee Retention Credit based on $6,000 of wages paid to an employee in 2020, can the employer claim the credit for wages paid to the same employee in 2021? The first part of the quoted statement would indicate that the employer can because wages are taken into account for each employee annually. However, the immediately following parenthetical states the exact opposite.

We may have to wait for IRS guidance on this point.

Qualified wages

Only wages paid to an employee whose principal place of employment immediately before the disaster was in the qualified disaster zone are included in computing the credit.

In addition, qualified wages (as defined by IRC §51(c)) are limited to those wages paid on or after the date on which the business became inoperable due to the Presidentially declared disaster and before the earlier of:

- The date the business resumed significant operations at the principal place of employment; or
- The date that is 150 days after the last day of the disaster incident period.

The wages may include wages paid to employees who are:

- Not working;
- Performing services at a difference location; or
- Performing services at the principal place of employment before significant operations resume.

Nonqualified wages

The credit may not be claimed for wages:

- For which an employer claims the Employee Retention Credit under the CARES Act; or
- Paid to an employee related to the employer as defined in IRC §51(i)(1) (including owners and those related to the owners, among others) and employees of a controlled group, as defined under IRC §52.
  (TCDTRA §303(c))

No double benefit

For other credits

Taxpayers may not claim the following credits for the wages used to determine the amount of the Employee Retention Credit:

- IRC §41 Credit for Increasing Research Activities;
- IRC §45A Indian Employment Credit;
- IRC §45P Employer Wage Credit for Employees Who are Active Duty Members of the Uniformed Services;
- IRC §45S Employer Credit for Paid Family and Medical Leave;
- IRC §51 Work Opportunity Credit; and
- IRC §1396 Empowerment Zone Employment Credit.

For wage expenses

A taxpayer may not claim a deduction for wages paid for the wages used to compute the Disaster-Related Employee Retention Credit. (TCDTRA §303(c))

Example of wage deduction reduced

ABC suffered a loss in the California fires. ABC continued to pay wages to its two employees after the business was shut down due to the fire. ABC paid $6,000 in wages to each employee. ABC may claim a credit of $4,800 for the two employees ($6,000 x 40% x 2). ABC must reduce the wage expense by $6,000. For California purposes, ABC may deduct the entire $6,000 in wages paid.

PPP loan forgiveness

PPP loan forgiveness may not include loan amounts that were used to pay wages taken into account for purposes of calculating the Disaster-Related Employee Retention Credit. (TCDTRA §303(g))

Electing out of the credit

Taxpayers may elect out of claiming the Disaster-Related Employment Tax Credit. The TCDTRA directs the Secretary of the Treasury to issue regulations and guidance to provide a method for electing out of the Disaster-Related Employee Retention Credit. As such, we do not know the method of electing out as of the date of this publication.

The Secretary is also directed to issue guidance that would allow PPP loan recipients that elect out of claiming the credit so they could include the wages in their payroll costs eligible for PPP loan forgiveness, to reverse their election out should their loan not be forgiven. (TCDTRA §303(e))

Payroll tax Employee Retention Credit for tax-exempt organizations

Qualified tax-exempt organizations are also eligible for the disaster-related Employee Retention Credit if they have unrelated business income. However, tax-exempt organizations may also claim a nonrefundable payroll tax credit for qualified wages even if the wages are not related to unrelated business income. The organization may not claim both credits for the same wages. (TCDTRA §303(d)(8))

Electing out of the payroll tax credit

Tax-exempt organizations have the same option to elect out of claiming the credit as is available under the Disaster-Related Employee Retention Credit previously discussed. (TCDTRA §303(d))

Calculation of the payroll tax credit

The payroll tax credit is claimed against the employer's share of Social Security taxes (6.2% OASDI tax) equal to 40% of the qualified wages paid to eligible employees during the calendar quarter.

Like the Disaster-Related Employee Retention Credit above, qualified wages are capped at $6,000 per year, meaning the maximum annual credit per employee is equal to $2,400. (TCDTRA §303(d)) The $6,000 maximum qualified wages are reduced by the amount of qualified wages with respect to which the payroll credit was allowed for any prior calendar quarter with respect to the employee.

Advance credits will be allowed based on forms, instructions, regulations, and guidance to be promulgated by the IRS. (TCDTRA §303(d)(89))

Limitations

The total credit claimed by an employer for all employees for any calendar quarter cannot exceed the amount of the employer's share of Social Security taxes, reduced by any payroll credits taken for:

- The employment of qualified veterans under IRC §3111(e); or
- Small business research expenditures under IRC §3111(f).

Carryover of unused credits

The payroll tax credits available to tax-exempt organizations are nonrefundable, but unused credits may be carried over to the next calendar quarter. (TCDTRA §303(d)(3)(B))

Caution

It appears that this limit will apply each quarter, until the taxpayers have fully used their credits, but we may need additional guidance on this issue.

Interplay with other payroll tax credits

Payroll credits for paid sick and family leave benefits under the FFCRA and the CARES Act Employee Retention Credit must be reduced by the amount of credit taken by the organization for the disaster-related Employee Retention Credit. (TCDTRA §303(d)(3)(C))

Interplay with Paycheck Protection Program loan forgiveness

Payroll costs eligible for loan forgiveness will not include any wages paid for which the payroll credit for employee retention is claimed. (TCDTRA §303(g))

California nonconformity

California does not conform to the disaster-related employee retention credit.

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BUSINESS LOSSES

NET OPERATING LOSSES

The TCJA made two major changes to net operating losses:

- For losses arising in tax years beginning after December 31, 2017, the NOL deduction is limited to 80% of the taxpayer's taxable income; and
- Carrybacks were no longer allowed (with limited exceptions for farm losses and insurance company losses).

However, the CARES Act provided two major modifications to the net operating loss (NOL) deduction:

- Five-year carrybacks are allowed for NOLs incurred in 2018–2020; and
- The 80% taxable income limitation for the 2018–2020 taxable years is suspended. (CARES Act §2303)

The five-year carryback applies to farmers and insurance companies as well. (CARES Act §2303(b); IRC §172(b)(1))

Practice Pointer

The five-year carryback means that taxpayers can retroactively go back and use their 2018 and 2019 NOLs and carry them back five years to 2013 or 2014, respectively. Taxpayers may make separate elections for each year. For example, a taxpayer could elect to forego the carryback election for 2018 but still choose to carryback the 2019 NOL to 2014. This could allow them to use some NOL to generate cash now, while preserving other losses to use later (when tax rates may be higher).

Example of NOL carryback

R&B, Inc. had the following income and losses for 2013 through 2019:

Year	**Taxable income/loss**
2013	$10,000
2014	$8,000
2015	$7,500
2016	$5,000
2017	$2,500
2018	($50,000)

R&B can carry back its 2018 loss to 2013 and then forward to 2014, 2015, 2016, and 2017, respectively. Because R&B's losses for 2013–2017 only equal $33,000, R&B will carry forward $17,000 of its 2018 NOL to 2019.

Election to forego the carryback

NOLs must be carried back unless the taxpayer files an election to forego the carryback on a timely filed income tax return. This is true for any tax year the Code allows an NOL carryback. Taxpayers that don't file an election to forego the NOL carryback must carry the loss back and can only carry forward the amount of their NOL that would not otherwise have been used had they properly carried the loss back. The unused portion that was not carried back is lost.

Example of losing an NOL carryback

R&B, in the previous example, fails to elect to forego the carryback of its 2018 NOL. As a result, R&B will be unable to utilize the $33,000 that could have been carried back as an NOL carryover.

R&B can carry over only $17,000 of its 2018 NOL, even though it did not carry back any of its $50,000 loss from 2018.

Relief from requirement of timely election

Normally the election to forego the carryback must be made by the due date (including extensions) for filing the taxpayer's return for the taxable year that generated the NOL.

The IRS has provided relief for taxpayers with 2018 and/or 2019 NOLs. Under Rev. Proc. 2020-24, the election to forego a carryback for an NOL arising in the 2018 or 2019 taxable year may be made by the due date (including extensions) of the return for the first taxable year ending after March 27, 2020 (the date of enactment for the CARES Act). (IRC §172(b)(1)(D)(v)(II))

This means the election to waive the carryback for 2018, 2019, and 2020 NOLs may be made by calendar-year taxpayers up to:

- April 15, 2021, if no extension request is filed; or
- October 15, 2021, if an extension request is filed.

How to make the election

Taxpayers electing to waive an NOL incurred in either tax year 2018 or 2019 must:

- Attach a statement electing to waive the carryback for each tax year (2018 or 2019) to the first federal income tax return filed for the tax year on or immediately following March 27, 2020; and
- Include the following language in the statement: "Taxpayer is electing to apply section 172(b)(3) under Rev. Proc. 2020-24 for [insert tax year]."

Example of relief from filing timely election

R&B, in the previous example, did not file an election to waive the carryback when it filed its 2018 return because there was no requirement to do so. There was no requirement because carrybacks were not allowed at that time.

Because carrybacks are now allowed for 2018 NOLs, R&B can:

- Carry back the $33,000 NOL and carry forward the $17,000; or
- File the election to waive the carryback for its 2018 NOL and attach it to its 2020 return following the requirements under Rev. Proc. 2020-24. If it does so, it will carry its entire $50,000 NOL forward from 2018.

Taxpayers with repatriation income

Special NOL carryback provisions apply to taxpayers with IRC §965 inclusion amounts (repatriation taxes).

The TCJA's foreign tax provisions moved us away from essentially a foreign tax deferral system to a system that taxes foreign-earned income on an annual basis at a much lower tax rate. One step in accomplishing this change was a one-time repatriation tax imposed on previously deferred income that was generally due with the 2017 return (although if the foreign corporation's 2017 tax year ends in the shareholder's 2018 tax year, then the shareholder would report it on their 2018 tax return). (IRC §965)

However, taxpayers could spread the tax on that income over eight years.

The CARES Act and Rev. Proc. 2020-24 prohibit applying an NOL carryback against any IRC §965 inclusion amount for the taxable year for purposes of determining the NOL deduction for that year. Accordingly, in such a year, any NOL deduction can only be applied against income that isn't an IRC §965 inclusion amount.

A taxpayer is allowed to forego carrying back an NOL to a taxable year in which there was an IRC §965 inclusion amount.

Example of NOL carryback and IRC §965

Al has a 2020 NOL that he wants to carry back to 2015. Al had IRC §965 inclusion amounts on his 2017, 2018, and 2019 returns. Al may carry back his 2020 NOL to 2015 and 2016 but may elect to forego applying the carryback to the 2017, 2018 and 2019 tax years (IRC §965 inclusion years).

Temporary repeal of 80% taxable income limit

For taxable years beginning before January 1, 2021, the 80% taxable income limit for NOLs is repealed. (CARES Act §2303(a))

Comment

The 80% limitation was already inapplicable to carryovers from pre-2018 taxable years (before the TCJA went into effect) that are carried over to post-2017 taxable years.

For taxable years beginning after December 31, 2020, the NOL deduction is equal to the sum of:

- The aggregate NOL carryovers of NOLs arising 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.

Example of new pre-2021 NOL rules

Scenario 1

Looper, Inc. is a delivery service that has a 2018 NOL of $70,000 and a 2019 NOL of $50,000. Looper has taxable income for 2020 of $100,000. Looper elected to waive the carryback of the 2018 and 2019 NOLs.

With the repeal of the 80% taxable income limitation, Looper can fully offset the $100,000 of taxable income with the 2018 and 2019 NOLs.

2020 taxable income	$100,000
2018 NOL	(70,000)
2019 NOL	(50,000)
NOL carryover to 2021	($ 20,000)

Looper now has a $20,000 NOL carryover to 2021.

Scenario 2

Assume that all three years appearing in the above example are advanced by one year:

2021 taxable income	$100,000
2019 NOL	(70,000)
2020 NOL	(50,000)
80% of taxable income	$ 80,000

Looper can only use $80,000 of its NOLs because the taxable year is 2021 and its NOLs were generated in taxable years beginning after December 31, 2017. It uses all of its 2019 NOL and carries forward $40,000 of its 2020 NOL.

Scenario 3

Assume that Looper's NOLs of $70,000 and $50,000 were generated in 2017 and 2019, respectively, and that its taxable income in 2018 was exactly zero:

2021 taxable income	$100,000
2019 NOL	(70,000)
2017 NOL	(50,000)
2021 taxable income	$100,000
2017 NOL	(50,000)
Taxable income after pre-2018 NOLs	$ 50,000
80% of taxable income after pre-2018 NOLs	$40,000
Post-2017 NOLs	$70,000
Lesser	$40,000

Looper can use all of its 2017 NOL ($50,000) and $40,000 of its 2019 NOL, reducing its taxable income to $10,000 ($100,000 - $50,000 - $40,000). It will carry forward $30,000 of its 2019 NOL to 2022 ($70,000 - $40,000).

NOL Treatment by Year Generated			
Year NOL generated	**Carrybacks**	**Taxable income limitation**	**Carryforward**
Pre-2018 taxable years (Pre-TCJA)	2 years	100% of taxable income	20 years
2018–2020 taxable years (CARES Act)	5 years	**Claimed on pre-2021 taxable year return:** 100% of taxable income **Carried over to post-2020 taxable year:** 100% of pre-2018 taxable year NOL carryovers 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: o Taxable income computed without regard to NOLs, IRC §199A, and IRC §250 deductions; over o The aggregate amount of NOL carryovers from pre-2018 taxable years	Indefinite
Post-2020 taxable years (TCJA as modified by CARES Act)	None	80% taxable income limitation	Indefinite

Remember that TCJA NOL carryback effective date glitch?

The CARES Act retroactively addresses that TCJA NOL effective date glitch. The TCJA repealed the NOL carrybacks and extended the NOL carryovers for NOLs arising in taxable years *ending* after December 31, 2017. So, calendar-year taxpayers could still carry back NOLs arising in 2017, but many 2017 fiscal-year taxpayers could not claim the NOL carryback because their fiscal year ended after December 31, 2017.

The CARES Act corrected this situation to retroactively repeal the NOL carrybacks enacted by the TCJA to apply to NOLs arising in taxable years beginning after December 31, 2017.

So now fiscal-year 2017 taxpayers will be able to claim a two-year carryback NOL if the NOL was incurred in their 2017 fiscal year. (CARES Act §2303(d))

California nonconformity

California has suspended NOLs for the 2020–2022 tax years for businesses with modified AGI or business income subject to California taxation of $1 million or more. (R&TC §§17276.23, 24416.23)

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. California also does not allow certain high-income taxpayers to use an NOL in the 2020 or 2021 tax years. (R&TC §§17276, 17276.21, 17276.22, 19131.5, 24416, 24416.21, 24416.22)

See page 8-6 for more information on California NOLs.

Farming losses

Taxpayers claiming a farming loss under IRC §172(b)(1)(B)(ii) may make an irrevocable election to not apply the CARES Act provisions that:

- Suspended application of the NOL 80% taxable income limitation; and
- Allowed five-year carrybacks for NOLs incurred in 2018, 2019, and 2020. (ACRRA §281)

The election must be made by the due date (including extensions) for filing the taxpayer's return for the taxpayers first taxable year ending after December 27, 2020, (the date of the enactment of the ACRRA).

EXCESS BUSINESS LOSSES

The CARES Act *retroactively* delays the implementation of the IRC §461(l) excess business loss limitation for three years. The excess business loss limitation will now be applicable for the 2021–2025 taxable years, after which it sunsets along with many other TCJA provisions. As originally enacted by the TCJA, the limitation applied beginning with the 2018 taxable year. (CARES Act §2304(a))

Amended returns

The Code now provides that the excess business loss rules apply "for any taxable year beginning after December 31, 2020, and before January 1, 2026." (IRC §461(l)(1)(B)) Therefore, it is as if the rules did not exist in 2018 and 2019. The repeal is nonelective, so it appears that any taxpayer with an excess business loss in 2018 or 2019 must file an amended return whether or not doing so is favorable to the taxpayer.

Example of claiming retroactive losses

Regina had an excess business loss of $200,000 on her 2018 tax return, and she reported $100,000 in taxable income for 2018.

Regina included the $200,000 carryforward in her NOL deduction on her 2019 return.

Regina files an amended 2018 return and claims the $200,000 in additional losses. This eliminates her $100,000 taxable income and creates a $100,000 NOL. The 2018 $100,000 NOL will be carried back to 2013 unless she files an election to forego the carryback with her 2020 return.

Regina must also file an amended 2019 return to recompute the amount of the NOL claimed on that return.

Technical corrections

Various technical corrections are made to the excess business loss deduction for when it does go into effect in the 2021 taxable year.

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).

The TCJA technical amendments:

- 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;
- 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.

  (CARES Act §2303(b))

Corrections provide much needed clarification

These changes make it clear that W-2 wages are not included in business income for purposes of the excess business loss limitation. This had been a big open question.

The changes also clarify how capital gains and losses are treated for purposes of calculating the limitation. Specifically, net capital gains (but not losses) from a taxpayer's trade or business are taken into account when computing the limitation, but the amount of such gain is limited to the taxpayer's overall capital gain net income. This prevents taxpayers from converting capital losses into NOLs.

California nonconformity

California law currently applies the excess business loss limitation for 2019 and 2020 returns. The threshold amount for the 2019 taxable year is $255,000 ($510,000 in the case of a joint return). For 2020, the threshold amounts are $259,000 and $518,000, respectively. (R&TC §17560.5) See page 10-13 for details.

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		
Assets placed in service in tax years beginning after …	**Expensing limitation**	**Phaseout threshold**
December 31, 2018 (Rev. Proc. 2018-57)	$1,020,000	$2,550,000
December 31, 2019 (Rev. Proc. 2019-44)	$1,040,000	$2,590,000
December 31, 2020 (Rev. Proc. 2020-45)	$1,050,000	$2,620,000

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 available through 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))

Qualified improvement property is now eligible for bonus depreciation. The CARES Act redefines qualified improvement property as 15-year MACRS property, retroactive to property placed in service after December 31, 2017. (CARES Act §2307; IRC §168(e)(3)(E)(vii) and (g)(3)(B)) See page 6-3 for a complete discussion of this provision.

Used property qualifies

For qualified property placed in service after September 27, 2017, the TCJA removed the requirement that made bonus depreciation available only for new property. Thus, the TCJA allows bonus depreciation for new and used equipment (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.

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

California nonconformity

California 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)) Such an 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. (Instructions, Form 4562)

IRC §179/bonus depreciation for specific properties

Specific types of property may dictate which deduction to claim:

- 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 $25,500 for 2019 ($25,900 for 2020) 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 $18,100 cap in the first year, whereas if IRC §179 is claimed, the deduction is limited to $10,100; 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.

AUTOMOBILE EXPENSES

STANDARD MILEAGE RATE

The 2020 standard business mileage rate is 57.5 cents. The 2021 rate is 56 cents. (Notice 2021-02)

Federal Mileage Rates			
	2019 (Notice 2019-02)	**2020 (Notice 2020-05)**	**2021 (Notice 2021-02)**
Business mileage	58 cents	57.5 cents	56 cents
Charitable mileage	14 cents	14 cents	14 cents
Medical mileage	20 cents	17 cents	16 cents
Moving mileage*	20 cents*	17 cents*	16 cents*
* Federal law only allows a moving expense deduction for active duty military.			

Luxury car caps

2020 Maximum Depreciation Amounts (Rev. Proc. 2020-37)								
	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	$10,100	$3,304	$18,100	N/A	$10,100	$3,721	$18,100	N/A
2nd year	$16,100	$5,277	$16,100	N/A	$16,100	$5,959	$16,100	N/A
3rd year	$9,700	$3,084	$9,700	N/A	$9,700	$3,502	$9,700	N/A
4th year and following	$5,760	$1,856	$5,760	N/A	$5,760	$2,169	$5,760	N/A
Note: These amounts are unchanged from 2019.								

Caution

Even though used property now qualifies for bonus depreciation, personal vehicles converted to business use do not qualify.

Caution

Business use must be at least 50% to qualify for bonus depreciation.

The dollar limits must be reduced proportionately if business or investment use of a vehicle is less than 100%.

Lease inclusion amounts

The lease inclusion threshold was dramatically increased in 2018 to $50,000. For 2019 and 2020, the lease inclusion threshold remains at $50,000. (Rev. Proc. 2019-26; 2020-37)

A taxpayer who leases a business vehicle may deduct the part of the lease payment representing business or investment use. If business/investment use is 100%, the full lease cost is deductible. But, to ensure that auto lessees cannot avoid the effect of the luxury auto limits, taxpayers must include a certain amount in income during each year of the lease to partially offset the lease deduction. (IRC §280F) The income inclusion amount varies with the initial FMV of the leased auto and the year of the lease and is adjusted for inflation each year.

The lease inclusion applies if the lease term begins in 2020 and if the vehicle's FMV on the first day of the lease exceeds the following value:

Lease Inclusion Amounts	
Autos	$50,000
Trucks and vans	$50,000

To view the lease inclusion tables, go to:

Website
www.irs.gov/pub/irs-drop/rp-20-37.pdf

California partial conformity

California conforms to the current federal mileage rates but only conforms to the lease inclusion amounts and maximum allowable auto deduction as in effect on January 1, 2015. It does not conform to the increase in the luxury auto or lease inclusion amendments by the PATH Act or the TCJA, or to the expansion of the definition of qualified property to used property.

The California lease inclusion amounts for 2020 are available at:

Website
www.caltax.com/files/2020/leasetables.pdf

TRADE OR BUSINESS EXPENSES

CHARITABLE CONTRIBUTIONS

The CARES Act increases the contribution limit for C corporations from 15% of taxable income to 25% for the 2020 tax year. (CARES Act §2205)

The TCDTRA increases the charitable contribution limit for disaster-related cash contributions for corporations to 100% by modifying and expanding the 25% corporate limit and increasing corporate charitable contribution allowed under Sec. 2205(a)(2)(B) of the CARES Act.

Comment

While all cash contributions to qualified 501(c)(3) organizations qualify for the CARES Act increased limits, only "qualified disaster relief contributions" are subject to the TCDTRA's 100% limitation.

Ordering rule

If a corporation makes both a qualified contribution under the CARES Act and a qualified disaster relief contribution, the CARES Act qualified contribution will be taken into account first.

Qualified disaster relief contribution

A qualified disaster relief contribution is a cash contribution that the taxpayer elects to be treated as a qualified disaster relief contribution and is:

- Paid during the period beginning on January 1, 2020, and ending 60 days after the TCDTRA's enactment;
- Made for relief efforts in one or more qualified disaster areas (the charitable organization itself does not have to be located in the qualified disaster area); and
- Substantiated by a contemporaneous written acknowledgement obtained by the taxpayer from an IRC §170(c) organization that the contribution was or will be used for qualified disaster relief efforts.

California nonconformity

California does not conform to the corporate charitable contribution changes made by the TCDTRA.

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Special provision for contributions of food inventory

The CARES Act increases the charitable contribution limits for contributions of food inventory for the 2020 tax year to 25% of:

- Aggregate net income (for taxpayers other than C corporations); and
- Taxable income (for C corporations).

Food inventory contribution calculation

Businesses are permitted a deduction for food inventory of the lesser of:

- The basis of the food inventory, plus one-half of the ordinary income that the taxpayer would have recognized if the property were sold at fair market value; or
- Twice the basis of the property.
  (IRC §170(e)(3)(B))

California nonconformity

California does not conform to the increased deductions for food inventory. (R&TC §§17201, 17275.5, 24359)

MEALS AND ENTERTAINMENT

In proposed regulations, the IRS clarified and expanded upon the new TCJA rules regarding the deductibility of meal and entertainment expenses. IRS Notice 2018-76 provided interim guidance on this issue and the proposed regulations provide the final IRS guidance.

Definition of entertainment

Under the TCJA, no deduction is allowed for an activity that is considered entertainment or for a facility used in connection with entertainment. (IRC §274; Prop. Treas. Regs. §1.274-11(a))

Entertainment is defined simply as "an activity that is generally considered to be entertainment." (Prop. Treas. Regs. §1.274-11(b)(1)(i)) The trade or business of the taxpayer must be considered. For example, a movie is generally considered entertainment, but for a movie critic it could be considered part of a trade or business.

Entertainment does not include food and beverages unless they are provided as part of an entertainment activity. If food or beverages are purchased separately at an entertainment activity with separate bills, or separately stated on a single bill, then they are not included with the entertainment activity and are deductible if they qualify as a business meal. The amount charged for food must either reflect the venue's usual price or approximate the reasonable value of those items.

Business meals

The proposed regulations allow a 50% deduction for food and beverages if:

- The expense is an ordinary and necessary expense paid or incurred during the tax year in carrying on a trade or business;
- The expense is not lavish or extravagant under the circumstances;
- The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and
- The food or beverages are provided to a business associate.
  (Prop. Treas. Regs. §1.274-12(a))

Food and beverages include delivery fees, tips, and sales tax. (Prop. Treas. Regs. §1.274-12(b)(2))

A "business associate" is a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective. (Prop. Treas. Regs. §1.274-12(b)(3)) This expands upon the much narrower requirements for deducting business meals outlined in Notice 2018-76.

Food and beverage as compensation

Employers can deduct meals without limitation (100% deduction) if the expense is treated:

- As compensation paid to the employee on the taxpayer's income tax return; and
- As wages to the employee for purposes of withholding.
  (Prop. Treas. Regs. §1.274-12(c)(2)(i))

Reimbursed expenses

Where food and beverage expenses are incurred by one person performing services for another, the deduction limitations apply either to the person who makes the expenditure or to the person who actually bears the expense, but not to both. (Prop. Treas. Regs. §1.274-12(c)(2)(ii)) This is true regardless of whether there is an employer–employee relationship.

Employee recreational and social activities

Food and beverages provided at a holiday party or an annual picnic or other similar outing for the benefit of employees are fully deductible (not subject to 50% limit). (Prop. Treas. Regs. §1.274-12(c)(2)(iii)(A)) However if such outing is limited to just certain officers, shareholders or highly compensated employees, the 50% limit applies. (Prop. Treas. Regs. §1.274-12(c)(2)(iii)(B))

Food and beverages provided in a breakroom and that are available to all employees are subject to the 50% deduction limitation because a breakroom is not considered a recreational or social activity for the benefit of employees. (Prop. Treas. Regs. §1.274-12(c)(2)(iii)(C), Example 3)

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
		(continued)

Meals and Entertainment Expenses (continued)		
Expense	**Federal**	**California**
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

California nonconformity

California does not conform to any of the changes to the meals and entertainment expense deduction, so you must use the pre-TCJA rules when preparing California returns. (R&TC §17024.5)

See page 4-36A.

IRC §199A DEDUCTION

New final regulations

The IRS has issued final regulations containing amendments to three sections of the February 2019 proposed regulations, each of which provides rules relevant to the calculation of the IRC §199A deduction:

- Treas. Regs. §1.199A-3(b)(1)(iv) provides additional rules and clarification on the treatment of suspended losses;
- Treas. Regs. §1.199A-3(d) provides guidance that allows a shareholder in a regulated investment company (RIC) to take an IRC §199A deduction with respect to certain income of, or distributions from, the RIC; and
- Treas. Regs. §1.199A-6(d) provides additional rules related to trusts and estates under section IRC §663, which provides special rules for income and deductions for estates and trusts that accumulate income or distribute principal.
  (T.D. 9899)

Full deduction for business meals

Businesses may claim a 100% deduction (rather than a 50% deduction) for food or beverages provided by a restaurant. The full deduction is available for purchases paid or incurred after December 31, 2020, and before January 1, 2023, as long as the taxpayer otherwise meets the criteria for deducting a business meal. (TCDTRA §210; IRC §274(n)(2))

Example of meal deduction

John is a tax professional and owns his own sole-proprietor tax practice. Every Friday morning during tax season, he brings bagels and coffee for breakfast for his staff. Under the TCDTRA, John's deduction for business meals for his Friday bagels and coffee depends on where he acquires them.

If John picks up bagels and coffee from the grocery store on the way to the office, he can deduct only 50% of the cost when he files his income tax return.

If John picks up bagels and coffee from the local bagel restaurant on the way to the office, he can deduct 100% of the cost when he files his income tax return.

Comment

The 100% business deduction for business meals has been promoted as a means to help revive the restaurant industry that has been devastated during the COVID-19 pandemic. But, what is a "restaurant"? The term is not defined in the TCDTRA. Is a catering business or a food truck classified as a "restaurant"? What about a coffee shop?

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Suspended losses

Previously disallowed losses or deductions allowed in the taxable year generally are taken into account for purposes of computing QBI to the extent the disallowed loss or deduction is otherwise allowed by IRC §199A. These previously disallowed losses include but are not limited to losses disallowed under IRC §§461(l), 465, 469, 704(d), and 1366(d). These losses are used for purposes of IRC §199A in order from the oldest to the most recent on a first-in, first-out (FIFO) basis and are treated as losses from a separate trade or business.

If a loss or deduction attributable to a trade or business is only partially allowed during the taxable year in which incurred, only the portion of the allowed loss or deduction that is attributable to QBI will be considered in determining QBI from the trade or business in the year the loss or deduction is incurred. The portion of the allowed loss or deduction attributable to QBI is determined by multiplying the total amount of the allowed loss by a fraction, the numerator of which is the portion of the total loss incurred during the taxable year that is attributable to QBI and the denominator of which is the amount of the total loss incurred during the taxable year.

Example of partial allowance

A is an unmarried individual and a 50% owner of AB LLC, an entity classified as a partnership for federal income tax purposes. In 2020, A's allocable share of loss from AB LLC is $100,000 of which $80,000 is negative QBI.

Under the at-risk rules of IRC §465, only $60,000 of the total allocable loss is allowed in determining A's taxable income for 2020. A has no other previously disallowed losses under IRC §465 or any other provision of the Code for 2020 or prior years. Because 80% of A's allocable loss is attributable to QBI ($80,000/$100,000), A will reduce the amount A takes into account in determining QBI proportionately. Thus, A will include $48,000 of the allowed loss in negative QBI (80% of $60,000) in determining A's IRC §199A deduction in 2020.

The remaining $32,000 of negative QBI is treated as negative QBI from a separate trade or business for purposes of computing the IRC §199A deduction in the year the loss is taken into account in determining taxable income as described in Treas. Regs. §1.199A-1(d)(2)(iii).

IRC §199A and rental real estate

We will cover the qualified business income deduction as it applies to rental real estate starting at page 6-12.

Maximizing the QBI deduction at the business level

Family partnerships and trusts

High-income families now have an additional incentive to use family partnerships or trusts because doing so can spread QBI among family members, some of whom may have lower incomes and benefit from the IRC §199A deduction.

Example of family partnership

Cindy and Josh are in the trade or business of leasing property and net $500,000 per year in rental income from eight commercial buildings that they've owned for 30 years. The unadjusted basis of the property is $2 million, and they pay no wages. As they are over the top of the phaseout threshold, their initial IRC §199A deduction is limited to $50,000 ($2 million × 2.5%).

They form an LLC and give each of their four children 10% interest in the entity. Each of the four adult children is married and has $150,000 of joint income, all from W-2s unrelated to the family LLC.

Cindy and Josh's share of the net income is now $300,000 per year, and they are under the phaseout threshold. They get the full IRC §199A deduction of $60,000 (20% of ($500,000 × 60%)). Each of the children can also claim the full IRC §199A deduction of $10,000 (20% of ($500,000 × 10%)).

Cindy and Josh cut their taxes by over $62,000. Each of the four children has a tax increase of about $9,000. The overall family reduction is about $26,000 ($62,000 – (4 × $9,000)).

And, there are likely some estate planning benefits as well.

The wages limitation and form of the entity

For non-SSTBs where taxable income is within or over the top of the phaseout range, the IRC §199A deduction depends on the wages limitation (the alternate calculation based on wages and depreciable assets).

All business entities can pay wages. But of the eligible business entities, only an S corporation owner can pay wages to *himself or herself* and have those wages count in the wages limitation (sole proprietors, members, and partners can't pay themselves wages, and guaranteed payments to partners don't count in the wages limitation).

Sole proprietors: Although Schedule C owners can't pay wages to themselves, they can pay wages to a spouse or child, as long as there is justification for doing so and the amount of compensation is reasonable.

Example of Schedule C owner paying wages

Melinda operates Mel's Diner as a sole proprietor and nets $550,000 per year. Hers and her husband's AGI is $600,000. Melinda's tentative IRC §199A deduction is $110,000 (20% of $550,000). The diner pays wages of $100,000 and has no UBIA. Melinda's IRC §199A deduction is limited to $50,000 (50% of wages).

Melinda's husband, Marc, is an accountant who has his own Schedule C tax practice and nets $100,000 per year. Marc has been doing the accounting and taxes for Melinda's business without pay.

Melinda hires Marc as an employee and pays him $40,000. The diner's net income is now $510,000 after paying Marc's wages, and total wages are now $140,000. Melinda's tentative IRC §199A deduction is now $102,000, but her deduction is limited to $70,000 (50% of $140,000).

S corporations: S corporation shareholder-employees possibly have the best deal in town for year-end tax planning. By paying wages to themselves at the end of the year, they can accomplish both a penalty-savings and enjoy a tax-saving benefit at the same time.

First, by making a large wage payment at the end of the year, they can catch up on underwithholding for the current year and avoid an underpayment of estimated tax penalty.

But more importantly, they can maximize their IRC §199A deduction.

Example of S corporation wages

Penny operates a sole proprietorship that is not a specified service trade or business, and she has net income from her Schedule C of $500,000 (which also equals her taxable income). She pays no wages and has qualifying depreciable assets (UBIA) of $100,000.

Because her taxable income is over the phaseout range and she pays no wages, her IRC §199A deduction is limited to $2,500 (2.5% × $100,000 depreciable assets).

Penny incorporates the business and makes an S election. She pays herself a salary of $200,000, leaving $300,000 flowing to her as ordinary income on Schedule K-1.

Her IRC §199A deduction is now $60,000, calculated as the lesser of:

- 20% of QBI (20% × $300,000) = $60,000; or
- The greater of:
  - 50% of W-2 wages (50% × $200,000) = $100,000; or
  - 25% of W-2 wages (25% × $200,000) + 2.5% of UBIA (2.5% × $100,000) = $52,500.

CORPORATIONS

CORPORATE CREDIT FOR PRIOR-YEAR MINIMUM TAX LIABILITY

The CARES Act accelerates the claiming of the refundable corporate credit for prior-year minimum tax, allowing taxpayers to claim 100% of any remaining credit in 2019 or, at the election of the taxpayer, to file an amended return and claim 100% of the credit in 2018. (CARES Act §2305; IRC §53(e)) Taxpayers that make the election to claim the full refund on a 2018 return may file an application for a tentative refund prior to December 31, 2020. The IRS must process the refund within 90 days.

Comment

The TCJA repealed the corporate alternative minimum tax and allowed any remaining AMT credit to offset the regular tax liability for any taxable year and allowed the taxpayer to receive a refund of 50% of the remaining credit for taxable years beginning after 2017 and before 2022, with 100% of the remaining credit claimed in 2022.

California nonconformity

California does not conform to the acceleration of the refundable credit for prior-year minimum tax liability of corporations (California does not allow a refundable credit). (R&TC §§23051.1, 23453)

PARTNERSHIPS

PARTNER CAPITAL ACCOUNTS

For partnership taxable years beginning on or after January 1, 2020, partnerships are required to report each partner's shares of partnership capital on the tax basis method. (Notice 2019-66)

For 2019, partnerships must only report negative tax basis capital accounts on a partner-by-partner basis.

Why the change?

The IRS is making this change because it previously had no way of knowing a partner's basis in the partner's interest. When a partner's basis goes down to zero, losses are disallowed and distributions are taxable.

Capital accounts, generally

Capital accounts must be maintained throughout the life of the partnership in accordance with the capital account maintenance rules in the regulations. (Treas. Regs. §1.704-1(b)(2)(4)(b))

A partner's capital account is clearly reflected each year on the partner's K-1.

The capital account may be thought of, in its simplest form, as a bank account. The balance at any point in time represents the accumulated history of deposits, earnings, and withdrawals to and from the account.

Annual capital account adjustments

Generally, when using tax basis capital accounts, annual adjustments are made the same way that annual basis adjustments are made, *except* for adjustments made for increases or decreases in liabilities.

The IRS gives a detailed listing of annual adjustments in its FAQs. (FAQ #2)

IRS issues FAQs

The IRS has issued FAQs on its website answering eight key questions regarding the new capital account requirement.

The FAQs can be found at:

Website
www.irs.gov/businesses/partnerships/form-1065-frequently-asked-questions

Determining tax basis capital accounts

For partnerships that have maintained their capital accounts on other than the tax basis, it may be tricky to determine tax basis and restate the capital accounts accordingly. Partnerships may need to trace partner activity back to the beginning of the partnership (or, at least, the partner's entrance into the partnership). Records that go back to the beginning are not always available.

IRS offers safe harbor

Fortunately, the IRS is offering a choice of two safes harbors:

- **Modified outside basis method:** This method is simple. The partnership simply takes that partner's outside basis in their interest and subtracts from that basis the partner's share of liabilities. For this purpose, the partnership is allowed to rely on outside basis information reported to it by the partner; or
- **Modified previously taxed capital method:** This method is more complex and involves computing the capital through the amount the partner would receive on a hypothetical liquidation of the partnership.
  (Notice 2020-43)

Example of modified outside basis method

Katie is a partner in a partnership that has maintained capital accounts using GAAP accounting. The partnership decides to use the modified outside basis method to establish tax basis capital accounts. Fortunately, the partners have maintained records on their bases in their interests.

Katie's basis in her interest is $100,000. Her share of partnership liabilities is $40,000. Therefore, the partnership will show Katie's tax basis capital account as $60,000.

Form 1065 instructions provide reporting guidance

The draft Form 1065 instructions released on October 21, 2020 provide K-1 reporting guidance for partnerships that reported capital accounts on a method other than the tax basis method in tax years prior to 2020.

The draft form instructions tell partnerships how to determine the beginning capital account balance on 2020 Schedule K-1s and provide that a statement must be attached to each partner's K-1 indicating the method used to determine each partner's beginning capital account (for example, the modified outside basis method or the modified previously tax capital method).

Not all partnerships required to comply

All partnerships are required to comply with the new reporting requirements except those that meet *all* of the following conditions:

- Less than $250,000 in total receipts for the tax year;
- Less than $1 million in total assets at the end of the tax year;
- Schedules K-1 are filed with the partnership return and furnished to the partners on or before the due date (including extensions) for the return; and
- No Schedule M-3 is filed or required to be filed.
  (FAQ #7)

Practice Pointer

These are the same four requirements from Form 1065, Schedule B, Question 4. If a partnership meets all four of these requirements, then the partnership is not required to complete Schedules L (balance sheet), M-1 (reconciliation of book and tax income, M-2 (analysis of partners' capital accounts), item F on page 1 of Form 1065 (listing total assets), or item L on Schedule K-1 (partner's capital account analysis).

FILING OF AMENDED PARTNERSHIP RETURNS SEVERELY CURTAILED

Buried within the new centralized partnership audit regime (CPAR) statutes and regulations are some provisions that may catch many partnerships and their partners by surprise, including severe limitations on when a partnership may file an amended return and the treatment of undisclosed inconsistent positions taken on a partner's return. This issue is discussed on page 2-11.

BUSINESS INTEREST LIMITATION

The TCJA enacted IRC §163(j), which limits the net interest business expense deduction for all taxpayers other than small or "excepted businesses" to the sum of:

- Business interest income;
- 30% of adjusted taxable income (ATI) (50% for 2019 and 2020 tax years). ATI cannot be less than zero; and
- Floor plan financing interest.
  (IRC §163(j)(1))

Small businesses are defined as those whose average gross receipts are less than $25 million, adjusted for inflation. The threshold is $26 million for 2019 and 2020.

California nonconformity

California does not conform to the IRC §163(j) limitation. Therefore taxpayers are not limited on how much business interest they can deduct on their California returns.

CARES ACT MODIFICATIONS

The CARES Act temporarily eases the business interest expense limitation enacted by the TCJA. (CARES Act §2306; IRC §163(j)) The CARES Act:

- Increases the adjusted taxable income limit from 30% to 50% for the 2019 and 2020 taxable years (only the 2020 taxable year for partnerships and partners);
- Allows all taxpayers to use their 2019 adjusted taxable income limit to calculate their 2020 interest expense limitation; and
- If partners were allocated excess business interest for 2019, they may deduct 50% of that excess business interest expense in 2020 not subject to these limitations. The remaining 50% is subject to the excess business interest expense limitations.

Electing out of 50% business interest limitation under the CARES Act

Taxpayers are given the option to elect out of using the increased excess business interest expense limitation or to use 2019 adjusted taxable income. See page 4-44 for a chart of how these elections may be made. (Rev. Proc. 2020-22)

Using 50% in 2019

Example of 50% in 2019

In 2019, Swingers, Inc. had adjusted taxable income of $200,000 and business interest expense of $90,000. They deducted $60,000 of their business interest expense (30% × $200,000). They may now file an amended 2019 return and amend the deduction to $90,000 (50% × $200,000 = $100,000; limited to the amount of interest paid).

Using 2019 ATI to calculate 2020 business interest limitation

The CARES Act provision that allows businesses to use their 2019 adjusted taxable income to calculate their 2020 business interest expense limitation will have a larger impact for many businesses than the increased limitation to 50%. Consider the following example.

Example of using 2019 ATI to calculate 2020 business interest limitation

Dee's Country Café is an S corporation that operates a chain of 65 restaurants. In 2019, Dee's had the following:

Gross receipts	$80,000,000
Adjusted taxable income	$4,000,000
Interest expense	$650,000

In 2019, Dee's Country Café was able to fully deduct its business interest expense because it was far less than 30% of its adjusted taxable income.

In 2020, Dee's suffered a major reduction in its business due to the COVID-19 pandemic and had the following:

Gross receipts	$30,000,000
Adjusted taxable income	$1,000,000
Interest expense	$600,000

Dee's 2020 business interest expense limitation is calculated as follows:

	Using 2019 ATI	**Using 2020 ATI**
50% of ATI	2,000,000	500,000
Business interest expense	- 600,000	- 600,000
Disallowed interest expense (if result is below zero)	N/A*	($ 100,000)

* Result is positive $1,400,000, so all business interest expense is deductible

The CARES Act provision allowing Dee's to use its 2019 adjusted taxable income to calculate its business interest income limitation is more valuable to the company than the increased ATI limitation to 50%. Because Dee's suffered such a massive drop in its business in 2020, the increased business interest limitation of 50% would still produce a result that would limit Dee's business interest expense deduction in 2020.

<table>
<tr><th colspan="4">Business Interest Expense Limitation Elections Pursuant to Rev. Proc. 2020-22</th></tr>
<tr><th>Type of election</th><th>Purpose of election</th><th>Election deadline</th><th>How to make election</th></tr>
<tr><td>Late IRC §163(j)(7) election</td><td>Allows real property and farming trades or businesses to make an irrevocable election to retroactively exempt themselves from the business interest expense limitation in exchange for using alternative depreciation system (ADS) and foregoing use of MACRS (including 15-year recovery period for qualified improvement property and ability to use bonus deprecation for such property)
Collateral adjustments (including allowed or allowable depreciation deduction) must be made for amended return tax year and all succeeding years</td><td>Election for 2018–2020 tax years can be made by filing amended federal income tax return, Form 1065, or administrative adjustment request (AAR) by later of:
• October 15, 2021 (September 29, 2020, for qualified partnerships subject to the centralized partnership audit regime that want to file an amended return); or
• The applicable statute of limitations</td><td>Election must be titled “Revenue Procedure 2020-22 Late Section 163(j)(7) Election” and must contain:
• The taxpayer’s name;
• The taxpayer’s Social Security number (SSN) or employer identification number (EIN);
• A description of the taxpayer’s electing trade or business, including the principal business activity code; and
• A statement that the taxpayer is making an election under IRC §163(j)(7)(B) or (C), as applicable</td></tr>
<tr><td>Withdrawal of IRC §163(j)(7) election</td><td>Allows real property and farming trades or businesses to withdraw election to exempt themselves from the business interest expense limitation thereby allowing them to use MACRS (including 15-year recovery period for qualified improvement property and ability to use bonus deprecation for such property) rather than 20-year ADS recovery period
Collateral adjustments (including allowed or allowable depreciation deduction adjustment under IRC §481) must be made for amended return tax year and all succeeding years</td><td>Withdrawal of election for 2018–2020 tax years can only be made by filing amended federal income tax return, amended Form 1065, or administrative adjustment request (AAR) by later of:
• October 15, 2021 (September 29, 2020, for qualified partnerships subject to the centralized partnership audit regime that want to file an amended return); or
• The applicable statute of limitations</td><td>Election withdrawal must be titled “Revenue Procedure 2020-22 Section 163(j)(7) Election Withdrawal” and must contain:
• The taxpayer’s name;
• The taxpayer’s Social Security number (SSN) or employer identification number (EIN);
• A statement that the taxpayer is withdrawing its election under IRC §163(j)(7)(B) or (C), as applicable</td></tr>
<tr><td colspan="4" align="right">(continued)</td></tr>
</table>

Business Interest Expense Limitation Elections Pursuant to Rev. Proc. 2020-22 (continued)			
Type of election	**Purpose of election**	**Election deadline**	**How to make election**
IRC §163(j)(1)(A)(iii) election out of 50% ATI limitation	Allows taxpayers to make a revocable election out of use of increased 50% ATI limitation for 2019 and 2020 taxable year. The election must be made separately each year	Timely filed return (including extensions) for 2019 or 2020 tax year (2020 tax year only for partnerships) or amended income tax return, amended Form 1065, or AAR	No election statement required. Taxpayer uses 30% ATI limitation rather than 50% limitation
IRC §163(j)(10)(B) election to use taxpayer's 2019 ATI	Allows taxpayers to make a revocable election to use their 2019 ATI for purposes of calculating their 2020 ATI limitation	Timely filed return (including extensions) Election may be revoked by timely filed amended return or AAR	No election statement required. Taxpayer uses 2019 ATI on 2020 return
IRC §163(j)(10)(A)(ii)(II) election by partner to elect out of deducting 50% of excess business interest expense	Allows partners to elect out of deducting up to 50% (rather than 30%) of excess business interest expense	Timely filed returns or amended returns (including extensions) or AARs Election may be revoked by timely filed amended return or AAR	No election statement required. Taxpayers use 50% limitation on the return

FINAL REGULATIONS

Final regulations pull back on expansive definition of business interest

The definition of "interest" for purposes of the business interest expense limitation goes beyond the standard understanding of what constitutes "interest." It includes any amount that is paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement.

The following items were included within the expansive definition of interest expense in the proposed regulations but were removed from the final regulations:

- Loan commitment fees;
- Debt issuance costs;
- Guaranteed payments paid for the use of capital under IRC §707(c); and
- Hedging transactions.

While the final regulations removed guaranteed payments for the use of capital, that does not mean that guaranteed payments for the use of capital are never treated as interest. The anti-avoidance rules contained in Treas. Regs. §1.163(j)-1(b)(22)(iv) include an example of a situation in which a guaranteed payment for the use of capital is treated as interest expense and interest income for purposes of IRC §163(j). (Treas. Regs. §1.163(j)-1(b)(22)(v)(E), Example 5)

As with guaranteed payments for the use of capital, the IRS, in its summary of the final regulations, states that in certain circumstances, the anti-avoidance rules may apply to require income, deduction, gain, or loss from a hedging transaction to be taken into account for purposes of IRC §163(j).

Partnership allocation rules

Treas. Regs. §1.163(j)-6(f)(2) provides an 11-step approach for partnerships to follow in determining how to allocate deductible interest expense, excess business interest expense, excess taxable income, and excess business income to each of its partners when a partnership uses special allocations. The rules are designed to prevent a partnership from allocating, on aggregate, more deductible expenses to the partners than would be available if the partnership alone had claimed the deduction and its carryovers.

The IRS broke down the 11-step approach into Worksheets A and B provided in the Form 8990 instructions.

Final regulations provide a simplified computation approach

The final regulations provide a simplified approach to the 11-step computation for partnerships that allocate all items of income and expense on a *pro rata* basis. (Treas. Regs. §1.163(j)-6(f)(2)(ii)) These partnerships are only required to complete steps 1 and 2 of the 11-step computation.

Partnerships that are exempt from the business interest expense limitation

If the partnership is exempt from the limitation due to the $25 million gross receipts threshold ($26 million in 2019 and 2020), no "excess" items are allocated to the partners. Under the 2018 proposed regulations, partnerships were required to pass through their business interest expense and business interest income to their partners, along with all items of income, gain, loss and/or deduction used to compute adjusted taxable income, and the partners must compute their limitation at the partner level. (Prop. Treas. Regs. §1.163(j)-6(m)(1)) This means that that the partnership would pass along items to the partner on the K-1 the same as it did prior to IRC §163(j).

Final regulations provide relief

The final regulations change course and provide that any business interest expenses incurred by a partnership that is an exempt entity (because, for example, its gross receipts are less than the $26 million threshold) are not subject to the IRC §163(j) business interest expense limitation at the partner level. (Treas. Regs. §1.163(j)-6(m)(3))

Example of partnership business interest expense incurred by exempt entity

Janice owns a 95% interest in MP, a manufacturing partnership, whose total gross receipts are $40 million. As such, MP is subject to the business interest limitation rules.

Janice also owns a 10% interest in UP, an unrelated partnership whose total gross receipts are $1 million. UP is an exempt entity because its gross receipts are far below the $26 million threshold.

According to the 2018 proposed regulations, Janice would be required to include her allocable share of UP's income, gain, loss and/or deduction to compute her adjusted taxable income and calculate her business interest expense limitation.

However, the 2020 final regulations reverse the 2018 proposed regulations and allow Janice to disregard her interest in UP when calculating her business interest expense limitation.

Relief extends to S corporations as well

This same rule naturally applies to S corporations and their shareholders as well.

Caution

Tax professionals should not jump into a false sense of security by the position taken in the final regulations regarding exempt business entities. If a client has a business interest whose gross receipts are less than $25 million ($26 million in 2019 and 2020), the inquiry should not end there.

If the UP partnership in the previous example was subject to the aggregation rules or is deemed to be a tax shelter, then it can still be pulled into Janice's business interest expense limitation.

Final regulations slightly modify definition of "tax shelter"

"Tax shelters" don't qualify for the gross receipts exemption. A "tax shelter" is defined by reference to IRC §461(i)(3), which includes a "syndicate." A syndicate is any partnership or other entity (other than a corporation which is not an S corporation) if more than 35% of the losses of such entity during the taxable year are actually allocated to limited partners or "limited entrepreneurs." (Treas. Regs. §1.163(j)-2(d)(1); IRC §1256(e)(3)(B)) Limited entrepreneurs are nonlimited partner owners that are not actively engaged in the operations or management of the business. (IRC §461(k)(4))

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))

Active participation is not defined in the Code or regulations for purposes of the business interest limitation.

Example of small business deemed to be tax shelter

Bren forms a partnership to buy an apartment building. She is the general partner, and she convinces two unrelated individuals to invest $200,000 each in exchange for a 20% limited partnership interest in the partnership, for a total of a 40% interest. All items of income, gain, loss, and deduction are allocated to the partners per their partnership interest.

The partnership borrows $400,000 to make the purchase.

During the first year of operations, the partnership pays $25,000 in business interest and the partnership operates at a loss, 40% of which is allocated to the two limited partners.

The partnership is considered a tax shelter in that year and therefore does not qualify for the small business exemption. The partnership is subject to the business interest expense limitation.

"Allocated" versus "allocable"

When IRC §163(j) was enacted, commentators wondered whether the operative word would be "allocated" or "allocable." If allocable, the limitation would apply in all tax years if more than 35% of losses are allocable to limited partners or limited entrepreneurs regardless of whether the partnership is actually allocating losses in a tax year. If allocated, the limitation would apply only in years in which the partnership is actually allocating losses.

In proposed regulations, the IRS made clear that the operative word is "allocated." (Prop. Treas. Regs. §1.163(j)-2(d)(1)) Moreover, the IRS stated that the determination as to whether the partnership is allocating losses is based on the excess of losses of the partnership over the amount of income recognized by the partnership under the partnership's method of accounting used for tax purposes. For this purpose, gains or losses from the sale of capital assets or IRC §1221(2) assets are not taken into account.

This could mean that a single dollar could trigger the tax shelter rules in any given year.

Example of allocated loss

Partnership has $20 million of gross receipts. It allocates 90% of its income and losses to limited partners.

During the taxable year it has $1 million of taxable income before its business interest expense and $1 million of business interest expense (its taxable income before business interest is also its ATI as is commonly the case). It is not subject to the tax shelter rules and it qualifies under the gross receipts exemption. Therefore, its business interest expense is not limited and it allocates zero to every partner.

Assume that its business interest expense was $1 more than $1 million. It is now allocating a $1 loss before the IRC §163(j) limitation. It is a tax shelter in that year and cannot use the gross receipts exemption and is subject to IRC §163(j). It can only deduct interest of 30% of its ATI (using the general rule of 30%). Therefore, it will allocate $700,000 of income to its partners.

Electing real property trade or business or farming business

The final regulations provide that taxpayers may make an election for a trade or business to be an electing real property trade or business or an electing farming business, provided they qualify to make such an election, even if their gross receipts are under the $25 million threshold ($26 million in 2019 and 2020). (Treas. Regs. §1.163(j)-9)

If the election is made in a year when gross receipts are under the gross receipts threshold, the election will be treated as a protective election until the first year that gross receipts are equal to or greater than the threshold. Until such year, the election will not be in effect and, therefore, the entity will not be limited to ADS depreciation until that year.

Example of protective elections

RP is a real estate partnership. Using the three-year gross receipts averaging, it calculates its average gross receipts of $24 million in 2020 and $28 million in 2021. RP also put $500,000 of qualified improvement property into service in 2020 and $650,000 in 2021.

RP makes an election to be treated as a real property trade or business under IRC §163(j) on its 2020 income tax return.

RP is an exempt business in 2020 because its average gross receipts are below $26 million. As such, its election to be treated as a real property trade or business under IRC §163(j) is treated as a protective election in 2020 — which means the election won't take effect until RP's average gross receipts climbs over the threshold or RP otherwise becomes subject to the business interest limitation rules.

For the 2020 tax year, RP can therefore claim bonus depreciation with respect to the $500,000 of qualified improvement property it placed into service during the year.

RP's average gross receipts are over the threshold in 2021, thus making the partnership subject to the business interest expense limitation rules. Likewise, RP's election to be treated as a real property trade or business under IRC §163(j), which was made as a protective election on its 2020 income tax return, is now effective for the 2021 tax year.

For the 2021 tax year, RP cannot claim bonus depreciation with respect to the $650,000 of qualified improvement property it placed into service during the year, or any future year. RP must use ADS depreciation for this property.

Qualified improvement property

The CARES Act corrected the TCJA drafting error and retroactively treats qualified improvement property as 15-year MACRS property, which is eligible for bonus depreciation. Taxpayers engaged in real property trades or businesses should think twice about electing out of the business interest limitation rules. A real property trade or business that elects out of the business interest limitation rules must use ADS depreciation and cannot use bonus depreciation.

Farming businesses can also elect out of the business interest limitation rules and likewise must use ADS depreciation.

NEW PROPOSED REGULATIONS

When the first set of proposed regulations were issued in November 2018 under IRC §163(j), two issues were intentionally left out to give the IRS more time to develop rules. They were:

- Self-charge lending transactions; and
- Treatment of excess business interest expense rules for tiered partnerships.

Self-charge lending transactions

The newly proposed regulations address self-charge lending transactions between a partnership and its partners. If:

- A partner makes a loan to a his or her partnership; and
- The partner is allocated excess business interest expense for the year; and
- The partner has interest income attributable to the self-charged loan for the year;
- Then the partner must treat the self-charged interest income as an allocation of excess business interest income from the partnership to the extent of the partner's allocation of excess business interest expense from the partnership.
  (Prop. Treas. Regs. §1.163(j)-6(n))

Self-charge lending rules do not apply to S corporations

The self-charge lending transactions do not apply to S corporations because excess business interest expense of an S corporation is carried over at the S corporation level.

Treatment of excess business interest expense for tiered partnerships

In its newly issued proposed regulations, the IRS has concluded that an entity approach is the most appropriate method to approach the business interest limitation rules where tiered partnerships are involved. Accordingly, the proposed regulations provide that if a lower-tier partnership allocates excess business interest expense to an upper-tier partnership, then the upper-tier partnership reduces its basis in the lower-tier partnership. (Prop. Treas. Regs. §1.163(j)-6(j)(3); Prop. Treas. Regs. §1.163(j)-6(h)(2))

Upper-tier partnership partners do not, however, reduce their basis in the upper-tier partnership interest until the upper-tier partnership treats the excess business interest expense as business interest expense paid or accrued. (Prop. Treas. Regs. §§1.163(j)-6(h)(2), 1.163(j)-6(g))

SAFE HARBOR FOR QUALIFIED RESIDENTIAL LIVING FACILITIES

In order to clear up confusion about whether residential living facilities (which include facilities that provide supplemental assistive, nursing, or routine medical services) qualify as an electing real property trade or business, the IRS issued Notice 2020-59 to provide a safe harbor for these businesses.

Qualified residential living facilities that meet the requirements of Notice 2020-59 are eligible to make an election to be treated as a real property trade or business for IRC §163(j) purposes only. The determination cannot be used outside of the business interest limitation rules. (Notice 2020-59)

AGGREGATION FAQs

At the same time it released its final regulations under IRC §163(j), on July 28, 2020, the IRS also issued a series of frequently asked questions pertaining to the aggregation rules under IRC §163(j).

The FAQs mainly address which sets of aggregation rules under the Internal Revenue Code apply to various types of business entities. For example, when all entities considered for aggregation are corporations, then the aggregation rules under IRC §52(a) apply, which in turn, refer to the rules under IRC §1563. (FAQ #1) However, if not all of the entities considered for aggregation are corporations, then the aggregation rules under IRC §52(b) and Treas. Regs. §1.52-1(b) apply. (FAQ #6)

The FAQs don't introduce new rules, rather they provide some common language clarification as well as some examples. There are 11 FAQs in total, and they can be found at the following IRS website:

Website
www.irs.gov/newsroom/faqs-regarding-the-aggregation-rules-under-section-448c2-that-apply-to-the-section-163j-small-business-exemption

EXTENDERS

The Further Consolidated Appropriations Act of 2020 was signed into law on December 20, 2019. The act reinstated many expired tax provisions (some of which expired on December 31, 2017). The following provisions were reinstated retroactively to the 2018 tax year and are effective through the 2020 tax year, except as otherwise noted. Taxpayers can go back and amend their income tax returns for 2018 and 2019 to take advantage of the retroactive tax extenders.

Note the following reinstated business provisions:

- Special expensing rules for film, television, and live theatrical production under IRC §181;
- Three-year depreciation for race horses two years old or younger under IRC §168(e)(3)(A)(i);
- Seven-year recovery period for motorsports entertainment complexes under IRC §168(i)(15)(D);
- Accelerated depreciation for business property on Indian reservations under IRC §168(j)(9);
- The Indian Employment Credit under IRC §45A;
- Designations for empowerment zones under IRC §1391;
- The railroad track maintenance credit under IRC §45G (now made permanent by the TCDTRA); and
- The mine rescue team training credit under IRC §45N.

The following provisions, originally scheduled to expire at the end of 2019, are extended one more year, to the end of 2020:

- The IRC §45D New Markets Credit, and the available credit allocation is increased from $3.5 billion to $5 billion for 2020;
- The credit for health insurance costs of eligible individuals under IRC §35;
- The employer credit for paid family and medical leave under IRC §45S;
- The work opportunity credit under IRC §51; and
- Various incentives related to beer, wine, and distilled spirits, including the reduced rate of excise taxes under IRC §§5001, 5041, 5051 (now made permanent by the TCDTRA).

The TCJA provision that included in unrelated business taxable income certain fringe benefit expenses paid by an exempt organization is repealed retroactively.

The bill also extends many disaster-related provisions for 2018 and 2019 disasters, but these provisions are not applicable to any California-related disasters.

OTHER YEAR-END STIMULUS BILL PROVISIONS

Under Division EE, Taxpayer Certainty and Disaster Tax Relief Act (TCDTRA) of the Consolidated Appropriations Act of 2021, the following tax provisions, have been made permanent:

- The IRC §179D energy efficient commercial buildings deduction and an inflation adjustment applies to the maximum deduction limitations, effective beginning with taxable years beginning after 2020. (TCDTRA §102; IRC §179D) In addition, various energy standards are updated and revised, applicable to property placed in service after December 31, 2020;
- The exclusion of state and local tax benefits and qualified payments made to volunteer firefighters and emergency medical responders under IRC §139B (TCDTRA §103);
- The IRC §45G Railroad Track Maintenance Credit; and
- The reductions in the beer, wine, and distilled spirits excise taxes enacted by the TCJA. (TCDTRA §106)

The following provisions, which were scheduled to sunset at the end of the 2020 taxable year, have now been extended an additional five years through the end of the 2025 taxable year:

- Work Opportunity Tax Credit (TCDTRA §113; IRC §51);
- Employer Credit for Paid Family and Sick Leave (TCDTRA §119; IRC §45S);
- New Markets Tax Credit (TCDTRA §112; IRC §45D);
- Carbon Oxide Sequestration Credit (TCDTRA §121; IRC §45Q);
- Empowerment zone tax incentives (TCDTRA §118; IRC §§1391, 1397, 1397B);
- Expensing rules for qualified film, television, and theatrical productions (TCDTRA §116; IRC §181);
- Seven-year recovery period for motorsports entertainment complexes (TCDTRA §115; IRC §168(i)(15)(D)); and
- The look-through rule for related controlled corporations. (TCDTRA §111; IRC §954)

The American Samoa Economic Development Credit is extended through the end of the 2021 taxable year. (TCDTRA §139)

The following were extended for an additional year, except as otherwise noted:

- The phaseouts for the business solar credit have been extended, allowing for construction that begins in 2021 and 2022 to qualify for a 26% credit, and the reduced 22% credit will apply to property for which construction begins in 2023. (TCDTRA §132; IRC §48) In addition the business Energy Credit is extended to apply to waste energy recovery property, which is defined as property that generates electricity solely from heat from buildings or equipment not normally used for generating electricity, beginning with the 2021 taxable year (TCDTRA §203; IRC §48);
- The election to claim the IRC §48 Investment Credit in lieu of the IRC §45 Energy Credit. The election is also extended to apply to offshore wind facilities through 2025 (TCDTRA §§131(b), 204; IRC §48(a)(5));
- Credit for Electricity Produced From Certain Renewable Sources, including the phaseouts (TCDTRA §§131, 132; IRC §45(d));
- Qualified Fuel Cell Motor Vehicles Credit (TCDTRA §142; IRC §30B);
- Alternative Fuel Refueling Property Credit (TCDTRA §143; IRC §30C);
- Energy Efficient Homes Credit for home builders (TCDTRA §146; IRC §45L);
- Second Generation Biofuel Producer Credit (TCDTRA §140; IRC §40); and
- Extension of Excise Tax Credits relating to alternative fuels. (TCDTRA §147; IRC §6426)

The following provisions, which were scheduled to sunset at the end of the 2020 taxable year, have now been extended an additional year through the 2021 taxable year:

- Indian Employment Credit (TCDTRA §135; IRC §45A);
- Mine Rescue Team Training Credit (TCDTRA §136; IRC §45N);
- Accelerated depreciation for Indian reservation business property (TCDTRA §138; IRC §168(j)(9)); and
- Classification of certain race horses as three-year property. (TCDTRA §137; IRC §168(e))

The TCDTRA and ACRRA also make the following changes:

- Sets a minimum 4% Low-Income Housing Credit rate for federally subsidized buildings (TCDTRA §201; IRC §42(b)); and
- Clarifies that ADS depreciation over 30 years applies for residential rental property, no matter when the property was placed in service, for taxpayers that are electing real property trades or businesses under the business interest imitation rules. (TCDTRA §202)

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.*

10. What are among the factors relating to the employee's portion of Social Security tax deferral?

    a) The deferral is available to employees with an annual salary under $150,000
    b) Under Notice 2020-65, the ultimate liability for the tax amounts not withheld is with the employee
    c) If the employee requests a deferral of taxes, the employer is not required to withhold the employee's portion of Social Security
    d) An employer may withhold from an employee's final paycheck the amount of the deferred tax

11. Employees must repay the deferral through double withholding during the period January 1, 2021, to April 1, 2021Under the FFCRA, how will employer payroll credits work?

    a) The employer's gross income must be increased by the amount of the payroll tax credit for paid sick leave and paid family leave
    b) Employers may claim a refundable credit of 50 cents on the dollar for paid sick leave or paid family leave against their payroll taxes
    c) The credits are claimed on Form 941, Employer's Quarterly Federal Tax Return, beginning with the first quarter of 2020
    d) The amount of health plan expenses taken into account in determining the credits includes only the portion of the costs paid by the eligible employer

12. How do payroll tax credits apply to self-employed taxpayers?

    a) The applicable credit is refunded to self-employed taxpayers when they compute their self-employment and income taxes when filing their Form 1040
    b) Refundable credits against self-employment tax may be taken quarterly
    c) Self-employed taxpayers that have employees may only get credits under the employer rules
    d) Self-employed individuals who are also employees of another company receive a double benefit on the amount of paid family leave and paid sick leave benefits they may receive

13. What is true about the Employee Retention Credit?

    a) Only a company that fully suspended operations qualifies for the credit
    b) A significant decline in gross receipts is 80%
    c) Wages paid to children of the owner are qualified wages
    d) There is no maximum number of employees who may lead to a credit

14. What are among the limitations of the Employee Retention Credit?

    a) For employers with more than 100 full-time employees, the credit applies whether or not the employee is furloughed with pay
    b) The credit may be claimed if the employer continues to pay 100% of the wages to employees who are working reduced hours, but the credit may only be claimed for that part of the wages that can be attributed to the reduced hours
    c) Any increase in wages may be included in qualified wages
    d) For employers with more than 100 full-time employees, amounts paid to employees for paid sick leave will count as qualified wages

15. Under the CARES Act, what is true about the excess business loss limitation?

    a) The implementation of the limitation applies beginning with the 2018 tax year
    b) An excess business loss is the excess of the aggregate of all of the taxpayer's business deductions or losses over aggregate gross revenues
    c) When it comes to the excess business loss limitation, W-2 wages are not included in business income
    d) The TCJA technical amendments include NOLs and IRC §199A in business deductions used to compute the excess business loss

16. For various types of property, how does bonus depreciation and/or §179 apply?

    a) §179 may be claimed on all or part of an asset
    b) Both §179 and bonus depreciation may be claimed for HVAC units, security systems, and fire alarms
    c) For 2020, there is an IRC §179 limitation of $18,100 for sports utility vehicles
    d) Bonus depreciation has no sunset date

17. What is the latest guidance from the IRS on meals and entertainment for businesses on the 2020 returns?

    a) Meals for employees who are traveling for business are 100% deductible
    b) Office parties for employees are subject to the 50% meals limitation
    c) Food that is purchased separately at an entertainment activity is eligible for a 50% deduction if it is a business meal
    d) Client meals that used to be deducted at 50% are now eliminated

18. In Notice 2020-43, the IRS provides two safe harbors for determining tax basis capital accounts. Which choice is true regarding this determination?

    a) With the modified outside basis method, the partnership subtracts the partner's share of partnership liabilities from their outside basis
    b) The simplest method to use is the modified previously taxed capital method
    c) All partnerships are required to comply with the new reporting requirements
    d) In order to use the safe harbor, Schedule M-3 must be filed

19. The IRS has finalized the proposed business interest expense limitation regulations. What is among the modifications?

    a) The IRS has included loan commitment fees and guaranteed payments for the use of capital in the definition of interest expense
    b) If a lower-tier partnership allocates excess business interest expense to an upper-tier partnership, the upper-tier partnership does not reduce its basis in the lower-tier partnership
    c) The definition of "tax shelter" has been broadened and now states that 35% of the losses must be allocable to passive investors in order to be treated as a tax shelter
    d) If a flowthrough entity is exempt from the business interest expense limitation rules, then any flowthrough items are not included in a partner's $26 million threshold for 2019 and 2020

SOLUTIONS TO REVIEW QUESTIONS

10. What are among the factors relating to the employee's portion of Social Security tax deferral? **(Page 4-4)**

    a) Incorrect. The deferral is available to employees with biweekly wages of $4,000, which annually equates to $104,000.
    b) Incorrect. Although the liability is with the employee, the ultimate liability under the notice remains with the employer.
    c) Correct. There is no requirement that the employer must comply with the request.
    d) Incorrect. The period for repayment is from January 1 to April 30, 2021.

11. Under the FFCRA, how will employer payroll credits work? **(Page 4-9)**

    a) Correct. In this way, the employer does not receive a double tax benefit.
    b) Incorrect. The credit is dollar for dollar against payroll taxes.
    c) Incorrect. The credits apply beginning with the second quarter of 2020.
    d) Incorrect. It also includes the portion paid by the employee with pretax salary reduction contributions.

12. How do payroll tax credits apply to self-employed taxpayers? **(Page 4-9)**

    a) Correct. Self-employers may factor in their expected credits when computing their quarterly estimated tax payments.
    b) Incorrect. They are only refunded when Form 1040 is filed, although they may be factored in for quarterly estimated tax purposes.
    c) Incorrect. Credits apply both under the employer and self-employed rules.
    d) Incorrect. There is no double benefit; the maximum benefit will still be $10,000 for paid family leave benefits and $5,110 for paid sick leave benefits.

13. What is true about the Employee Retention Credit? **(Page 4-14)**

    a) Incorrect. The credit is allowed for a business the fully or partially suspended operations.
    b) Incorrect. A significant decline in gross receipts is 80%.
    c) Incorrect. Wages paid to relatives are not qualified wages.
    d) Correct. There is no limit on the number of qualified employees.

14. What are among the limitations of the Employee Retention Credit? **(Page 4-19)**

    a) Incorrect. The employee must be furloughed with pay.
    b) Correct. If wages are reduced by 40%, but 100% of the normal wage rate is paid for those hours, for example, the credit may only be claimed for 40% of the wages paid.
    c) Incorrect. An increase in wages paid after the immediately prior 30-day pay period is not included in qualified wages.
    d) Incorrect. For 2019, wages paid for vacations, holidays, sick leave, etc., don't count as qualified wages, although if the employer has 100 or fewer employees, paid leave or vacation does count.

15. Under the CARES Act, what is true about the excess business loss limitation? **(Page 4-29)**

    a) Incorrect. It applies to the 2021-2025 taxable years.
    b) Incorrect. This amount must be added to a threshold amount for the year ($250,000, or $500,000 MFJ, adjusted for inflation.
    c) Correct. This was unclear prior to changes brought about under the CARES Act.
    d) Incorrect. NOLs, §199A, and capital loss deductions are excluded from the calculation.

16. For various types of property, how does bonus depreciation and/or §179 apply? **(Page 4-31)**

    a) Correct. It may be elected on an asset-by-asset basis or on a portion of an asset.
    b) Incorrect. Only §179 may be claimed.
    c) Incorrect. There is a §179 limitation on sport utility vehicles of $25,900.
    d) Incorrect. §179 has no sunset date, but bonus depreciation will be phased out beginning in 2023.

17. What is the latest guidance from the IRS on meals and entertainment for businesses for 2020? **(Page 4-36)**

    a) Incorrect. They are 50% deductible.*
    b) Incorrect. A holiday party or other activity for the employees' benefit is fully deductible.*
    c) Correct. The food and beverages must have separate bills from the entertainment activity.
    d) Incorrect. Client meals that are related to a business meeting remain 50% deductible.*

    *Under TCDTRA, business meals provided by a restaurant are 100% deductible if the meal is provided by a restaurant from 1/1/21-12/31/22

18. In Notice 2020-43, the IRS provides two safe harbors for determining tax basis capital accounts. Which choice is true regarding this determination? **(Page 4-41)**

    a) Correct. This is considered the easier method. The partner's outside basis is their basis in their partnership interest.
    b) Incorrect. This is the more complex method. The easiest method is the modified outside basis method.
    c) Incorrect. There are exceptions for those partnerships that meet certain requirements applicable to lower total receipts and assets, for example.
    d) Incorrect. Schedule M-3 is from Form 1120 – Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More. This schedule should not be filed or required to be filed.

19. The IRS has finalized the proposed business interest expense limitation regulations. What is among the modifications? **(Page 4-46)**

    a) Incorrect. The definition has been narrowed so that loan commitment fees, debt issuance costs, guaranteed payments for the use of capital, and hedging transactions are not considered business interest expenses.
    b) Incorrect. The upper-tier partnership does reduce its basis in the lower-tier partnership.
    c) Incorrect. It's just the opposite. The definition has been narrowed by changing the word "allocable" to the requirement that the allocation must actually have been made.
    d) Correct. This would be the case, for example, if the partnership's gross receipts are below the threshold.

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Chapter 5

Retirement

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RETIREMENT

The Further Consolidated Appropriations Act of 2020, signed into law in December 2019, included the Setting Every Community Up for Retirement Enhancement (SECURE) Act within its provisions. The majority of the SECURE Act dealt with retirement provisions, which we will discuss throughout this chapter. A summary of all the SECURE Act provisions can be found at page 12-25.

The CARES Act also provided some relief to taxpayers who needed to access their retirement accounts early to help weather the COVID-19 pandemic.

TRADITIONAL IRAs

IRA CONTRIBUTION AMOUNTS

An individual may make deductible contributions to an IRA up to the lesser of $6,000 or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored plan. Married couples can make a deductible IRA contribution of up to $12,000 if the combined compensation of both spouses is at least equal to the contributed amount.

Maximum IRA Contribution	
2020 (Notice 2019-59)	**2021 (Notice 2020-79)**
$6,000	$6,000

Catch-up contributions

Catch-up contributions for individuals age 50 and older remain at $1,000 for 2020 and 2021.

Earned income may include alimony

Earned income includes alimony, but only if it is includable in the taxpayer's gross income. (IRC §219(f)(1)) This generally includes alimony income received pursuant to divorce or separation agreements executed prior to January 1, 2019, but not after December 31, 2018 (see page 1-22).

Expansion of earned income for IRA contributions

For taxable years beginning after December 31, 2019, the SECURE Act expands the definition of earned income to include:

- Amounts included in an individual's gross income and paid to the individual in the pursuit of graduate or postdoctoral activity. (SECURE Act §106; IRC §219(f)(1)) Such amounts include fellowships, stipends, or any other similar amounts paid to the individual; and
- In-home supportive services (IHSS) payments for purposes of IRAs and defined contribution plans. (SECURE Act §116(b); IRC §§408(o)(5), 415(c)(9))

California conformity

California conforms to this expanded definition of "earned income." (R&TC §17203)

TAXPAYER ACTIVE IN EMPLOYER-SPONSORED PLANS

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)**
2020 (Notice 2019-59)	$65,000–$75,000	$104,000–$124,000	$0–$10,000
2021 (Notice 2020-79)	$66,000–$76,000	$105,000–$125,000	$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	**2020**	**2021**
AGI phaseout range	$196,000–$206,000	$198,000–$208,000

California conformity

California currently conforms to these contribution limits. (R&TC §17501)

CONTRIBUTIONS AFTER AGE 70½

For taxable years beginning after December 31, 2019, the SECURE Act removed the age restrictions for taxpayers to contribute to a traditional IRA. (SECURE Act §107, repealing IRC §219(d)(1)) Contributions are still limited to the lesser of the taxpayer's earned income or the contribution limits ($6,000 in 2020, plus a $1,000 catch-up for taxpayers age 50 and over).

California conformity

California does not conform to the SECURE Act provisions permitting a deduction for traditional IRA contributions after age 70½. This creates a basis in the IRA for California purposes.

Example of traditional IRA contributions after age 70½

Rex is 74 years old and mostly retired. However, he still works part-time at the local hardware store. In 2020, Rex's earned income is $20,000, If Rex makes the maximum traditional IRA contribution of $7,000 for 2020, then he can claim a federal above-the-line deduction for his contribution, and he will have zero basis in his contribution (because he received a tax deduction for it).

For California purposes, Rex will not receive a deduction for his contribution because California does not conform to this provision. Therefore, Rex has basis in his traditional IRA of $7,000 for California purposes because of his nondeductible contribution.

Spousal IRA contributions

A taxpayer who files a joint return can contribute to an IRA even if they don't have earned income as long as their spouse has sufficient earned income. (IRC §219(c)(2)) The total combined contributions of both spouses can't be more than the total earned income reported on the return.

The spousal IRA contribution rule has been around long before the SECURE Act, but it can be a great opportunity where one spouse is still working and the other spouse is retired.

Example of spousal IRA contribution

Deena is 71 years old and retired. Her husband Joe is 68 years old and still working. Joe has earned income of $100,000. Their AGI is $120,000. Under the SECURE Act, Deena can contribute up to $7,000 to a traditional IRA using Joe's earned income.

Caution

The only downside to making post-age 70½ contributions is limitations on the IRA-to-charity deduction (see page 5-4).

IRA contracts must be amended to accept post-age 70½ contributions

Even though the SECURE Act removes the age requirement to contribute to a traditional IRA, financial institutions must amend their IRA contracts to allow post-age 70½ contributions. (IRS Notice 2020-68, Q&A B-2) Additionally, financial institutions are not required to amend their IRA contracts. (IRS Notice 2020-68, Q&A B-1)

Practice Pointer

Make sure the client's financial institution has amended the plan. If it has not, find another institution that has language in their plan permitting the contribution.

IRA-TO-CHARITY RULES

Individuals who are at least 70½ years old may exclude from gross income qualified charitable distributions (QCDs) made directly from IRAs of up to $100,000 per year. (IRC §408(d)(8)(F)) These distributions are treated as distributions for RMD purposes. No charitable contribution deduction is allowed for these contributions, but they are excluded from income, so it is like an above-the-line deduction.

Planning Pointer

The SECURE Act increases the age at which taxpayers must take required minimum distributions to age 72. However, the age at which taxpayers can make QCDs remains age 70½. We will discuss the increased age for required minimum distributions on page 5-13.

The distributions may be made from a traditional IRA or from a Roth IRA but not from a SEP, SIMPLE IRA, or other qualified plan. (IRC §408(d)(8))

Practice Pointer

Taxpayers must keep acknowledgement letters for charitable contributions even where the contributions were made directly from an IRA.

Also, QCDs are not reported on Form 1099-R, so practitioners must communicate with their client regarding which charitable contributions were made directly from the client's IRA. Because the Form 1099-R does not indicate when QCDs are made, practitioners must reduce Form 1099-R, box 2a (taxable distributions) from gross income and write "QCD" on the taxable distribution line on their Form 1040. Most tax preparation software products will easily handle this for you.

California conformity

California automatically conforms to the charitable contribution of an IRA to charity. No separate election is allowed. (R&TC §17501(b)) However, see page 8-5 for information on how a QCD with post-70½ contributions is made.

IRA-to-charity limitation

Taxpayers who choose to make deductible IRA contributions after age 70½ will face a new limitation if they later make direct IRA-to-charity contributions (QCDs).

A taxpayer's annual qualified charitable distribution is reduced (but not below zero) by the excess of:

- All aggregate deductible IRA contributions made for years on or after the year the taxpayer reaches age 70½; over
- The aggregate amount of those contributions that have previously reduced QCDs for all years prior to the tax year at issue.
  (SECURE Act §107; IRC §408(d)(8)(A))

This means that each post-age-70½ deductible IRA contribution will reduce a taxpayer's QCD, even if the QCD is in a later year. However, the QCD will only be reduced up to the amount of each post-age-70½ deductible contribution.

Example of SECURE Act's IRA-to-charity limitation

Jane is age 73 in 2020. Jane is still working and makes a $6,000 deductible traditional IRA contribution in 2020, 2021, and 2022, for a total of $18,000 over the three years. In 2023 she stops working and starts making annual $10,000 QCDs from her IRA. Jane's QCDs are reduced as follows:

2023 QCD		$10,000
Minus:		
2020, 2021 and 2022 deductible IRA contributions	18,000	
Prior QCD reductions	- 0	
Total current year QCD reductions	18,000	(18,000)
Jane's QCD for 2023		$ 0[1]

[1] The QCD cannot be reduced below zero; further reductions will happen in future years. In this example, $8,000 of post-age-70½ traditional IRA contributions will carry over to Jane's next taxable year

2024 QCD		$10,000
Minus:		
2020, 2021 and 2022 deductible IRA contributions	18,000	
Prior QCD reductions	- 10,000	
Total current year QCD reductions	8,000	(8,000)
Jane's QCD for 2024		$ 2,000

2025 QCD		$10,000
Minus:		
2020, 2021 and 2022 deductible IRA contributions	18,000	
Prior QCD reductions	- 18,000	
Total current year QCD reductions	0	(0)
Jane's QCD for 2025		$10,000

Comment

We believe the disallowed QCDs will qualify for charitable contribution deductions on Schedule A, as those amounts will be included in the taxpayer's taxable income. However, we will need clarification on this issue.

✎ **Practice Pointer**

For clients who make deductible IRA contributions after age 70½, practitioners should notify them that those cumulative contributions will reduce later QCDs.

How to avoid this limitation

You could avoid the later limitation on QCDs by contributing to a Roth IRA. The other option for self-employed taxpayers with no employees is to make a contribution to a SEP, a 401(k), or a profit sharing plan. Taxpayers who are still working can make contributions to these plans after age 70½, and though these contributions are deductible, they do not reduce future QCDs if subsequently rolled into an IRA.

California nonconformity

California conforms to the IRA-to-charity rules, but because California does not allow a deduction for traditional IRA contributions after age 70½, California taxpayers are not subject to the SECURE Act's new IRA-to-charity limitation that is triggered when taxpayers make deductible traditional IRA contributions after age 70½.

CLIENT LETTER

See page 12-8 for a customizable client letter on making charitable donations from an IRA directly to a charity. You may also download a copy at:

Website
www.caltax.com/files/2020/cl-iracharity.doc

IRA CONTRIBUTION PLANNING

Funding 2020 in 2021

For clients who are still working beyond the age of 70½, the ability to make deductible contributions to their traditional IRA is a great way to reduce AGI, which can reduce the amount of the taxpayer's taxable Social Security benefits and lower the medical expense threshold, among other benefits.

Reducing a taxpayer's AGI in 2020 may also increase economic impact payments under the CARES Act. Economic impact payments are an advance against a 2020 tax credit. Economic impact payments are discussed in greater detail at page 1-1.

Example of last-minute IRA contribution

Sam is single and 71 years old. His AGI in 2018 and 2019 was $135,000. Using those numbers, he does not qualify for an economic impact payment.

Sam retired at the end of 2019, and his 2020 AGI dropped to $79,000, including $5,000 in part-time work. If he makes a $5,000 IRA contribution for 2020, that will drop his AGI to $74,000, and his economic impact payment credit goes from $1,000 to $1,200 on his 2020 return.

EARLY WITHDRAWAL PENALTY/ADDITIONAL TAX

CORONAVIRUS-RELATED DISTRIBUTIONS

Some taxpayers may make penalty-free coronavirus-related withdrawals of retirement funds of up to $100,000 in the aggregate between January 1, 2020, and December 31, 2020.

In addition, the taxpayer may spread the withdrawn amount in taxable income over a three-year period beginning in 2020.

Finally, the taxpayer can recontribute the amounts within three years and avoid taxable income altogether.

Qualifying distributions

Distributions may be made from a plan as described in IRC §402(c)(8)(B), which includes:

- Individual retirement accounts;
- Individual retirement annuities;
- A qualified retirement plan, such as a 401(k), pension, and profit sharing plan;
- An annuity plan;
- An IRC §457 plan for government and nonprofit employers; and
- An annuity contract described in IRC §403(b).
  (CARES Act §2202(a)(4)(C))

Comment
Defined benefit plans are not included.

A coronavirus-related distribution is a distribution made:

- On or after January 1, 2020, and before December 31, 2020;
- To a person diagnosed with SARS-CoV-2 or COVID-19 by a test approved by the Centers for Disease Control and Prevention or whose spouse or dependent was so diagnosed; or
- To a person experiencing adverse financial consequences as a result of:
  - Being quarantined, furloughed, or laid off;
  - Having work hours reduced due to the virus;
  - Being unable to work due to a lack of child care;
  - The closing or reducing of hours of a business owned or operated by the individual due to such virus; or
  - Other factors determined by the Secretary of Treasury.

IRS Notice 2020-50 expands on this list and provides that a coronavirus-related distribution is one made to a qualified individual as a result of:

- The individual having a reduction in pay (or self-employment income) due to COVID-19, or having a job offer rescinded or start date for a job delayed due to COVID-19;
- The individual's spouse or a member of the individual's household (as defined below) being quarantined, being furloughed or laid off, or having work hours reduced due to COVID-19, being unable to work due to lack of child care due to COVID-19, having a reduction in pay (or self-employment income) due to COVID-19, or having a job offer rescinded or start date for a job delayed due to COVID-19; or
- Closing or reducing hours of a business owned or operated by the individual's spouse or a member of the individual's household due to COVID-19.

For purposes of applying these additional factors, a member of the individual's household is someone who shares the individual's principal residence.

Practice Pointer

The administrator of an eligible retirement plan may rely on an employee's certification that the employee satisfies the conditions just listed in determining whether any distribution is a coronavirus-related distribution. (CARES Act §2202(a)(4)(B))

Businesses and plan administrators should keep a copy of the employee's written self-certification for its records.

Three-year income inclusion

The withdrawn amount is included in the taxpayer's gross income ratably over a three-year period beginning in 2020. However, the taxpayer may elect to report the income in the year the distribution was received (2020). (CARES Act §2202(a)(5))

Example of qualified distribution treatment

Daniel took a $90,000 distribution from his IRA account in 2020 after being laid off from his job for a qualifying coronavirus-related reason. He may elect to include the entire $90,000 in his 2020 return, or include $30,000 per year for 2020, 2021, and 2022. In any case he will not be subject to a penalty under IRC §72(t).

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) We believe that a taxpayer could make a different election for California purposes and, for example, report 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)

Withholding

Although the income is subject to tax, there is no withholding required on a coronavirus-related distribution from an employer plan. (CARES Act §2202(a)(b))

Repayments

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)) 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 5-30).

If a taxpayer repays all, or some, of their coronavirus-related distribution after they filed prior-year returns, then the taxpayer must go back and amend their previously filed returns to reduce the distributions reported by the amount that was repaid.

Example of repayments into different retirement account and amended return requirement

Samantha withdrew $60,000 from her employer's 401(k) plan as a coronavirus-related distribution on April 9, 2020. On April 8, 2023, Samantha repaid the $60,000 into her traditional IRA.

In this scenario, Samantha repays the IRA distribution on the last possible day (the date that is three years from the day after she received her coronavirus-related distribution).

Samantha may treat the $60,000 repayment into her traditional IRA as a rollover from her employer's 401(k) because rollovers from 401(k)s into traditional IRAs are permitted transactions under the Code.

When she filed her 2020 income tax return, she had the option of either including the entire $60,000 into her income in 2020 or including $20,000 in her income in 2020, 2021, and 2022. In either event, Samantha must file amended returns to reverse the previous income inclusion.

Practice Pointer

In its coronavirus-related distribution guidance, the IRS has not addressed how a taxpayer calculates their three-year income inclusion where the taxpayer only repays a portion of their coronavirus-related distribution in a later year.

For example, assume that in the previous example Samantha only repaid $30,000 (one-half) of her coronavirus-related distribution into her traditional IRA on April 8, 2023, and that when she filed her 2020 income tax return, she elected to spread her income inclusion over three years (2020, 2021, and 2022). We do not know what options the IRS will permit for taxpayers in Samantha's position.

California conformity

California conforms to the provision allowing the recontribution to the IRA. (R&TC §§17024.5(e), 17507)

See pages 5-9A through 5-9C.

PENALTY-FREE "BABY WITHDRAWALS"

The SECURE Act allows parents to take a penalty-free withdrawal of up to $5,000 from an eligible retirement plan within one year of the birth or adoption of a child, effective for distributions made after December 31, 2019. (IRC §72(t)(2)(H); SECURE Act §113)

A distribution related to an adoption will qualify for penalty-free treatment if the child is under age 18 or is physically or mentally incapable of self-support. However, an "eligible adoptee" does not include a child who is a child of the taxpayer's spouse.

The distribution is subject to income tax but will not be subject to the 10% penalty.

RETIREMENT PLAN DISASTER RELIEF

Penalty-free disaster distributions

Individuals may take 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)) However, if an individual is affected by more than one disaster, the $100,000 limitation above is applied separately with respect to distributions made with respect to each qualified disaster.

The amount withdrawn is recognized in gross income ratably over a three-year period beginning with the year of withdrawal, unless the taxpayer elects to have it recognized in the year of the withdrawal. (TCDTRA §302(a)(5))

The distributions are not subject to withholding. (TCDTRA §302(6))

If the retirement plan accepts rollover contributions, taxpayers may repay the amount distributed within a three-year period, beginning on the date on which the distribution was received. The distribution/repayment will be treated as a direct trustee-to-trustee transfer. This means it will not be counted against the "one rollover per year" limitation.

Qualifying distributions

The distribution only qualifies if it is made:

- On or after the first day of the incident period of the qualified disaster and before June 25, 2021, (180 days after the date of the TCDTRA's enactment);
- To an individual whose principal place of abode is located in the qualified disaster area (see page 4-22A for the definition of a "qualified disaster area"); and
- To an individual who has sustained an economic loss by reason of the qualified disaster.

Eligible retirement plans

Distributions may be made from a plan described in IRC §402(c)(8)(B), which includes:

- Individual retirement accounts;
- Individual retirement annuities;
- A qualified retirement plan, such as a 401(k), pension, and profit sharing plan;
- An annuity plan;
- An IRC §457 plan for government and nonprofit employers; and
- An annuity contract described in IRC §403(b).

Comment

Defined benefit plans are not included. However, the TCDTRA confirmed that money purchase plans qualify.

Comparison to coronavirus-related distributions provided under the CARES Act

Penalty-free disaster distributions from retirement accounts under the TCDTRA are different from coronavirus-related withdrawals provided under the CARES Act, even though some of the provisions are similar. For example, both the disaster distributions under the TCDTRA and the coronavirus-related distributions under the CARES Act provide:

- A three-year window to repay the distributions and treat them as trustee-to-trustee rollovers; and
- Distributions are eligible from the same type of retirement accounts.

However, there are a couple of key differences:

- The CARES Act limits coronavirus-related withdrawals to $100,000 in total, but the TCDTRA allows withdrawals of up to $100,000 per disaster;
- Coronavirus-related distributions under the CARES Act must be made during 2020, but disaster withdrawals under the TCDTRA must be made between the first date of the applicable disaster's incident period and June 25, 2021, (180 days after the end of the incident period), regardless of year. But keep in mind, only taxpayers located in areas that are a Presidentially declared disaster from January 1, 2020, until February 25, 2021, (60 days after the date of the TCDTRA's date of enactment) qualify for this relief.

See page 5-6 for a complete discussion of coronavirus-related withdrawals.

Recontributions of withdrawals for home purchases

Individuals who withdrew funds from a retirement account to purchase a home and were unable to complete the sale due to a qualified disaster can recontribute the funds, or any portion thereof, to the same retirement account or another retirement account to which a rollover contribution is allowed. (TCDTRA §302(b)) The recontribution is treated as a direct trustee-to-trustee rollover.

There are very specific requirements in the TCDTRA that must be met for a recontribution to be allowed. The original retirement account distribution must have been:

- Treated as:
  - A hardship distribution from a 401(k) plan (IRC §401(k)(2)(B)(i)(IV)) used to purchase a home;
  - A hardship distribution from an employee annuity (IRC §403(b)(7)(A)(i)(V) and (b)(11)(B)) used to purchase a home; or
  - A penalty-free distribution for first-time homebuyers (applies to IRAs, SEP IRAS, SIMPLE IRAs, and SARSEP plans only) (IRC §72(t)(2)(F));
- Intended for use to purchase or construct a principal residence in a qualified disaster area, but was not so used due to the qualified disaster;
- Received within 180 days before the first day of the disaster incident period and ending 30 days after the last day of the disaster incident period; and
- Repaid within the "applicable period," which begins on the first day of the disaster's incident period and ends June 25, 2021, (180 days after the date of the enactment of the TCDTRA).

Disaster-related loans from qualified retirement plans

Under the TCDTRA, if a taxpayer's principal place of abode is located in a qualified disaster area and the taxpayer has sustained a disaster-related economic loss, then the taxpayer is eligible to increase his or her qualified plan loan limit:

- From $50,000 to $100,000; and
- Can borrow up to 100% of the employee's vested account balance.
(TCDTRA §302(c))

In order to qualify for the disaster-related qualified plan loan rules, the taxpayer must borrow the funds from his or her qualified plan by June 25, 2021, (within 180 days of the TCDTRA's date of enactment). (IRC §72(p)(A))

Comment

Remember, taxpayers are only eligible to take qualified plan loans, including any enhancements made under the TCDTRA, if the employer plan allows them. Employers are not required to include loan provisions in their retirement plans.

Delay of repayment

If a taxpayer had an outstanding loan from a qualified employer plan at the time of the disaster, then the due date for any payments that falls within the period beginning with the disaster's first incidence day and ending 180 days after the incident period, the due date for repayment will be extended to the later of:

- One year from the due date; or
- June 25, 2021, (180 days after the date of enactment of the TCDTRA).
(TCDTRA §302(c)(2))

All payments due under the loan are delayed accordingly. (TCDTRA §302(c)(2)(B)) This provision is intended to push back all payments due under the plan loan.

Plan amendments

Businesses that choose to do so have until January 1, 2022, to retroactively amend their plans in accordance with the aforementioned benefits. Employers are not required to offer these benefits.

California nonconformity

California does not conform to any of these provisions except the qualified plan distributions and recontributions previously discussed.

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$5,000 limitation

The $5,000 limit applies per individual, not per family, so if both parents have an eligible retirement plan, they can each take penalty-free distributions of up to $5,000. There is no cost-of-living adjustment provided for this benefit, so the maximum penalty-free distribution will remain at $5,000 going forward.

The IRS has clarified that each taxpayer, including both spouses filing a joint return, can withdraw up to $5,000 from their own retirement account within a year of the qualified birth or adoption of each child. (IRS Notice 2020-68, Q&A B-7 and B-8)

Example of baby withdrawals

Oliver and Ann are married filing jointly. On January 9, 2020, Ann gave birth to twins. Oliver and Ann can each withdraw up to $10,000 ($5,000 per child) from their respective retirement accounts by January 8, 2021, without being subject to early withdrawal penalties.

What can the distributions be used for?

The SECURE Act does not place any restrictions as to how the money withdrawn is spent. So, if the new parents feel like they really want a hot tub or weekly massages to cope with the added stress of a new child, there does not appear to be anything that would prevent this.

Employer verification

Because the $5,000 limit applies per individual, employers are only responsible for ensuring that withdrawals from their plan(s) and any plans offered by a controlled group in which the employer is a member do not exceed $5,000. Allowing distributions in excess of $5,000 from the employer's plan(s) will result in the plan being disqualified.

Employers are not required to verify that the employee has not made withdrawals from other accounts that, in combination, would result in more than a $5,000 distribution.

Eligible retirement plans

The distribution may be made from an eligible retirement plan as defined under IRC §402(c)(8)(B), which includes:

- IRAs;
- 401(k) plans;
- SIMPLE IRAs;
- SEP IRAs;
- An IRC §403(b) annuity contract; and
- State and local government plan under IRC §457.

According to the joint committee report, it does not include defined benefit plans.

Not all plans are participating

Employer retirement plans are not required to permit distributions for qualified births or adoptions. However, a taxpayer who receives an otherwise permissible distribution from their employer's retirement plan can still treat the distribution as an eligible distribution on their income tax return for the year without the early withdrawal penalty. (IRS Notice 2020-68, Q&A D-18)

Practice Pointer

A taxpayer who takes a "baby withdrawal" from an employer plan that does not permit them will receive a Form 1099-R indicating an early withdrawal. In this situation, tax professionals should use form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, to request a penalty waiver.

Most small employer plans don't permit any distributions, including hardship loans.

Example of "baby withdrawal" from employer plan

Bethany adopted a child on January 10, 2020. She has a 401(k) through her employer, but the plan does not permit "baby withdrawals." Despite the plan's "baby withdrawal" prohibition, Bethany can still distribute up to $5,000 within one year from the date she adopted her child, assuming the plan allows other types of distributions, which many do not.

Bethany's 1099-R for the year will indicate an early withdrawal from the account, and she must use Form 5329 to request a penalty waiver.

While the issue of employer plans allowing "baby withdrawals" may be an issue for 401(k) and other employer programs, it does not seem to be a problem for IRA accounts. If a client is unable to access this benefit from their employer plan, they may still be able to take advantage of this through their IRA account if they have one.

California conformity

California currently conforms to the penalty-free baby withdrawals. (R&TC §17085(c))

ADDITIONAL TAX ON IRA DISTRIBUTION PURSUANT TO DIVORCE

A taxpayer was liable for income tax and the additional 10% tax on an IRA distribution made to him from his ex-spouse. (***Rosenberg v. Comm.***, TCM 2019-124) The taxpayer's ex-wife was to pay him $10,000 from her retirement account, and she did so by transferring the funds from her retirement account directly to an IRA the taxpayer had just opened.

Within seven days of the transfer, the taxpayer withdrew the funds and closed the IRA account. The taxpayer objected to the tax, saying he didn't think temporarily transferring the funds to an IRA would change what he believed was a property settlement into a retirement distribution. The court disagreed and ruled that the transaction was an early withdrawal subject to tax.

LOANS FROM QUALIFIED PLANS

RULES LIBERALIZED UNDER CARES ACT

Limits on plan loans increased

The limit on the amount of loans that may be made from qualified plans is increased from $50,000 to $100,000 for loans made to coronavirus-impacted taxpayers (described on page 5-6) during 2020. (CARES Act §2202(b)(1)) The increased loan limitation was only valid for plan loans within 180 days of the date of enactment of the CARES Act (loans made from March 27, 2020, through September 22, 2020).

Comment

Loans cannot be taken from IRAs or from IRA-based plans such as SEPs, SARSEPs, and SIMPLE IRA plans. Loans are only possible from qualified plans that satisfy the requirements of IRC §401(a), from annuity plans that satisfy the requirements of IRC §403(a) or (b), and from governmental plans. (IRC §72(p)(4); Treas. Regs. §1.72(p)-1, Q&A-2)

The loan may be made up to the full present, nonforfeitable value of the plan. Prior to the CARES Act, only 50% of the nonforfeitable present value of a qualified retirement plan was eligible for a qualified plan loan.

Under the CARES Act, as before, loans from qualified employer retirement plans are only permitted if the plan allows them. (IRS Notice 2020-50) Many employer retirement plans do not allow participants to take loans. Employers who did not have this option available during early days of the COVID-19 pandemic could have allowed employees to take out loans immediately but must amend the plan on or before December 31, 2022 (or such later date as the Secretary of the Treasury allows). (CARES Act §2202(c))

Period for repayment extended

Any qualified plan loan repayments due during the period beginning on March 27, 2020, and ending on December 31, 2020, are delayed for one year, and the five-year repayment requirement is extended to six years. This applies even if the repayment is related to a loan taken out prior to March 27, 2020. (CARES Act §2202(b)(2)) This allows qualified plan participants more time to repay plan loans. However, this repayment rule only applies so long as the taxpayer is still employed by the same employer.

California conformity

California conforms to this provision. (AB 276 (Ch. 20-62); R&TC §17081)

Don't forget TCJA's changes to plan loan rules

The TCJA gives employees whose retirement plan terminates or who separate from employment while they have outstanding plan loans more time to roll over the loan balance to an IRA before the income is subject to tax.

The repayment must be made by the due date for filing their tax return, including extensions, for the year of the separation from service in order to avoid the loan being taxed as a deemed distribution and possibly subject to the 10% early withdrawal penalty. (IRC §402(c)) Previously, taxpayers had 60 days from separation of service to make this type of rollover.

To qualify, the employee's separation from service may be due to layoff, cessation of business, termination of employment, or otherwise. This provision is effective for plan loan offset amounts treated as distributed in taxable years beginning after December 31, 2017.

The TCJA provided a much larger window of time to recontribute the loan balance to an eligible retirement plan as a rollover contribution.

> ***Example of timing of repayment***
>
> On June 10, 2020, ABC Corporation ceased its operations due to COVID-19 and Tina lost her job. At that time, she had an outstanding $20,000 loan from her retirement plan. Tina is under 59½ years old.
>
> Under pre-TCJA law, she was required to recontribute the $20,000 within 60 days of separation from service to an IRA in order to avoid the loan being taxed as a distribution and being assessed the early withdrawal penalty.
>
> Under the TCJA, Tina has until April 15, 2021 (October 15, 2021, if she files a valid tax extension), which gives her just over 16 months from the date she lost her job to make this contribution and avoid recognizing the $20,000 as income and being assessed the 10% penalty.
>
> If Tina fails to recontribute the $20,000 to an IRA, then she must recognize the retirement distribution in the year she separated from her employment (2020) and will be subject to early withdrawal penalties.

REQUIRED MINIMUM DISTRIBUTION CHANGES

RMDs DON'T BEGIN UNTIL AGE 72 — SECURE ACT

The SECURE Act increased the age at which taxpayers must begin taking required minimum distributions from age 70½ to age 72, but only for taxpayers who turned age 70½ after December 31, 2019. (SECURE Act §114; IRC §401(a)(9))

Taxpayers who turned age 70½ in 2019 (or earlier) must continue taking RMDs each year, even for those years before they turn age 72 (with the exception of the 2020 tax year, discussed in the next section).

California conformity

California automatically conforms to the RMD age increase to age 72 for taxpayers who turn age 70½ after December 31, 2019. (R&TC §17501)

RMDs amount cannot be offset by post-age 70½ IRA contributions

Taxpayers who make traditional IRA contributions after age 70½ cannot offset their RMDs for the same taxable year. (IRS Notice 2020-68, Q&A B-4)

> ***Example of post-age 70½ RMDs***
>
> Robert is 74 years old and his 2021 RMD is $48,000, calculated using the fair market value of his IRA account as of December 31, 2020. Robert's 2021 RMD amount is not affected by any IRA contributions he may make in 2021.

RMD planning

Taxpayers who turn age 70½ after December 31, 2019, have no RMD requirement until the year they turn age 72. It is only the age at which RMDs must be taken that has changed; all other RMD rules remain the same, including the ability to put off the first RMD until April 1 of the year following the year the taxpayer turns age 72.

Comment

On November 8, 2019, the IRS issued new proposed regulations under IRC §401(a)(9), which provide rules regarding RMDs from qualified retirement plans. The proposed regulations provide for longer life expectancies, thus reducing taxpayers' annual RMDs. The new life expectancy tables will take effect for RMDs on or after January 1, 2021.

The IRS's life expectancy tables can be found at the following website:

Website
www.irs.gov/retirement-plans/plan-participant-employee/required-minimum-distribution-worksheets

RMDs WAIVED FOR 2020 — CARES ACT

The CARES Act waives the RMD requirement in 2020. The 2020 RMD suspension also includes anyone who turned age 70½ in 2019 and would have had to take their first RMD by April 1, 2020. The 2020 RMD suspension does not apply to defined benefit plans, but it does apply to:

- 401(k)s;
- Defined contribution plans (IRC §403(a) and (b));
- Tax-sheltered annuity plans (IRC §403(b));
- Defined contribution plans under IRC §457(b) maintained by a state or municipal government (the waiver does not apply to current or former employees of exempt organizations that maintain an IRC§457(b) plan); and
- An individual retirement plan such as a traditional, SEP, or SIMPLE IRA.

Comment

As of the date of publication, it is still unknown whether a taxpayer who turned age 70½ in 2019, who put off their first RMD until April 1, 2020, but didn't take the RMD due to the RMD waiver for 2020, will be required to take an extra RMD in 2021.

For example, Jesse turned age 70½ on December 1, 2019. Jesse elected to put off her first RMD until April 1, 2020. Under the CARES Act, Jesse's first RMD that should have been taken by April 1, 2020, was waived as well as her regular 2020 RMD. Will Jesse be forced to take the RMD that should have been taken by April 1, 2020, in 2021 along with 2021's regular RMD? We'll have to wait for additional IRS guidance for taxpayers in this situation.

Expanded RMD relief

On June 23, 2020, the IRS released Notice 2020-51, which provides that anyone who already took a required minimum distribution (RMD) in 2020, at any point during the year, from eligible retirement accounts had the opportunity to roll those funds back into a retirement account by August 31, 2020.

One rollover per 12 months does not apply

Notice 2020-51 clarifies that the one rollover per 12-month period limitation did not apply to 2020 RMDs that were recontributed to retirement accounts by August 31, 2020, regardless of what account the funds are put back into. (IRC §408(d)(3)(B))

✐ Practice Pointer

The 1099-R received by taxpayers for 2020 will only reflect the gross amount of their retirement account distribution. The amount reflected in box 1 of the Form 1099-R will not be reduced for RMDs recontributed back into a retirement account.

Tax professionals must ask their clients who receive 1099-Rs for RMDs in 2020 whether they recontributed any funds back into their retirement accounts.

Extended time for making election to use five-year rule or life expectancy rule

If an eligible retirement plan permits an employee or beneficiary to elect whether RMDs are determined using the five-year rule or the life expectancy rule, the CARES Act's 2020 RMD suspension extends the time for making this election until December 31, 2021. (IRS Notice 2020-51)

For example, if a 50-year-old employee in a qualified retirement plan died in 2019 with his sister as his designated beneficiary, the plan would require the election by the end of 2020. However, that type of plan may now be amended to permit the extension of the deadline to the end of 2021.

✐ Practice Pointer

The extended time for making the election is not automatic. The retirement plan must be amended to permit the use of the extended deadline.

Quick Law: Five-year rule

When a taxpayer inherits a retirement account from a person who passed away on or before December 31, 2019, the taxpayer generally has two options regardless of their age or whether they are the surviving spouse of the retirement account owner:

- Distribute the entire account immediately; or
- Take distributions under the five-year rule. Under the five-year rule the entire retirement account must be distributed no later than December 31 of the fifth year after the account owner's death.

In addition to these two options, more options are available depending on whether the account beneficiary is the decedent's surviving spouse — including taking distributions over either the beneficiary's or the decedent's life expectancy.

The five-year rule still matters for 2020 because a retirement account owner who passed away on or before December 31, 2019, is still subject to the pre-SECURE Act inherited retirement account rules (the SECURE Act inherited retirement account rules are discussed on page 5-16). If a retirement account owner passed away on or before December 31, 2019, their beneficiaries ordinarily would have until December 31, 2020, to elect whether to use the five-year rule. The CARES Act allows plan administrators to extend the election to December 31, 2021, where a retirement account owner passed away during 2019.

Extended time for making a direct rollover for nonspouse beneficiaries

The CARES Act's 2020 RMD suspension extends the time for making a direct rollover for a nonspouse designated beneficiary if the participant died in 2019. (IRS Notice 2020-51) If the five-year rule applies to a benefit under a plan, the nonspouse designated beneficiary may determine the amount that is not eligible for rollover because it is an RMD using the life expectancy rule in the case of a distribution made prior to the end of the year following the year of death. (Notice 2007-7) If the employee's death occurred in 2019, the nonspouse designated beneficiary has until the end of 2021 to make the direct rollover and use the life expectancy rule.

RMDs that would have had a start date in 2020 if not for the RMD suspension

The CARES Act waives the RMD for 2020 regardless of whether the employee's required beginning date is April 1, 2021. (IRS Notice 2020-51) Thus, for example, if an employee who is not a 5% owner attained age 70½ before January 1, 2020, and retires in the 2020 calendar year, that employee's required beginning date is April 1, 2021.

Pursuant to the CARES Act's 2020 RMD suspension, the employee is not required to receive an RMD for 2020 before April 1, 2021, but must still receive the RMD for the 2021 calendar year by December 31, 2021.

California conformity

California conforms to the waiver of 2020 RMDs and the ability to recontribute distributions by August 31, 2020. (R&TC §17501(b))

INHERITED ACCOUNTS SUBJECT TO SECURE ACT'S NEW RULES FOR DEATHS AFTER 2019

Under the SECURE Act, most beneficiaries of retirement plans, IRAs, and some government plans of taxpayers who pass away after December 31, 2019, must now distribute the entirety of their inherited account by the end of the year that contains the 10th anniversary of the account owner's date of death, even if the beneficiary is a named beneficiary. This new rule applies, unless the beneficiary is one of the following:

- Surviving spouse;
- Minor child (a child who has not reached the age of majority) of the deceased IRA owner;
- 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.
  (SECURE Act §401; IRC §401(a)(9))

Following the death of one of these eligible designated beneficiaries, any remaining account balance must be distributed within 10 years. (IRC §401(a)(9)(H)(iii))

SURVIVING SPOUSE

Only the surviving spouse may roll over an inherited IRA account into his or her own account. The surviving spouse has two options for postponing distributions:

- Wait to take the required minimum distributions until the end of the year following the year of the owner's death or the year the deceased IRA owner would have turned age 72, whichever is later (IRC §§401(a)(9)(B)(iv), 408(a)(6)); or
- Roll over the IRA into his or her own IRA and begin distributions when the surviving spouse's reaches age 72. (IRC §408(d)(3)(C))

If the deceased IRA owner was required to take an RMD in the year of the owner's death, the surviving spouse must receive a minimum distribution only to the extent that the amount required was not distributed to the owner before death.

A surviving spouse who receives an IRA distribution (except the minimum distribution) can roll the funds over within 60 days into an IRA in the surviving spouse's own name to the extent that the distribution is not a required distribution, regardless of whether the surviving spouse was the IRA owner's sole beneficiary.

Leaving funds in deceased spouse's account

However, for a surviving spouse who elects to leave the funds in the deceased spouse's account, required minimum distributions will begin in the year the deceased spouse would have reached age 72 (not age 70½), the age for required minimum distributions.

MINOR CHILD

Minor children of the decedent take distributions based on their own life expectancies until reaching the age of majority (age 18 in some states, age 21 in others). Once they reach the age of majority, the remaining balance of the inherited account must be distributed within 10 years of the date the child reached the age of majority. (IRC §401(a)(9)(E)(iii))

Comment

Minor children beneficiaries who are not the children of the deceased account owner must distribute the entire inherited account by the end of the year that contains the 10th anniversary of the account owner's death.

NOT MORE THAN 10 YEARS YOUNGER

If the beneficiary is not more than 10 years younger, the pre-SECURE Act RMD rules apply. If the decedent had started receiving distributions, the RMD is computed using the decedent's life expectancy. If the decedent had not yet started taking RMDs, the distributions are paid out over the life expectancy of the beneficiary.

Example of beneficiary not more than 10 years younger than decedent

In 2020, Constance passes away and leaves her IRA to her sister Molly as a designated beneficiary, who was born nine years after Constance. Molly is an eligible designated beneficiary, and the balance in the IRA at Constance's death may be paid over Molly's life expectancy. If Molly dies before the IRA account is exhausted, the remaining balance must be paid out within 10 years after Molly's death.

California conformity

California automatically conforms to the new inherited IRA provisions. (R&TC §17501)

PLANNING FOR NEW INHERITED ACCOUNT RULES

Planning for inherited accounts for surviving spouses, persons who are not more than 10 years younger than the decedent, disabled individuals, or chronically ill individuals does not change under the SECURE Act. These individuals are subject to essentially the same inherited account rules that were in place prior to the SECURE Act.

Minor children and account beneficiaries not listed above who inherit accounts after 2019 must plan ahead for the increased taxable distributions they are required to take under the SECURE Act. The key to planning for these individuals will be forecasting their income until the end of the 10th year after the decedent's date of death (the 10th year after the beneficiary turns age 18 in the case of minor children).

Easy planning techniques

A quick and simple planning technique to avoid pushing the beneficiary into a higher tax bracket is to simply spread out the inherited account over the maximum number of years possible, thus ensuring a minimum amount of additional taxable income each year. For taxpayers who are not minor children, this will typically be over 11 taxable years.

Example #1 of easy inherited IRA planning

John is 40 years old. His mother, Barbara, passed away on January 15, 2020, and named him as the beneficiary of her IRA. As of her date of death, Barbara's traditional IRA had a balance of $200,000.

John must distribute the entire balance of his inherited IRA by December 31, 2030 (the end of the year that contains the 10th anniversary of Barbara's date of death). If John times his distributions such that he takes annual distributions, the first one in 2020 and the last one in 2030, then he can spread the distributions out over 11 tax years.

John won't be able to take 11 exactly equal distributions, however, because each year the account's balance will change because the funds in the IRA will continue to grow (or decline in value).

By spreading the distributions out in this way, John can ensure that no single year will have a large bump in his taxable income, thus driving him into a much higher tax bracket.

An alternative, yet equally easy, tax planning technique is to avoid taking any distributions until the last day possible, thus maximizing the tax-free growth in the inherited account.

Example #2 of easy inherited IRA planning

Assume the facts are the same as the previous example, except that John decides to take no distributions from his inherited IRA until December 31, 2030.

By doing this, John can capitalize on 10 years of tax-deferred growth with zero reductions in the account due to distributions. The cost of doing so is that in 2030, John will have $200,000 (plus 10 years of tax-deferred growth) brought into his taxable income all at once.

A California twist

This second example of John putting off all distributions until the date that is 10 years after his mother passed away goes from easy inherited IRA planning to brilliant strategic planning if John is planning to move out of California. The state of California automatically conforms to the federal RMD rules, which includes the SECURE Act changes.

If John plans to move from California to a low-tax or no-tax state before the date that is 10 years after his mother passed away, then by putting off all distributions from the inherited IRA until after he moves out of California, John will avoid California tax on the entirety of his inherited IRA.

Comment

John is not bound by any planning method he has chosen. He can withdraw any amount in any year so long as the account is fully distributed by the end of the 10 years. Assume he decides to defer all distributions until the end of Year 10. However, in Year 5, he has a low income year; a year in which he has only, say, $10,000 of other income and $50,000 of deductions. John can take $40,000 without increasing his tax liability and may want to take additional amounts beyond $40,000 in low tax brackets.

REVIEW ESTATE PLANS AFTER SECURE ACT

Due to the change in beneficiary treatment of IRA distributions, clients should review their estate plans and beneficiary designations to ensure that the accelerated distributions of inherited IRAs won't alter the results of their planned asset distributions (see page 5-16 for details).

Review trust terms

Prior to the SECURE Act, trusts that met the requirements to be treated as designated beneficiaries could defer IRA distributions based on the life of the trust beneficiary in the same manner as if that beneficiary had been named individually. (SECURE Act §401; IRC §401(a)(9))

Under the SECURE Act, for accounts inherited after 2019, even if the trust qualifies as a designated beneficiary the assets must be distributed under the new 10-year rules.

Conduit versus accumulation trust

Once the IRA assets are passed to the trust, the trust can either distribute the income to the beneficiary each year (a conduit trust), or hold the distributions until the beneficiary reaches a certain age or some other triggering event occurs (an accumulation trust). These planning decisions are particularly important for young beneficiaries or those who require help managing their money.

If the trust was a conduit trust designed to take advantage of life expectancy distributions, the IRA assets must now be distributed using the accelerated 10-year rules. This exposes plan assets to the possible imprudence of the beneficiary, as well as the beneficiaries' creditors or divorcing spouses. As a result, your clients may want to consider converting conduit trusts to accumulation trusts to maintain control over the trust assets. Although the trust will pay tax at a higher rate than an individual, the trust can be used to protect and control the after-tax assets.

The accumulation trust can be used to distribute funds based on any factors that the grantor chooses. For example, the trust could distribute funds when the beneficiary reaches a certain age, for education, housing, or medical expenses. The trust could also be drafted to provide specific annual distributions, with other distributions based on age or other needs. Unlike a conduit trust, the accumulation trust is not required to distribute the funds to the beneficiary within 10 years.

Example of amending trust

Fran has a daughter, Carmen, who is age 19 (and not considered a minor in her state). Fran's estate includes an IRA with $1.5 million in assets.

Fran's estate plan is currently drafted so that the IRA beneficiary is a trust. The trust is a conduit trust, which will distribute the IRA distributions to Carmen each year. This allows Carmen to benefit from the inherited funds without having complete control over the $1.5 million.

Prior to the SECURE Act, when Fran drafted the plan, the annual IRA distributions to the trust would have been based on Carmen's life expectancy. Using the current life expectancy tables, Carmen has a life expectancy of 64 years, meaning she would receive annual distributions of approximately $23,500.

Under the SECURE Act, the IRA distributions must now be made within 10 years. If Fran does not amend the trust, Carmen will receive approximately $150,000 annually from the trust.

Instead, Fran amends the trust to accumulate the IRA distributions. She directs the trustee to make annual distributions of $20,000, plus any necessary amounts for education or medical expenses. When Carmen reaches age 40, the remaining trust assets will be fully distributed to her.

Charitable remainder trust

With a charitable remainder trust, the IRA funds are distributed to the trust at the donor's death; the trust pays the donor's beneficiary a certain amount each year for a specified period; and at the end of the term of the trust, the remaining trust assets are distributed to a charitable organization.

The trust pays at least 5% annually to the noncharitable beneficiaries for the term of the trust, which can be:

- A term not to exceed 20 years; or
- A term measured by the life or lives of the designated recipients.
(IRC §401(a)(9)(E)(iii))

This allows the donor to create a distribution stream much like they had under the pre-SECURE Act rules, while avoiding the higher tax rates of the accumulation trust.

Example of a charitable remainder trust

Hank has an IRA with $1 million in assets. His sole beneficiary is his daughter Meredith.

At Hank's death his IRA assets will be contributed to a charitable remainder trust, which will provide Meredith with an annual unitrust payment of 7% for her lifetime. That means that the trust assets will be valued each year, and she will receive 7% of that value annually.

No tax will be paid on the assets when they are contributed to the trust at Hank's death, but Meredith will pay tax on income distributed to her.

Because no tax is paid on the assets at Hank's death, the full $1 million can be invested and continue to grow. Meredith's distributions will be based on the value of the assets each year.

If the assets are valued at $1 million, Meredith's unitrust payment will be $70,000 ($1 million × 7%). If the value increases to $1.2 million, her unitrust payment will increase to $84,000 ($1.2 million × 7%). If the value of the assets drops to $800,000, her unitrust payment will decrease to $56,000 ($800,000 × 7%).

At Meredith's death the remaining assets will pass to the charity that Hank chose when he established the trust.

Advantages and disadvantages

Advantage

This strategy works particularly well when the beneficiary is younger, as distributions will continue for many years. Also, for an individual who wants to make a large charitable bequest, this can be a tax-efficient way to leave part of the money to friends and family, and also support the charity.

Disadvantage

If the grantor chooses the life expectancy structure, the trust distributions end at the beneficiary's death. Unlike an IRA, where a secondary beneficiary can be designated, the trust beneficiary may not designate an individual to benefit from trust distributions at his or her death. As a result, for individuals who may not be in good health, or who do not have an anticipated life expectancy of greater than 20 years, the grantor may want to choose a trust structure that provides benefits for a set number of years, rather than the life of the beneficiary.

✎ Practice Pointer

Be sure your client uses an attorney with expertise in this area to draft the documents for these trusts and to help them make these complex planning decisions.

OTHER SECURE ACT PROVISIONS

CHANGES TO IRC §403(b) PLANS

Portability of lifetime income options of IRC §403(b) plans

For plan years beginning after December 31, 2019, plan holders with retirement plans that are no longer offering a lifetime income investment option (e.g., annuity contracts) under their plan may make a direct trustee-to-trustee transfer to another lifetime investment option in another employer-sponsored retirement plan or an IRA. To qualify, the distribution must be made within the 90-day period ending on the date when the lifetime income investment is no longer authorized to be held as an investment option under the plan. (IRC §§401(a)(37) and (k)(2)(B)(VI), 403(b)(7) and (11), 457(d)(1)(A); SECURE Act §109)

This change allows plan holders to retain their lifetime income investments and avoid surrender charges and fees.

This option is available for participants in a:

- Qualified defined contribution plan;
- 401(k) plan;
- IRC §403(b) plan offered by nonprofits and educational institutions; or
- IRC §457 government plan.

California conformity

California conforms to the portability of lifetime income options for IRC §403(b) plans. (R&TC §17501)

Treatment of IRC §403(b) custodial accounts upon plan termination

The SECURE Act allows IRC §403(b) plans (retirement plans sponsored by nonprofits and state and local schools) to distribute a custodial account in-kind to the participant/beneficiary when a plan is terminated, rather than paying out the amounts in the accounts in cash. A custodial account is an account established for a beneficiary/plan participant in a regulated investment company (mutual fund).

This allows the tax-deferred treatment to continue after the plan is terminated as long as the accounts are maintained in compliance with the IRC §403(b) rules in effect at the time that the individual account is distributed. The participant/beneficiary is not required to include the amounts in the accounts in their gross income until the cash is actually distributed. This provides similar treatment for custodial accounts as was adopted by the IRS in Rev. Rul. 2011-7 for IRC §403(b) annuity contracts upon the termination of an IRC §403(b) plan.

California conformity

California conforms to the treatment of IRC §403(b) custodial accounts upon plan termination. (R&TC §17501)

PLAN LOANS VIA CREDIT CARDS PROHIBITED

For loans made after December 20, 2019, retirement plans may no longer allow employees to access loans from a retirement plan through the use of a credit card or similar mechanism. (IRC §72(p)(2)(D); SECURE Act §108) Any such loan made via credit card, etc., is treated as a taxable distribution.

EMPLOYER-FOCUSED RETIREMENT PROVISIONS OF THE SECURE ACT

Extended due date to create a new retirement plan

Under the SECURE Act an employer may adopt a plan up to the extended due date of a plan sponsor's income tax return, rather than on or before the end of the taxable year.

The change allows plans adopted by the filing due date (including extensions) for the year to be treated as in effect as of the close of year. This is applicable to plans adopted for taxable years beginning after December 31, 2019. This means that the SEP IRA plan is not the only way to establish a plan and be able to deduct contributions after a valid estimate of the net income is established.

Example of plan established after end of year

Great Year Inc., a calendar-year corporation, estimated their 2020 income would be $100,000. However, in December they sold a building with a profit of $500,000. Prior to the SECURE Act, Great would be required to form and adopt the plan (other than a SEP IRA plan) by December 31, 2020.

Due to the rush at the end of the year, Great did not do that. Under the new provisions, Great can set up a pension or profit sharing plan on or before the extended due date of their 2020 return and be able to take deductions for contributions made into the plan in 2021 on their 2020 tax return.

California conformity

California conforms to the extended due date to create a new retirement plan. (R&TC §17501)

Small employer pension plan startup costs

Maximum credit (IRC §45E)

The SECURE Act increases the maximum small employer pension plan startup costs credit for taxable years beginning after December 31, 2019. The small employer pension plan startup costs credit is still 50% of qualified pension plan startup costs, but cannot exceed the greater of:

- $500; or
- The lesser of:
  - $250 for each employee of the eligible employer who is not a highly compensated employee (generally not a 5% owner or has income in 2020 of $130,000) and who is eligible to participate in the eligible employer plan maintained by the eligible employer; or
  - $5,000.

The credit is available for a maximum of three consecutive taxable years. Taxpayers must also reduce their deduction for qualified startup costs by the amount of the IRC §45E credit claimed. (IRC §45E(e)(2))

Eligible employers can claim the credit for the taxable year that includes the date the eligible employer plan to which eligible costs relate becomes effective (referred to as the first credit year), plus the two immediately following years. (IRC §45E(d)(3)(A)) However, an eligible employer can elect to treat the immediately preceding tax year as the first credit year where costs were incurred in the previous year to set up the plan for the current year. (IRC §45E(d)(3)(B))

Eligible employers

An eligible employer is an employer with no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding taxable year. (IRC §§45E(c)(1), 408(p)(2)(C)(i))

Two-year grace period for employers who no longer qualify as small employers: An eligible employer who establishes and maintains an eligible retirement plan then fails to be an eligible employer for any subsequent year is treated as an eligible employer for the two years following the last year the employer was an eligible employer. (IRC §408(p)(2)(C)(i)(I))

What this means is that an employer who sets up an eligible retirement plan will be able to claim the small employer pension plan startup costs credit for the full three-year period, even if the employer becomes too large in the second or third year.

Must be a new qualified employer plan: An employer plan is not eligible for the small employer pension plan startup costs credit if, during the three taxable year period immediately preceding the first credit year, the employer established or maintained a qualified employer plan with respect to which contributions were made, or benefits were accrued, for substantially the same employees as are in the qualified employer plan. (IRC §45E(c)(2))

Eligible retirement plans

Even though the credit under IRC §45E is called the small employer pension plan startup costs credit, the term "eligible employer plan" includes:

- Any plan under IRC §401(a), including a trust exempt from tax under IRC §501(a);
- An annuity plan under IRC §403(a);
- Any simplified employee pension under IRC §408(k); and
- Any simple retirement account under IRC §408(p).
  (IRC §§45E(d)(2), 4972(d)(1))

In common terms, this list includes, among others, both qualified defined benefit plans and defined contribution plans, 401(k)s, SIMPLE IRAs, and SEP IRAs.

Qualified startup costs

Qualified pension plan startup costs are ordinary and necessary expenses that are paid or incurred to:

- Establish or administer an eligible employer plan; or
- Provide retirement-related education of employees with respect to the plan.
  (IRC §45E(d)(1)(A))

An expense is not a qualified pension plan startup cost unless the employer plan has at least one employee eligible to participate who is not a highly compensated employee. (IRC §45E(d)(1)(B))

New employer credit for adopting auto enrollment

The SECURE Act adds new IRC §45T, Auto-Enrollment Option for Retirement Savings Options Provided by Small Employers. (SECURE Act §105; IRC §45T)

The new IRC §45T provides a $500 credit, which is part of the general business credit under IRC §38, for small employers who adopt an automatic enrollment feature to either a 401(k) plan or a SIMPLE IRA plan. Small employers are eligible for the $500 credit for taxable years beginning after December 31, 2019.

Eligible small employers

Small employers are defined as those with no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year. (IRC §408(p)(2)(C)(i)(I)) Even sole proprietors are eligible employers. (Notice 98-4, Q&A B-1)

An employer who satisfies this requirement for at least one year and then subsequently fails the small employer requirement will be treated as a small employer for a two-year grace period following the last year the employer qualified. (IRC §408(p)(2)(C)(i)(II)) However, if the employer fails the small business definition due to acquisition, disposition, or similar transaction, then the two-year grace period does not apply.

Practice Pointer

There is nothing in the law that says there must be more than one employee. So, sole shareholders/employees could get this credit for putting themselves on auto enrollment.

Credit period

Small employers qualify for the $500 credit for three taxable years, beginning with the first taxable year for which the employer includes an eligible automatic enrollment arrangement as part of its 401(k) or SIMPLE IRA plan. (IRC §45T(b))

Retirement plans for long-term, part-time employees

The SECURE Act requires employers who offer 401(k) plans to allow long-term, part-time employees to make elective contributions to the plan, applicable to plan years beginning after December 31, 2020. (IRC §401(k)(2)(D); SECURE Act §112) A long-term, part-time employee is one who:

- Is not a member of a collective bargaining agreement;
- Has worked at least 500 hours for three consecutive 12-month periods; and
- Is at least age 21 by the end of the three-consecutive-year period.

Comment

This means employees who work 10 hours per week for 52 weeks of the year must be allowed to participate in an employer's 401(k) plan. Currently, employers are only required to include employees age 21 and older who work at least 1,000 hours of services in a 12-month period in their 401(k) plans (approximately 19.2 hours per week).

While the employer must allow eligible long-term, part-time employees to make elective contributions to the plan, employers are not required to make nonelective or matching contributions on behalf of these employees (although they may choose to adopt a plan that does provide for these nonelective and/or matching contributions). (SECURE Act §112; IRC §401(k)(15)(B)(i))

Counting years

The mandate that employers must include long-term, part-time employees in their 401(k) plans is effective for plan years beginning after December 31, 2020. Additionally, employees are not given credit for years of service prior to January 1, 2021, when determining an employee's eligibility.

> ***Example of effective date application***
>
> Debbie, who is age 21, has been working 15 hours per week for Company C since January 2017. Although she's been working at Company C for more than 500 hours per year for three years, Company C is not required to include Debbie in its 401(k) plan during the 2021 plan year because only years commencing after December 31, 2020, are counted. If Debbie continues to work for Company C for the same number of hours, Company C must include Debbie in its plan starting in 2024.

Exclusion from various requirements

Employers may choose, but are not required, to exclude part-time employees from the application of the top-heavy and nondiscrimination rules as well as the safe harbor contribution amounts.

California conformity

California conforms to the retirement plans for the long-term, part-time employees provision of the SECURE Act. (R&TC §17501)

ROTH IRA PROVISIONS — IRC §408A

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 (in 2020) 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	**2019 (Notice 2018-83)**	**2020 (Notice 2019-59)**	**2021 (Notice 2020-79)**
Single, HOH, or MFS and did not live with spouse at any time during the year	$122,000–$137,000	$124,000–$139,000	$125,000–$140,000
MFJ	$193,000–$203,000	$196,000–$206,000	$198,000–$208,000
MFS and lived with spouse at any time during the year	$0–$10,000	$0–$10,000	$0–$10,000

Practice Pointer

Unlike a traditional IRA that has a limitation on the ability to contribute 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 IRA contributions (like traditional IRAs) can be made even after an individual attains age 70½. (IRC §§219(d)(1), 408A(c)(4)) Not only is there no upper age limit, there is no lower age limit. Any individual with earned income can contribute to a Roth IRA.

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

Joseph works at a golf course during the summer and earns $6,000 each year from age 13 through age 17. Each year his parents fund a Roth IRA with $6,000 (equal to his earned income). Assuming a growth rate of 5%, Joseph will have over $42,000 in his Roth IRA at age 18. With no additional contributions the account will top $330,000 when he turns age 59½, assuming a 5% annual rate of return.

Back door Roth conversions

The "back door" 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 back door 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 back door conversion***
>
> Beth made a $6,000 nondeductible contribution to an IRA. Her income was $500,000, so she was unable to make a Roth contribution. Immediately after contributing the $6,000 to the IRA, she converted the $6,000 IRA to a Roth IRA in a nontaxable event. She had no other IRA accounts.

> ***Example of aggregation rules***
>
> Aaron made a nondeductible $6,000 contribution to his IRA. Aaron also has a rollover IRA with a balance of $600,000. When he converts the $6,000 to the Roth, his basis in his IRA accounts is $6,000. He must include all $606,000 in his taxable income computation. His taxable amount is $5,940:
>
> $600,000 ÷ $606,000 = 99%
> $6,000 × 99% = $5,940

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

[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)

2019 AND 2020 PLAN LIMITATION AMOUNTS

Maximum Contributions to Retirement Plans					
	2017	**2018**	**2019**	**2020**	**2021**
IRAs (regular and Roth)					
Up to age 50	$5,500	$5,500	$6,000	$6,000	$6,000
Age 50+	$6,500	$6,500	$7,000	$7,000	$7,000
401(k); 403(b); 457 plans					
Up to age 50	$18,000	$18,500	$19,000	$19,500	$19,500
Age 50+	$24,000	$24,500	$25,000	$26,000	$26,000
SIMPLE IRAs					
Up to age 50	$12,500	$12,500	$13,000	$13,500	$13,500
Age 50+	$15,500	$15,500	$16,000	$16,500	$16,500
Defined contribution plans					
Profit sharing/ money purchase	$54,000	$55,000	$56,000	$57,000	$58,000
SEP IRA	$54,000	$55,000	$56,000	$57,000	$58,000

Solo 401(k): The maximum contribution for a solo 401(k) for taxpayers is $57,000 ($63,500 for taxpayers age 50+) in 2020 ($58,000 or $64,500 in 2021).

Annual Compensation Limits of Defined Benefit Plans (IRC §§401(a)(17), 404(j), 408(k)(3)(C)(7))	
2017	$270,000
2018	$275,000
2019	$280,000
2020	$285,000
2021	$290,000

California conformity

California conforms to these amounts. (R&TC §17501)

SOCIAL SECURITY

SOCIAL SECURITY (FICA)

FICA wage base — $142,800 in 2021

The Social Security Administration (SSA) announced the 2021 FICA wage base to be $142,800. For 2020, the wage base is $137,700.

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
Maximum FICA (OASDI) wage base	$132,900	$137,700	$142,800
FICA tax rate (employer/employee)	7.65%/7.65%	7.65%/7.65%	7.65%/7.65%
Self-employment tax rate	15.3%	15.3%	15.3%
Maximum FICA tax (employer/employee)	$10,167/$10,167	$10,534/$10,534	$10,924/$10,924
Maximum self-employment tax (to OASDI limit)	$20,334	$21,068	$21,848
Maximum Medicare health insurance wage base	Unlimited	Unlimited	Unlimited
Medicare health insurance rate	$1.45% + 0.9% above $200,000	$1.45% + 0.9% above $200,000	$1.45% + 0.9% above $200,000
Earned income ceilings for Social Security benefits: early retirement age	$17,640	$18,240	$18,960
Earned income ceilings for Social Security benefits: full retirement age and over	Unlimited	Unlimited	Unlimited
Basic Medicare B premium	$135.50/month $1,626.00–$5,526.00/year	$144.60/month $1,735.20–$5,899.20/year	$148.50/month $1,782.00–$6,058.80/year

COLA for 2021 is 1.3%

Social Security and Supplemental Security Income (SSI) beneficiaries will receive a 1.3% cost of living adjustment in 2021. For 2020, it was 1.6%.

MEDICARE

For 2020, the basic Medicare premiums are $144.60, plus the cost of a prescription drug plan. For 2021, basic Medicare premiums are $148.50 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 2021 surcharge is based on 2019 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.

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.

2021 Medicare Parts B and D Premium Surcharge			
If 2019 Modified AGI is ...		**2021 Part B monthly premium**	**2021 Part D monthly premium**
Single	**Married**		
$88,000 or less	$176,000 or less	$148.50	Plan premium
$88,001–$111,000	$176,001–$222,000	$207.90	Plan premium + $12.30
$111,001–$138,000	$222,001–$276,000	$297.00	Plan premium + $31.80
$138,001–$165,000	$276,001–$330,000	$386.10	Plan premium + $51.20
$165,001–$500,000	$330,001–$750,000	$475.20	Plan premium + $70.70
$500,001 and above	$750,001 and above	$504.90	Plan premium + $77.10

2020 Medicare Parts B and D Premium Surcharge			
If 2018 Modified AGI is ...		**2020 Part B monthly premium**	**2020 Part D monthly premium**
Single	**Married**		
$87,000 or less	$174,000 or less	$144.60	Plan premium
$87,001–$109,000	$174,001–$218,000	$202.40	Plan premium + $12.20
$109,001–$136,000	$218,001–$272,000	$289.20	Plan premium + $31.50
$136,001–$163,000	$272,001–$326,000	$376.00	Plan premium + $50.70
$163,001–$500,000	$326,001–$750,000	$462.70	Plan premium + $70.00
$500,001 and above	$750,001 and above	$491.60	Plan premium + $76.40

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

OTHER PROVISIONS

The Consolidated Appropriations Act of 2021 (H.R. 133) makes the following changes:

- Clarifies that money purchase pension plans are included in the retirement plans from which taxpayers may make penalty-free withdrawals to cover COVID-19 related expenses (ACRRA §280);
- Allows pension plans to make distributions to an employee who has attained age 59 ½ (age 55 in the case of certain building and construction industry employees) and is still working without disqualifying the plan (TCDTRA §208; IRC §401(a)(36)); and
- Provides a reprieve from the partial plan termination requirements of IRC §411(d) during any plan year that includes the period beginning on March 13, 2020, and ending on March 31, 2021, if the number of active participants covered by the plan on March 31, 2021, is at least 80% of the number of active participants covered by the plan on March 13, 2020 (TCDTRA §209).

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.*

20. What is true about IRA contributions under the SECURE Act?

    a) The age restrictions have been removed for taxpayers to contribute to a traditional IRA for tax years after December 31, 2019
    b) A taxpayer filing a joint return must have earned income in order to contribute to an IRA
    c) Financial institutions are required to amend their IRA contracts to follow the SECURE Act provisions
    d) Earned income for IRA contributions does not include alimony

21. What are among the details of making withdrawals from retirement accounts under the CARES Act?

    a) Coronavirus-related distributions from an employer plan are subject to withholding
    b) Any coronavirus-related distribution amount that is withdrawn must be reported in the year the distribution is received
    c) Repayments subsequent to a distribution from an eligible retirement plan do not have to be made to the same account
    d) The limit on a loan made from a qualified plan is $50,000

22. The limit on a loan made from a qualified plan is $50,000If an individual is the surviving spouse and sole beneficiary of their deceased spouse's IRA, which of the following is correct?

    a) If they become the owner, they must take the deceased owner's RMD for that year if the deceased owner was required to take an RMD
    b) If they elect to leave the funds in the deceased spouse's account, RMDs will begin the year the deceased spouse would have reached age 70½
    c) The surviving spouse must wait to take RMDs until the end of the year following the year of the owner's death
    d) Rolling over the inherited IRA into their own account is prohibited

23. How has the SECURE Act affected inherited IRAs in a trust?
    a) When the IRA assets are passed to the trust, the trust must hold the distributions until the beneficiary reaches a specified age
    b) If the trust is a designated beneficiary, IRA distributions can be deferred based on the life of the trust beneficiary
    c) If the trust is a conduit trust, the IRA assets must be distributed under the 10-year rules
    d) Both conduit trusts and accumulation trusts are required to make distributions to the beneficiary within 10 years

24. Which of the following is true regarding the small employer pension plan startup costs credit?
    a) The credit amount is $500
    b) There is a two-year grace period for those employers who maintain an eligible retirement plan and then fail to be eligible for any later year
    c) The credit is available for a maximum of two years
    d) The first credit year is always the taxable year that includes the date the eligible employer plan becomes effective

25. What are among the details of retirement plans for long-term, part-time employees?
    a) A long-term, part-time employee is one who works at least 500 hours for two consecutive 12-month periods
    b) Employers are required to make matching contributions on behalf of these employees
    c) The mandate to include these employees in 401(k) plans begins on January 1, 2020
    d) Employers may choose, but are not required, to exclude part-time employees from the application of the top-heavy and nondiscrimination rules

26. Which statement best explains factors pertaining to Medicare for high-income individuals?
    a) For the Medicare premium surcharge, taxpayers filing as head of household are treated as single
    b) High-income individuals must still benefit from the hold-harmless rule
    c) High-income individuals will pay a 2021 surcharge based on 2020 modified AGI
    d) Taxpayers may contest the Medicare surcharge for any reason

SOLUTIONS TO REVIEW QUESTIONS

20. What is true about IRA contributions under the SECURE Act? **(Page 5-2)**

    a) Correct. Taxpayers may contribute to a traditional IRA after they reach age 70½ within the limits of their earned income or the contribution limits.
    b) Incorrect. The nonworking or retired spouse may contribute to an IRA as long as their spouse has enough earned income.
    c) Incorrect. There is no requirement that financial institutions must amend their contracts.
    d) Incorrect. Alimony is included in earned income if it is includable in the taxpayer's gross income.

21. What are among the details of making withdrawals from retirement accounts under the CARES Act? **(Page 5-8)**

    a) Incorrect. They are not subject to withholding.
    b) Incorrect. The amount is included in the taxpayer's gross income ratably over three years, or the taxpayer may elect to report the distribution in the year received.
    c) Correct. The account to which the repayment is made must be of the type that is eligible to receive a rollover from where the funds were originally withdrawn.
    d) Incorrect. The limit has been increased from $50,000 to $100,000.

22. If an individual is the surviving spouse and sole beneficiary of their deceased spouse's IRA, which of the following is correct? **(Page 5-17)**

    a) Correct. They take the deceased owner's RMD for that year and only to the extent it was not distributed to the owner before their death.
    b) Incorrect. The age for RMDs is now age 72.
    c) Incorrect. They may either roll over the funds into their own IRA or wait to take RMDs until the end of the year following the owner's death or the year in which the deceased owner would have turned age 72, whichever is later.
    d) Incorrect. The surviving spouse is the only one who may roll over an inherited IRA.

23. How has the SECURE Act affected inherited IRAs in a trust? **(Page 5-20)**

    a) Incorrect. If the trust holds distributions until some triggering event, this is known as an accumulation trust. The trust may also distribute its income to the beneficiary each year. This is a conduit trust. Conduit trusts are required to distribute funds within 10 years, but accumulation trusts are not.
    b) Incorrect. Under the SECURE Act and after 2019, assets must be distributed using the 10-year rule.
    c) Correct. With a conduit trust, the trust is able to distribute income to the beneficiary each year. Under the SECURE Act, the IRA assets must be distributed under the accelerate 10-year rules.
    d) Incorrect. An accumulation trust is not under the 10-year rules.

24. Which of the following is true regarding the small employer pension plan startup costs credit? **(Page 5-24)**
    a) Incorrect. The credit is the greater of $500 or the lesser of $250 per employee (not a highly compensated employee) or $5,000.
    b) Correct. They will still be considered eligible employers for the two years after the last year they were an eligible employer.
    c) Incorrect. The maximum is three years.
    d) Incorrect. The first credit year may be the immediately preceding tax year if the employer so elects if there were costs incurred to establish the plan.
25. What are among the details of retirement plans for long-term, part-time employees? **(Page 5-26)**
    a) Incorrect. Long-term means three consecutive 12-month periods.
    b) Incorrect. Matching contributions are not required, although employers may choose to have plans that provide for this.
    c) Incorrect. The mandate applies to plan years after December 31, 2020.
    d) Correct. These employees may also be excluded for determining the safe harbor contribution amounts.
26. Which statement best explains factors pertaining to Medicare for high-income individuals? **(Page 5-33)**
    a) Correct. This is also true for a qualifying widow or widower.
    b) Incorrect. They do not receive the benefit of the hold-harmless rules, which otherwise limits the financial strain for certain recipients if Medicare costs go up.
    c) Incorrect. The look-back period is two years, so a 2021 surcharge is based on 2019 modified AGI.
    d) Incorrect. It may only be contested if there has been a life-changing event such as a divorce, death of spouse, etc.

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Chapter 6

Miscellaneous

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MISCELLANEOUS

ESTATE, TRUST, AND GIFT TAXES

UNIFIED EXCLUSION AMOUNT

The 2020 unified exclusion amount is $11.58 million. (Rev. Proc. 2019-44) The 2021 amount is $11.7 million. (Rev. Proc. 2020-45) 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).

ANNUAL GIFT TAX EXCLUSION

For 2020 and 2021, the annual gift tax exclusion is $15,000. (Rev. Procs. 2019-44, 2020-45)

☑ Planning Pointer

Taxpayers can make up to five years' worth of annual gifts into a qualified tuition program, per recipient, under IRC §529(c)(4)(C) without the contribution being deemed a taxable gift. However, if the donor dies within the five-year period, then the portion of the upfront §529 contribution allocable to years after the donor's year of death must be included in the donor's gross estate.

Example of front-loading §529 contributions

Veronica is a single taxpayer and wants to help fund her granddaughter's college savings. In 2020, Veronica can contribute up to $75,000 ($15,000 × 5 years) directly into her granddaughter's §529 account without the contribution being deemed a taxable gift. However, if she gives her any other gifts of cash or property during the year she will be over the annual exclusion amount.

The following chart shows how much of the $75,000 gift must be included in her gross estate if she passes away within the next five years.

Year of death	Inclusion in gross estate
2020	$60,000
2021	$45,000
2022	$30,000
2023	$15,000
After 2023	$0

REGULATIONS ISSUED REGARDING DEDUCTIONS OF ESTATES AND TRUSTS

How various deductions claimed by nongrantor trusts, estates, and beneficiaries should be treated has been somewhat up in the air since the Tax Cuts and Jobs Act suspended the 2% miscellaneous itemized deduction. (IRC §67(g)) The IRS issued final regulations in 2020 that:

- Specify that the suspension of the miscellaneous itemized deductions does not impact the ability of nongrantor trusts and estates to deduct administrative expenses allowed under IRC §67(e); and
- Address the ability of beneficiaries to deduct excess deductions passed on to them in the final year of the estate or nongrantor trust.
  (Treas. Regs. §1.67-4)

As a result, the reporting of excess deductions by the nongrantor trust and estate, as well as the claiming of these deductions by the beneficiaries, has just gotten much more complicated.

What constitutes an allowable deduction for estates and trusts?

According to the proposed regulations, estates and nongrantor trusts may continue to deduct:

- Costs paid or incurred in connection with the administration of the estate or trust which would not have been incurred if not for the existence of the trust;
- Deductions for the personal exemption of an estate or nongrantor trust;
- Deductions for trusts distributing current income; and
- Deductions for trust distributions accumulating income.

Administrative costs include attorney fees, accounting fees, trustee and/or executor fees, and other administrative expenses such as appraisal fees. They do not include investment expenses. (Instructions, Form 1041, U.S. Income Tax Return for Estates and Trusts)

Excess deductions upon termination

Excess deductions on the termination of an estate or nongrantor trust are passed through to the beneficiaries. (Treas. Regs. §1.642(h)-2) These are deductions that are allowable on Form 1041 in excess of the estate's or nongrantor trust's gross income. Excess deductions do not include the personal exemption or amounts permanently set aside for charitable purposes. (IRC §642(b) and (c))

Excess deduction treatment clarified

The regulations clarify the character and manner of allocating the excess deductions as follows:

- The character of the deduction in the estate or trust remains the same in the hands of the beneficiary. For example, a nongrantor trust's excess nonmiscellaneous itemized deduction will remain so with the beneficiary;
- The fiduciary must separately identify deductions that may be limited when claimed by the beneficiary;
- The passed-through deductions are only allowed in the taxable year of the beneficiary in which the trust's or estate's termination occurs;
- Deductions exceeding the beneficiary's gross income cannot be carried over; and
- Unused net operating loss carryovers and capital loss carryovers are treated the same for the beneficiary as for the estate or trust.
  (Treas. Regs. §1.642(h)-1)

REAL ESTATE

QUALIFIED IMPROVEMENT PROPERTY

CARES Act fixes qualified improvement property problem

The CARES Act made the long-awaited correction to the TCJA's omission of qualified improvement property (QIP) as 15-year recovery property eligible for bonus depreciation. The correction applies retroactively to qualified property placed in service after December 31, 2017. (CARES Act §2307; IRC §168(e)(3)(E)(vii) and (g)(3)(B))

Because of Congress' omission of qualified improvement property (QIP) from the 15-year recovery property category in the TCJA, taxpayers were required to depreciate QIP placed in service in 2018 and 2019 as 39-year recovery property and were ineligible to claim bonus depreciation.

This new CARES Act provision allows taxpayers to go back and claim bonus depreciation for that property.

Comment

This change couldn't be coming at a better time as it can provide a big tax break for restaurants, retailers, commercial property owners, and other businesses, all of whom have been hit hard by the COVID-19-induced economic slowdown. If these companies placed any QIP in service in 2018 or 2019, retroactively claiming bonus depreciation, or at least a shortened recovery period, can put money in these taxpayers' hands quickly.

As discussed later, Rev. Proc. 2020-25 gives taxpayers a simplified method to retroactively claim bonus depreciation, or the ability to make a late election to retroactively opt out of bonus depreciation if the taxpayer so desires.

California nonconformity

California has never allowed bonus depreciation and has never allowed a shortened recovery period for real property improvements. (R&TC §§17250, 17255, 24349, 24356)

Practice Pointer

Even though the changes reported on an amended federal return to claim bonus depreciation or a shortened recovery period will not impact a corporate income taxpayer's California tax liability, they must report the federal change to the FTB in order to prevent the extension of the statute of limitations for the taxable year. (R&TC §§18622, 19059, 19060) Personal income taxpayers are only required to report the change if it will increase their California tax liability for any year.

Defining qualified improvement property

As amended by the CARES Act, "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, it 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, 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.

Caution

Keep in mind that improvements to residential rental property are not included in qualified improvement property.

How to claim retroactive benefits

To help taxpayers take advantage of this provision, the IRS is allowing a "simplified method" for taxpayers to claim bonus depreciation for qualified improvement property placed in service in 2018 or 2019. (Rev. Proc. 2020-25, Section 6)

A taxpayer may file amended returns for years QIP was placed in service. However, rather than filing an amended return to claim bonus depreciation for the year the property is placed in service, the taxpayer may file a Form 3115, Application for Change in Accounting Method, in the subsequent year(s) (e.g., in the 2020 taxable year if the property was placed in service in 2018 and 2019) and claim an IRC §481(a) adjustment in that subsequent year(s). Essentially, this allows a taxpayer to claim the bonus depreciation in the year(s) after the property is placed in service.

Form 3115 may benefit CPAR partnerships

CPAR partnerships cannot file amended returns, so filing a Form 3115 for a change of accounting method in a year after qualified improvement property was placed in service can save them from going through the new, and onerous, process of filing an administrative adjustment request. See page 2-11 for a discussion of the prohibition of CPAR partnerships to file amended returns.

Practice Pointer

This change in accounting method is treated as an automatic accounting method change, and the assigned designated automatic accounting method change number (DSN) is 244.

Comment

Form 3115 is generally used to apply for a change of accounting method when a taxpayer has used an improper accounting method (including depreciation) for at least two years. If a taxpayer has only claimed a deduction or exclusion for one year, then a "method of accounting" has not been adopted, and therefore a Form 3115 is not usually used. Typically, in this situation a taxpayer would file an amended return.

Rev. Proc. 2020-25 provides guidance allowing taxpayers to use Form 3115 to claim bonus depreciation for the 2018 through 2020 taxable years, or a shortened recovery period for QIP going forward, even if they had only placed the property in service in the prior year. This saves taxpayers from having to file an amended return.

Most taxpayers who place qualified improvement property in service in 2020 will simply claim bonus depreciation when they file their income tax return.

Example of IRC §481(a) adjustment

In January 2019, ABC Corp. invested $50,000 in qualified improvement property. On its 2019 return, ABC claimed a $1,282 depreciation deduction for the property based on a 39-year recovery period. Rather than filing an amended 2019 return, ABC may file a Form 3115 with its 2020 return and make an IRC §481(a) adjustment for an additional $48,718 depreciation deduction ($50,000 bonus depreciation - $1,282 depreciation already taken on the 2019 return).

Ineligible taxpayers

This simplified method is not available if the taxpayer:

- Currently expensed the cost of the improvements on the return (e.g., under the tangible personal property repair regulations or claiming an IRC §179 expense deduction);
- Elected to be treated as an electing real property business or electing farming business for purposes of the business interest expense election. The IRS has developed other procedures for these taxpayers to retroactively revoke their election to be treated as an electing real property trade or business for business interest expense limitation purposes (see the discussion on page 4-42); or
- Is changing its method of accounting for depreciation due to a change in use of the property. (Rev. Proc. 2020-25)

Relationship to IRC §179 expense deduction

Many taxpayers who were precluded from taking bonus depreciation for QIP in 2018 or 2019 claimed an IRC §179 expense deduction instead. While this option was available for many taxpayers, not all taxpayers could make that election. IRC §179 could only be claimed if a taxpayer showed taxable income, so taxpayers who were operating at a loss were ineligible.

However, taxpayers who had taxable income, but an insufficient amount of taxable income to absorb the full QIP expenses, could carry over the unused IRC §179 expense to future years. It appears that these taxpayers would not be able to use Form 3115 because they currently expensed the cost of improvements on the 2018 or 2019 return. We believe these taxpayers would be able to file an amended return to revoke the IRC §179 election and claim bonus depreciation instead. However, this would only benefit them if their income prevented them from taking full advantage of the IRC §179 deduction.

To amend or not to amend?

Filing an amended 2018 or 2019 return is advantageous for those taxpayers who want to create or increase a 2018 or 2019 NOL to carry back five years and generate some cash now (see page 4-23 for the NOL rule changes made by the CARES Act). This would be particularly advantageous for corporations that can carry the loss back to a tax year where the rate was 35%.

For taxpayers that aren't in immediate need of funds, it might be more advantageous to claim the retroactive bonus depreciation amounts on a Form 3115 with their 2020 return and carry over any resulting NOL to future tax years.

Effect on other elections

The retroactive treatment of qualified improvement property as 15-year MACRS property may also impact other depreciation elections that were made or should have been made by a taxpayer. Therefore, the IRS is providing taxpayers an extension to make late elections or withdraw previous elections related to:

- **IRC §168(g)(7):** Election to use the alternative depreciation system (ADS) rather than MACRS for a class of property placed in service during a taxable year;
- **IRC §168(k)(5):** Election to accelerate the bonus depreciation deduction for specified plants;
- **IRC §168(k)(7):** Election out of bonus depreciation. Bonus depreciation is automatic for all property in a class unless a taxpayer elects out; and
- **IRC §168(k)(10):** Election to claim 50% bonus depreciation rather than 100% bonus depreciation for property purchased after September 28, 2017, and placed in service during the taxpayer's first taxable year that includes September 28, 2017.

Taxpayers may use similar procedures and follow similar timelines as those previously outlined for claiming bonus depreciation. The new designated automatic accounting method change number assigned (DSN) is 245 for late elections under IRC §168(g)(7), (k)(5), (k)(7), and (k)(10) or revocation of elections under IRC §168(k)(5), (k)(7) and (k)(10). The DSN is used to identify the type of accounting method change when filing Form 3115.

However, taxpayers wanting to withdraw a previously made ADS election under IRC §168(g)(7) may only make the revocation by filing an amended return. Filing a Form 3115 and making an IRC §481(a) adjustment is not available for revoking this election.

Late election out of bonus depreciation for 2018 and 2019

Rev. Proc. 2020-25 provides that taxpayers who want to elect out of bonus depreciation for qualified improvement property placed in service in 2018 and/or 2019 must do so by either:

- Filing an amended income tax return; or
- Filing Form 3115, Application for Change in Accounting Method, with the taxpayer's timely filed original federal income tax return for:
  - The taxpayer's first or second taxable year succeeding the taxable year in which the taxpayer placed the property in service;
  - Where a federal tax return is filed on or after April 17, 2020, and on or before October 15, 2021.

Bonus depreciation is mandatory unless a taxpayer elects out. So, if a taxpayer failed to elect out in 2018 and/or 2019, the IRS will treat the property as being 100% depreciated in the year it is placed in service, meaning that there will be no basis left to depreciate in later years.

Note, however, that Rev. Proc. 2020-25 also provides that taxpayers who have expensed the entire cost of their qualified improvement property by, for example, claiming IRC §179, are not required to make a late election out of bonus depreciation. (Rev. Proc. 2020-25, Section 3.01(2))

Caution

Rev. Proc. 2020-25 only provides the two options previously listed. *All* taxpayers who put qualified improvement property in service in 2018 or 2019 and did not fully expense it under IRC §179 must take action by either filing amended returns for filing Form 3115.

Failure to do so will subject the taxpayer to the "allowed or allowable" depreciation rules later. (IRC §1245(a)(2)(A); Treas. Regs. §1.1245-2(a)(7))

Example of allowed or allowable depreciation rules

GHI, Inc. operates a wholesale distribution business and owns the building where it conducts its business. GHI put $200,000 of qualified improvement property in service on June 30, 2018, and did not claim IRC §179 expensing. It did not make an affirmative election out of bonus depreciation. Therefore, when it timely filed its 2018 income tax return, GHI treated the $200,000 of qualified improvement property as 39-year property with straight-line depreciation.

GHI took depreciation deductions of $2,782 in 2018 and $5,128 in 2019 related to the qualified improvement property ($7,910 in total).

Even though it only claimed $7,910 in total depreciation, GHI cannot depreciate the qualified improvement property anymore because its allowable depreciation with respect to the qualified improvement property was $200,000. So, technically, GHI claimed depreciation it was not allowed to in 2019. This is because of the retroactive qualified improvement property provision in the CARES Act, even though when it filed its 2018 and 2019 income tax returns, GHI depreciated the property based on the law at the time.

GHI must either:

- Amend its 2018 income tax return or file Form 3115 with its 2020 income tax return to make the election out of bonus depreciation with respect to the qualified improvement property; or
- Alternatively, GHI can claim the additional bonus depreciation by either filing an amended 2018 income tax return or filing Form 3115 with its 2020 income tax return (as discussed on page 6-4).

If GHI amends its 2018 income tax return to claim bonus depreciation, it will also be required to amend its 2019 income tax return to remove the depreciation deduction it should not have taken.

If GHI amends its 2018 income tax return to elect out of bonus depreciation, it will continue to depreciate its QIP over 39 years.

Form 3115

A taxpayer filing a Form 3115 to make a depreciation/accounting change or to make or revoke an election only needs to complete the following information:

- The identification section of page 1 (above Part I);
- The signature section at the bottom of page 1;
- Part I;
- Part II, all lines except lines 11, 12, 13, 15, 16, 17, and 19;
- Part IV, all lines; and
- Schedule E, all lines except lines 1, 4b, 5, and 6.
  (Rev. Proc. 2020-25, Section 6)

✐ Practice Pointer

Only one Form 3115 is needed showing the IRC §481(a) net taxable income adjustment for taxpayers making multiple changes under Rev. Proc. 2020-25, such as revoking an election to forego bonus depreciation and making an accounting method change to claim bonus depreciation.

The following automatic change prohibitions outlined in Rev. Proc. 2015-13 do not apply to the QIP changes in Rev. Proc. 2020-25:

- Prohibiting an automatic change for final year returns; and
- Prohibiting a second accounting method change for the same item in a five-year period.

Starting July 31, 2020, and until further notice, the duplicate copy of Form 3115 must be fax-filed to the IRS at:

Fax
(844) 249-8134

The temporary fax-filing procedure only applies to taxpayers requesting a change in accounting method under the automatic change procedures. (www.irs.gov/newsroom/temporary-procedure-to-fax-automatic-consent-forms-3115-due-to-covid-19)

Taxpayers still must attach a copy of Form 3115 to their income tax return.

LIKE-KIND EXCHANGES

Regulations address cost segregation studies

The IRS has finally provided guidance to help define real property for purposes of IRC §1031 exchange transactions. When the Tax Cuts and Jobs Act was passed in December 2017, it limited like-kind exchanges to real estate transactions only. (IRC §1031(a)(1))

The big question at the time revolved around owners of real estate who engaged in cost segregation studies. A cost segregation study segregates the components of real property into its shorter depreciable-life components.

The purpose of a cost segregation study is to take an asset with a long depreciable life, such as 39-year nonresidential real estate that must be depreciated on the straight-line basis, and break it out into five-year, seven-year, 10-year, 15-year, 20-year, and/or 39-year property. Breaking the components of a building out into shorter-life property allows for accelerated depreciation, thus front-loading deductions.

So, if a building that has been the subject of a cost segregation study has been broken out into components, does that mean the shorter-life assets are no longer defined as real property, and thus cannot be included in a fully tax-deferred exchange? That was the big question when the TCJA limited like-kind exchanges to real property. The IRS has issued proposed regulations that largely answer this question for exchanges of real property beginning after December 31, 2017.

Comment

We will dive into a bit of technical detail regarding the newly issued proposed regulations here. However, for most taxpayers who own real property that has been subjected to a cost segregation study, they can breathe a sigh of relief because these proposed regulations will allow them to treat most, if not all, of the segregated components of their property as real property for purposes of the like-kind exchange rules.

IRC §1031 real property

For purposes of applying the like-kind exchange rules under IRC §1031 and the associated regulations, the term "real property" includes:

- Land;
- Improvements to land;
- Unsevered natural products of land; and
- Water and air space superjacent to land.
  (Prop. Treas. Regs. §1.1031(a)-3(a)(1))

Comment

The Proposed Treasury Regulations provide rules for defining real property but only for purposes of the like-kind exchange rules under IRC §1031 and its associated regulations. (Prop. Treas. Regs. §1.1031(a)-3(a)(2)(i)) In other words, these rules do not apply for purposes of defining real property anywhere else within the Internal Revenue Code.

Structures and improvements

The term "improvements to land" means inherently permanent structures and the structural components of inherently permanent structures. (Prop. Treas. Regs. §1.1031(a)-3(a)(2)(ii)(A)) Further, the term "inherently permanent structures" means any building or other structure that is a distinct asset and is permanently affixed to real property and that will ordinarily remain affixed for an indefinite period of time. (Prop. Treas. Regs. §1.1031(a)-3(a)(2)(ii)(C)(1)–(5)) We discuss the definition of "distinct asset" later.

✐ **Practice Pointer**

The proposed regulations provide a long list of inherently permanent structures that are too numerous to list here. They include in-ground swimming pools, telephone poles, gas lines, boat docks, etc. To determine whether a particular improvement upon land is an inherently permanent structure, practitioners should start by referencing Prop. Treas. Regs. §1.1031(a)-3(a)(2)(ii)(C) to determine if their property is specifically listed.

For any property not listed in the proposed regulations, the determination of whether the property is an inherently permanent structure is based on the following factors:

- The manner in which the distinct asset is affixed to real property;
- Whether the distinct asset is designed to be removed or to remain in place;
- The damage that removal of the distinct asset would cause to the item or to the real property to which it is affixed;
- Any circumstances that suggest the expected period of affixation is not indefinite; and
- The time and expense required to move the distinct asset.
  (Prop. Treas. Regs. §1.1031(a)-3(a)(4))

Distinct assets

A distinct asset must be analyzed separately from all other assets to which it relates to determine if the asset is real property (i.e., land, an inherently permanent structure, or a structural component of an inherently permanent structure). (Prop. Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B)) Buildings and other inherently permanent structures are distinct assets unto themselves. Additionally, walls, doors, HVAC systems, elevators, etc., are also treated as distinct assets. (Prop. Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B))

If an asset is not automatically determined to be a distinct asset because it is not a building, an inherently permanent structure, or specifically listed in the proposed regulations (Prop. Treas. Regs. §1.1031(a)-3(a)(4)(ii)(A)–(D)), then factors similar to the factors used to determine whether an asset is a structure must be taken into account to determine whether the asset is a distinct asset. (Prop. Treas. Regs. §1.1031(a)-3(a)(2)(ii)(D))

Machinery

Machinery or equipment is generally not an inherently permanent structure and not real property for purposes of the like-kind exchange rules. (Prop. Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B)(1)–(4)) However, if a building or inherently permanent structure includes property in the nature of machinery or equipment as a structural component, then the machinery is defined as real property if it serves the inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of the space.

Example of machinery defined as real property

Dale owns a two-story rental building in an area that contains many senior citizen renters. In order to attract more tenants, he installs a chair lift on the staircase to his rental property.

A chair lift is a piece of machinery, but it serves the permanent structure of the building and contributes to the use or occupancy of the rental property. As such, if Dale were to relinquish his rental property in a like-kind exchange, then the chair lift is deemed to be part of the real property.

✐ Practice Pointer

Similar to the definition of "inherently permanent structure," the proposed regulations provide a long list of structural components that are too numerous to list here. They include walls, partitions, elevators, floors, HVAC systems, etc. To determine whether a particular piece of machinery is part of a structural component, practitioners should start by referencing Prop. Treas. Regs. §1.1031(a)-3(a)(2)(iii)(B).

For any property not listed in the proposed regulations, the determination of whether the component is a structural component is based on the following factors:

- The manner, time, and expense of installing and removing the component;
- Whether the component is designed to be moved;
- The damage that removal of the component would cause to the item or to the inherently permanent structure to which it is affixed; and
- Whether the component is installed during construction of the inherently permanent structure.

(Prop. Treas. Regs. §1.1031(a)-3(a)(3))

Natural products of land

Unsevered natural products of land, including growing crops, plants, and timber; mines; wells; and other natural deposits, generally are treated as real property. (Prop. Treas. Regs. §1.1031(a)-3(a)(5)) Natural products and deposits stop being real property when they are severed, extracted, or removed from the land.

Intangible assets

To the extent that an intangible asset derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of the property, the intangible asset is deemed to be real property for purposes of the like-kind exchange rules under IRC §1031 and its associated regulations. (Prop. Treas. Regs. §1.1031(a)-3(a)(6))

RENTAL REAL ESTATE AND IRC §199A

Rental real estate may constitute a qualifying trade or business for purposes of the qualified business income deduction if it:

- Meets the definition of a trade or business under IRC §162;
- The taxpayer uses the IRC §199A rental real estate safe harbor; or
- Meets the self-rental exception; that is, the property is rented to a commonly controlled party as described in Treas. Regs. §1.199A-1(b)(14).
  (Rev. Proc. 2019-38)

Trade or business standard

Neither the Code, regulations, IRS guidance, Congressional intent, nor case law has provided a clear answer to the question: When does a rental activity rise to the level of a trade or business under IRC §162? In the realm of IRC §199A, the IRS has provided a safe harbor through Rev. Proc. 2019-38, discussed later, but only for taxpayers who meet the safe harbor requirements.

Taxpayers who do not meet the safe harbor requirements of Rev. Proc. 2019-38 are left with conflicting guidance at best when determining whether their rental activity rises to the level of a trade or business and is therefore eligible for IRC §199A deduction.

Groetzinger standard

When determining whether any activity is a trade or business or an investment, courts and commentators alike turn to the 1987 ***Groetzinger*** case. (***Comm. v. Groetzinger*** (1987) 480 US 23) In this case, the U.S. Supreme Court examined whether a full-time gambler was in the trade or business of gambling and therefore not subject to AMT. The court found that ***Groetzinger***, who devoted between 60–80 hours a week wagering on dog races, was in a trade or business. In making that determination, the court stated that to be engaged in a trade or business, the taxpayer:

- Must be involved in the activity with continuity and regularity; and
- The taxpayer's primary purpose for engaging in the activity must be for income or profit.

The court also stated that whether an activity rises to the level of a trade or business "requires an examination of the facts in each case."

Trade or business rental cases

Most of the U.S. district and appellate courts use a standard similar to the ***Groetzinger*** standard, requiring a finding of some form of continuous and regular activity in relation to the rental property before finding that the taxpayer was engaged in a trade or business. The one exception is the Seventh Circuit's decision in ***Reiner v. U.S.***, in which the court adopted the Tax Court's ***Lagreide*** reasoning, that the owning of a single rental property amounts to a "trade or business." (***Reiner v. U.S.*** (1955) 222 F.2d 770; ***Lagreide v. Comm.*** (1954) 23 TC 508)

The Tax Court had historically adopted the position taken in ***Lagreide***. However, in 1980, the Tax Court, too, began following a similar position as the other federal appellate and district cases. In ***Curphey v. Comm***., the Tax Court allowed a dermatologist to claim a home office deduction because the taxpayer used the office in relation to managing six rental properties. (***Curphey v. Comm.*** (1980) 73 TC 766) The court noted that his activities in screening tenants, supplying furnishings, and maintaining the units were "sufficiently systematic and continuous to place him in the business of real estate."

The Tax Court reached the opposite conclusion but applied the same standard in ***Anderson v. Comm.*** in 1982, in which another dermatologist rented out farmland, finding that the taxpayer simply leased the farmland to a tenant farmer and relieved himself of all responsibilities for the land and that he failed to "establish that his activities were sufficiently regular, systematic, and continuous as to place him in the business of farm management." (***Anderson v. Comm.***, TCM 1982-576)

Similarly, in ***Jafarpour v. Comm.*** in 2012, the Tax Court denied GO-Zone bonus depreciation to California taxpayers who purchased three rental properties in Louisiana and Alabama. (***Jafarpour v. Comm.***, TCM 2012-165) The court noted that the taxpayer simply reviewed rental agreements and left all management of the properties to property managers. (**Note:** Other court cases have found that the property managers were agents of the taxpayers, and the managers acted as the taxpayers' agents for purposes of establishing the requisite level of continuous and regular activities.)

Substantiating a trade or business

While we feel it is possible to establish a rental activity as a trade or business even if the taxpayer and their agents do not meet the 250-hour threshold of Rev. Proc. 2019-38, it's important that the taxpayer conduct its activities in a business-like manner. This means:

- Establishing separate accounts for the activity;
- Documenting what work was done and time spent (both for the taxpayer and any agents such as property managers, repair persons, landscapers, etc.); and
- Sending out Forms 1099-MISC if appropriate.

Practice Pointer

Tax professionals should ask their clients for copies of all 1099s, including the 1099 issued to a property manager to help substantiate the trade or business. This is true even if someone else, such as the property manager, is the one preparing the 1099s.

IRC §199A rental real estate safe harbor

Rev. Proc. 2019-38 provides a safe harbor under which certain rental real estate interests, including mixed-use property, will be treated as a trade or business solely for purposes of IRC §199A and the regulations thereunder.

Relevant passthrough entities (RPEs) may also use this safe harbor to determine whether a rental real estate enterprise is a trade or business. The determination is made at the entity level, not the shareholder/partner/member level. RPEs include partnerships, S corporations, LLCs taxed as partnerships or S corporations, and estates and trusts.

The safe harbor requirements

The safe harbor requirements are applied annually. Solely for the safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or multiple properties. The following four requirements must be satisfied during the taxable year with respect to the rental real estate enterprise:

1. Separate books and records must be maintained to reflect income and expenses for each rental real estate enterprise;
2. A minimum of 250 hours of rental services must be performed per year with respect to each rental enterprise;
3. Contemporaneous records must be maintained, including time reports, logs, or similar documents; and
4. The individual taxpayer or RPE must attach a statement to a timely filed original return for each taxable year in which the safe harbor is relied upon. For more than one rental real estate enterprise relying on the safe harbor, the taxpayer may submit a single statement with the required information listed separately for each.

Election statement

The statement each taxpayer must attach to the year the safe harbor provisions apply contains the following:

- A description including the address and rental category of all properties that are included in each rental real estate enterprise;
- A description including the address and rental category of all properties acquired and disposed of during the year; and
- A representation that the requirements of Rev. Proc. 2019-38 have been satisfied.

Excluded real estate

The following types of property may not be included in a rental real estate enterprise and are therefore not eligible for the safe harbor:

- Real estate used by the taxpayer (including an owner or beneficiary of a relevant passthrough entity (RPE)) as a residence under IRC §280A(d);
- Real estate rented or leased under a triple net lease. A triple net lease includes an agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to pay for maintenance activities;
- Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled under Treas. Regs. §1.199A-4(b)(1)(i); or
- The entire rental real estate ownership interest if any portion of the property is treated as a specified service trade or business under Treas. Regs. §1.199A-5(c)(2).

Rev. Proc. 2019-38 applies to tax years ending after December 31, 2017. The contemporaneous records requirement begins with tax years beginning January 1, 2020.

Rental real estate from the K-1

The instructions to Form 1065 state:

"The determination of whether rental real estate constitutes a trade or business for purposes of the QBI deduction is made by the partnership. The partnership must first make this determination and then only include the distributive share of rental real estate items of income, gain, loss, and deduction from a trade or business on the statement provided to partners. Rental real estate that does not meet any of the three conditions noted above does not constitute a trade or business for purposes of the QBI deduction and must not be included in the QBI information provided to partners."

Furthermore, in prescribing the rules for the rental real estate safe harbor, the IRS states in Rev. Proc. 2019-38:

"Solely for purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties. The taxpayer or RPE relying on this revenue procedure must hold each interest directly or through an entity disregarded as an entity separate from its owner under any provision of the Code."

What this means to the partner

The IRS is steadfast that:

- The determination as to whether rental real estate income is qualifying QBI is made by the partnership and not by the partner; and
- To treat a real estate rental as part of a real estate rental enterprise, the taxpayer must own the property directly.

Example of enterprise

Kay owns 10 single-family residences that she rents. She spends 45 hours per year performing services for each one.

No single one of the ten rentals can meet the 250-hour safe harbor requirement. However, by treating them as a single enterprise, her total time spent on the enterprise is 450 hours. If she meets the other requirements of the safe harbor, the income from the rentals is QBI.

She is also a partner in a partnership that owns a single residential rental. The partnership has not indicated on her K-1 that the rental generates qualifying QBI.

Kay is out of luck. The determination was made at the partnership level. Furthermore, she can't rescue it my making it a part of her rental real estate enterprise because she does not own the property directly.

Caution

Remember, you don't always want rental real estate to qualify. Rental real estate often generates losses, and losses will offset QBI from other sources.

QUALIFIED OPPORTUNITY ZONES

Under the QOZ program, taxpayers may defer the recognition of capital gains for a specified period if the taxpayer invests the capital gains in a Qualified Opportunity Fund (QOF). In addition to the deferral, taxpayers who hold the property for a sufficient period of time may permanently exclude up to 15% of the gain deferred, and may exclude all postacquisition gain (gain from the QOF investment) if the investment is held for at least 10 years.

Due dates postponed

In IRS Notice 2020-39, the IRS provided the following relief to Qualified Opportunity Funds (QOFs) and their investors:

- **180-day investment deadline:** The 180-day investment deadline for taxpayers to invest their capital gains into a QOF and qualify for tax deferment is extended to December 31, 2020, if the last day of the original 180-day investment period falls on or after April 1, 2020, and before December 31, 2020. Previously, IRS Notice 2020-23 extended the investment deadline to July 15, 2020;
- **90% investment standard:** The standard that requires a QOF to hold at least 90% of its assets in Qualified Opportunity Zone (QOZ) property or be subject to penalty is temporarily waived. A QOF will automatically be deemed to have reasonable cause for failing to satisfy this requirement if the following deadlines fall within the period beginning on April 1, 2020, and ending December 31, 2020:
  - The last day of the first six-month period of the taxable year; or
  - The last day of the taxable year.
- **30-month substantial improvement period:** The period beginning on April 1, 2020, and ending on December 31, 2020, is disregarded in calculating the 30-month substantial improvement period for purposes of determining whether tangible property used in a QOF's trade or business is QOZ property. To be treated as QOZ property, the property's original use must begin with the QOF, or the QOF must substantially improve the property within the 30-month period after acquiring the property;
- **Working capital safe harbor:** QOZ businesses holding working capital assets intended to be covered by the working capital safe harbor will be given an additional 24 months to expend the working capital assets. One of the requirements to be a QOZ business is that less than 5% of the entity's property be nonqualified financial property, but taxpayers may qualify for up to a 62-month maximum working capital safe harbor (now extended to up to 86 months); and
- **12-month reinvestment period:** QOFs are given an additional 12 months to reinvest QOZ property/stock if the QOF's initial 12-month reinvestment period includes January 2020. Under the QOZ regulations, a QOF will continue to satisfy the 90% investment requirement if it reinvests proceeds from sales of QOZ property or stock within 12 months. (Treas. Regs. §1.1400Z2(f)-1(b)(1))

Final Qualified Opportunity Zone regulations issued

The IRS has issued final regulations and FAQs governing Qualified Opportunity Zones (QOZs). (T.D. 9889; Final Regulations on Opportunity Zones: Frequently Asked Questions available at: https://home.treasury.gov/news/press-releases/sm864)

Only eligible gains from the sale of an asset to an unrelated person qualify for deferral. The key changes regarding "eligible gains" that were adopted in the final regulations include:

- **IRC §1231 gains:** The final regulations do not follow the proposed regulations' requirement that taxpayers net their IRC §1231 gains and losses from the sale of business property at the end of the year to determine whether there were eligible capital gains to invest in a QOF. Instead, the final regulations allow taxpayers to invest an IRC §1231 gain (less any IRC §1245 or IRC §1250 recapture income) from each individual transaction in a QOF, without having to net any losses from other sales throughout the year. (Treas. Regs. §1.400Z2(a)-1(b)(11)(iii)) Not only does this allow for investing in a QOF by taxpayers who might not otherwise have been able to under the proposed regulations, but it also increases the amount of IRC §1231 losses that might be given ordinary loss treatment, rather than being applied against the IRC §1231 gain at the end of the year;

- **Installment sales:** Payments from installment sales received after December 22, 2017, (the date the QOZ deferral was enacted) are eligible for deferral, even if the initial sale occurred prior to December 22, 2017;
- **Reinvestment of previously invested gains:** The final regulations, unlike the proposed regulations, allow a taxpayer to defer gain recognized as a result of an inclusion event (e.g., the sale of a partial QOF interest) even if the taxpayer disposes of less than its entire investment in the QOF as long as the taxpayer otherwise satisfies all requirements for a deferral election;
- **Sales to QOFs/QOZ business:** According to the preamble to the final regulations, taxpayers are generally prohibited under the step-transaction doctrine and circular cash flow principles from deferring gain received from selling assets to a QOF or QOZ business even if the sale proceeds are reinvested in the QOF or business. Such a transaction is treated as a contribution of capital to the QOF or business in exchange for an ownership interest. Thus, there is no "sale" giving rise to an eligible gain;
- **Built-in gains:** Built-in gains of an S corporation that would be required to be recognized under IRC §1374 or of a real estate investment trust (REIT) or regulated investment company (RIC) required to be recognized under Treas. Regs. §1.337(d)-7 qualify for deferral if invested in a QOF; and
- **Nonresident investment:** Regarding eligible gain of foreign or exempt persons, deferral is available if the gain would otherwise be subject to federal income tax. A deferral election may generally be made by nonresident alien individuals and foreign corporations with respect to an item of capital gain that is effectively connected with a U.S. trade or business. Similarly, an organization that is subject to the unrelated business income tax may generally make a deferral election with respect to an item of capital gain to the extent the item would be included in computing the organization's unrelated business taxable income.
(Treas. Regs. §1.400Z2(a)-1)

180-day period

The final regulations make the following changes to when the 180-day investment period commences:

- **Passthrough entity owners:** Passthrough entity owners (other than grantor trust owners) are given an additional election option as to when the 180-day period begins when the gain originates at the passthrough entity level and may now elect to commence the 180-day period on the due date of the entity's return (not including extensions). As under the proposed regulations, the 180-day period generally begins at the end of the entity's taxable year, unless the owner elects to commence the 180-day period at the date of the transaction that triggered the entity's gain;
- **IRC §1231 gains:** The 180-day period begins at the time of the transaction that triggers the IRC §1231 gain (see previous discussion under "Eligible capital gains");
- **Installment sales:** Taxpayers may choose to begin the 180-day period on the day each installment payment is received or the last day of the taxable year in which the taxpayer would have recognized the gain under the installment method absent the QOF deferral; and
- **RICs/REITs:** The 180-day period for RIC/REIT capital gain dividends generally begins at the close of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized by the shareholder, unless the shareholder elects to begin the 180-day period on the day each capital gain dividend is paid. Under the proposed regulations the 180-day period

commenced at the time the RIC/REIT shareholder received a RIC/REIT dividend even though the shareholder may not know whether the dividend was paid from capital gains until the end of the RIC's/REIT's taxable year.
(Treas. Regs. §1.400Z2(a)-1)

Inclusion events

The final regulations clarify that the following inclusion events, in addition to the other events originally listed in the proposed regulations, will trigger recognition of any deferred gain:

- Decertification of a QOF, either voluntarily or involuntarily;
- An entity classification change of a QOF under the check-the-box rules;
- Transfers between spouses or incident to a divorce; and
- A distribution by a QOF partnership to a partner to the extent the distribution is of cash or property with a fair market value in excess of the partner's outside basis in the QOF partnership. However, with respect to distributions by a partnership that owns a QOF, such distribution will only be an inclusion event for the indirect QOF owner if the distribution is a liquidating distribution.
(Treas. Regs. §1.400Z2(b)-1)

The final regulations eliminated a provision in the proposed regulations that would have treated a greater-than-25% aggregate change in ownership of an S corporation as an inclusion event.

Basis adjustments

The final regulations clarify:

- The 10% and additional 5% basis increase in a QOF for investments held five and seven years, respectively, apply for all purposes of the Code, including for purposes of suspended losses under IRC §§704(d) and 1366(d); and
- The IRC §1014 step-up in basis does not apply to inherited investments in QOFs. These assets will continue to be income in respect of the decedent under IRC §1400Z-2.

Postacquisition gain exclusion

As mentioned above, taxpayers who hold their investments in a QOF for at least ten years may exclude the gain from the sale of the investment as long as the gain related to the investment of previously deferred gain. But this appeared to only apply to the sales of the equity interest. Realizing that this may preclude many taxpayers from receiving this incentive, the proposed regulations extended this exclusion to apply to capital gain from the sale or disposition of the QOF's property assets reported on the investor's Schedule K-1.

The final regulations further extend the exclusion to apply to the sale of assets by a Qualified Opportunity Zone business, as well as to some, but not all, hot assets such as unrealized receivables and depreciation recapture. Sales of inventory must still be recognized. The election to exclude the postacquisition gain can be made multiple times and so may be claimed for sales of assets made over multiple years.

RENTAL ASSISTANCE GRANTS AND EVICTION MORATORIUM

The eviction moratorium is extended until January 31, 2021, (ACRRA §502) and a new rental assistance program is established to assist landlords and tenants to avoid the eviction process.

The ACRRA allocates $25 billion for fiscal-year 2021 in tax-free rental assistance to state and local governments and Native American tribes to be used to help pay up to 12 months (15 months in some situations) of a tenant's:

- Current and back rent;
- Current and back utilities and home energy costs; and
- Other expenses related to housing incurred due to COVID-19.

Nontaxable

Assistance provided through this program is not considered as income to the tenant and is not regarded as a resource for purposes of determining the eligibility of the household or any of its members for benefits or assistance under any governmental program. (ACRRA §501(j)) However, these amounts are considered taxable income to the landlord.

Eligible recipients

Eligible recipients are households with one or more members who have:

- Qualified for unemployment benefits; or
- Experienced a reduction in household income, incurred significant costs, or experienced other financial hardship due to COVID-19; and
- Can demonstrate a risk of homelessness or housing insecurity (e.g., past due utility or rent notice, unsafe or unhealthy living conditions); and
- Have household income that is not more than 80% of area median income for the household.

Landlords can apply

Landlords may apply on behalf of their tenants but must obtain the tenant's original or digital signature on the application. They must provide a copy of the completed application to the tenant.

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FOREIGN TAX ISSUES

FOREIGN-EARNED INCOME EXCLUSION

Current limits

In 2020, a U.S. individual living abroad can exclude up to $107,600 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. 2019-44) The exclusion applies separately to spouses; as such, if both spouses are qualified individuals, the spouses may exclude up to $215,200.

The 2021 foreign earned-income exclusion amount is $108,700. (Rev. Proc. 2020-45)

Relief for workers who returned to U.S. due to COVID-19

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 the COVID-19 pandemic. (Rev. Proc. 2020-27) The waiver applies to any individual who reasonably expected to meet the eligibility requirements for the foreign-earned income exclusion during 2019 or 2020 but failed to do so because the individual departed a foreign country during the following dates:

- December 1, 2019, through July 15, 2020, for taxpayers who left the People's Republic of China; and
- February 1, 2019, through July 15, 2020, for all other countries.

Individuals seeking to qualify for the foreign-earned income exclusion because they could reasonably have been expected to have been present in a foreign country for 330 full days but for the COVID-19 pandemic and have met the other requirements for qualification may use any 12-month period to meet the qualified individual requirement. (Rev. Proc. 2020-27)

Example of relaxed time requirements for the exclusion

Jay arrived in China on September 1, 2019, and established that he reasonably expected to work in China until September 1, 2020, but departed China on January 10, 2020, due to the COVID-19 pandemic. Under Rev. Proc. 2020-27, Jay would be a qualified individual for the period from September 1, 2019, through December 31, 2019, and for the period January 1, 2020, through January 9, 2020, assuming he has met the other foreign-earned income exclusion requirements. (Rev. Proc. 2020-27) As such, Jay can claim the foreign-earned income exclusion for the lesser of his foreign-earned income or the exclusion amount.

California nonconformity

California does not conform to the foreign-earned income exclusion. (R&TC §17024.5(b)(8)) California residents are subject to tax on their worldwide income.

FOREIGN REPORTING

U.S. persons with interests in foreign accounts (FBAR) or foreign assets (FATCA) must file annual reports with the U.S. government (see page 12-22 for a chart outlining these requirements and page 12-23 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).

For individuals, in most cases, the FTB requires a copy of the federal tax return to be attached to the California return. If the federal return is attached, that will include Form 8938, which will meet the requirement. If not, you must attach the Form 8938. For entity returns, you must attach the appropriate form if a complete federal return is not attached.

FBAR penalties

Under IRC §5321 the maximum penalty for an FBAR violation is $12,921 (inflation-adjusted for penalties assessed after January 15, 2017) unless the violation is willful. Willful violations are subject to a maximum penalty equal to the greater of $129,210 (inflation-adjusted for penalties assessed after January 15, 2017) 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 January 2017.

Nonwillful FBAR penalty is per FBAR, not per account

A district court has ruled that the penalty for a nonwillful FBAR violation is assessed per FBAR, not per account. (31 U.S.C. §5321(a)(5)(A) and (B)(i); ***U.S. v. Bittner*** (June 29, 2020) U.S. District Court, Easter Dist. of Texas, Case No. 4:19-cv-415)

An FBAR may be used to report multiple accounts. The court examined the statute and found that penalties for willful failure to file an FBAR may relate to the balance in that account at the time of the violation, and the willfulness provision existed well before Congress added the nonwillfulness provision. Congress therefore had a template for how to relate an FBAR reporting penalty to specific financial accounts, and the fact that it did not do so for nonwillful violations is persuasive evidence that it intended for the nonwillful penalties not to relate to specific accounts.

Courts split on how high FBAR penalties may go

Although IRC §5321 was amended in 2004 to authorize increased penalties of up to the greater of $100,000 ($129,210 as adjusted for inflation) or 50% of the amount in the foreign accounts, Treas. Regs. §103.57 was never amended to reflect this increased ceiling. The regulation only authorized the IRS to impose the lesser of $100,000 (adjusted for inflation) or 25% of the amount in the accounts, which reflected the prior statutory limits.

The federal district courts are divided as to whether the IRS's failure to update the regulation limits the amount of the penalty that may be imposed. The issue is whether the limit is an annual limit or an overall limit. Here are the most recent cases.

Teacher hit with FBAR penalty

A schoolteacher was hit with a 50% FBAR penalty equal to $803,530 for failing to report her numbered Swiss bank account in any year including 2007, the tax year at issue. (***Norman v. U.S.*** (November 8, 2019) U.S. Court of Appeals, Federal Circuit, Case No. 2018-2408) For years 2001–2008, the account balance was between $1.5 million and $2.5 million. The taxpayer claimed that she had only discovered the account in 2009 and had no control over it, and argued that the penalty should be limited to $100,000. However, prior to 2009 she had numerous conversations with her account representative about the account and signed tax returns knowing that the account was not reported. The court rejected the taxpayer's contention that the penalty was limited by regulation to $100,000, finding that 2004 legislation increasing the penalty to the greater of 50% of the balance of the account or $100,000 superseded the regulation.

FBAR failure results in huge penalty

A taxpayer was held to have willfully failed to file an FBAR, costing him penalties of $988,254 for tax years 2007–2009. (***U.S. v. Ott*** (February 26, 2020) U.S. District Court, Eastern District of Michigan, Case No. 18-cv-12174) The court found the taxpayer had acted in numerous ways to conceal the existence of the account, which had its highest balance of $1.9 million.

The taxpayer, a U.S. resident, opened a brokerage account with a Canadian financial institution in 1993, and the funds were ultimately deposited with Octagon, another Canadian financial institution, in 2006. When the taxpayer opened the Octagon accounts, he used his sister's Canadian home address. While he had regular contact with the securities broker at Octagon over the years, he did not mention the accounts to his long-time accountant.

Between 2007 and 2009, the Octagon accounts ranged in value from $770,000 to $1.9 million, in aggregate. In contrast, the taxpayer reported income of $21,381 for tax year 2007.

On the taxpayer's Schedule B for the years at issue, the "No" box was checked regarding ownership of foreign accounts; however, this box was not affirmatively checked, rather it was a default setting in the tax practitioner's software.

In 2010, the taxpayer finally told his tax professional about the accounts and was referred to a tax attorney who recommended the taxpayer enter the IRS Offshore Voluntary Disclosure Initiative. However, the taxpayer opted out of the OVDI and submitted a statement outlining his reasonable cause defense to the FBAR penalties. An audit ensued, and the court upheld the IRS's assessment that the taxpayer had willfully failed to file FBARs because:

- He signed a return each year under penalty of perjury and, whether he actually read the returns or not, signing the return as they were filed was a certification that he did not have an interest in a foreign account;
- He relied on advice he had received decades earlier from a friend regarding the taxability of foreign accounts — specifically that he did not need to report foreign accounts. Failing to discuss this advice with his accountant was a conscious effort to avoid reporting the accounts;
- He avoided detection by using his sister's address, which was in the same country as the location of the accounts;
- He maintained contact with his Canadian broker and regularly checked the balance online; and
- The balance in the accounts was significantly disproportionate to the amount of income he claimed.

FATCA withholding requirements scaled back

A 30% withholding requirement applies to payments made to account holders in foreign financial institutions, nonfinancial foreign entities that fail to adopt information reporting requirements with respect to U.S.-owned accounts, and substantial U.S. owners. The IRS has determined that implementing withholding on gross proceeds is no longer necessary given current rates of FATCA reporting compliance, and deferral of the foreign passthrough payment withholding is necessary due to complex implementation concerns.

The IRS has issued proposed regulations that:

- Eliminate the 30% withholding requirement for gross proceeds from the sale or other disposition of an asset (e.g., stocks or private equity) and certain insurance premiums; and
- Defer implementation of the 30% withholding requirement for foreign passthrough payments. (REG-132881-17)

Reporting ownership in foreign corporations

In addition to foreign bank account (FBAR) and foreign asset (FATCA) reporting, U.S. persons must also report their ownership interest in foreign corporations if they own at least 10% of a controlled foreign corporation (CFC). Ownership interest of 10% or more of CFCs is done on Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations.

Failure to file Form 5471 can result in:

- Immediate imposition of a $10,000 penalty by the IRS under IRC §6038;
- An additional $10,000 for each 30-day period the taxpayer fails to file within 90 days after receiving an IRS notice (up to a $50,000 maximum);
- A 10% reduction of the Foreign Tax Credit; and
- An open-ended statute of limitations period, not only for the Form 5471, but for the return to which it should have been attached (e.g., Form 1040 or 1120).
  (IRC §§6038, 6501(c)(8))

TCJA FOREIGN TAXATION UPDATES

Under changes to the U.S. international taxation scheme enacted by the TCJA, U.S. shareholders (10% owners of a controlled foreign corporation (CFC)) are subject to tax on global intangible low-tax income (GILTI) received from a CFC, generally beginning with the 2018 taxable year. (IRC §951A; Treas. Regs. §1.951A-1(b)) Tax is imposed on a U.S. 10% shareholder's *pro rata* share of a CFC's "intangible" income when it is earned (even though it may not actually be distributed). This especially impacts U.S. shareholders (and their owners if the shareholder is a passthrough entity) of CFCs that are tech companies, provide services, or have a lot of intangible assets.

With the enactment of "GILTI," most of a U.S. shareholder's undistributed income from a CFC is taxed as either Subpart F income (e.g., income from dividends, interest, rents, and royalties) or GILTI.

The tax on GILTI is imposed against all 10% U.S. shareholders of a CFC, including individuals, passthrough entity owners, and C corporations. There are no *de minimis* exceptions to this tax.

However, the TCJA provided various tax breaks and deductions related to this foreign-source income, including:

- A 50% deduction of GILTI income (reduced to 37.5% for post-2025 tax years) to domestic corporations that are U.S. shareholders in a CFC (IRC §250);
- A 100% dividends received deduction available for the foreign-source portion of any dividend paid by foreign corporations to a domestic corporation that is a 10% or greater U.S. shareholder (IRC §245); and
- A 37.5% deduction (reduced to 21.875% for post-2025 tax years) for U.S. corporations providing goods or services to foreign entities or for foreign use. (IRC §250) This is referred to as the foreign-derived intangible income (FDII) deduction.

Latest developments

The IRS has issued the following proposed and final regulations regarding these provisions:

- Clarify when foreign income is excludable high-taxed income (essentially taxed by a foreign jurisdiction at 90% of the effective U.S. tax rate or 18.9%) for purposes of both GILTI and Subpart F regimes and how taxpayers may make the election to exclude such income from taxation (NPRM Reg-127732-19; T.D. 9902);
- Finalize the 2019 proposed regulations regarding the deduction for foreign-derived intangible income (FDII) and GILTI (T.D. 9901), with changes that:
    - Affirm that individuals may make an IRC §962 election to be treated as a corporation for purposes of the IRC §250 50% GILTI deduction and allow individuals to claim this deduction on an amended return;
    - Ease some of the more burdensome substantiation requirements; and
    - Defer regulatory action on ordering rules for the IRC §250 GILTI and FDII deduction, IRC §163(j) business interest expense limitation, and IRC §172 NOLs. In the interim taxpayers may choose any reasonable method if the method is applied consistently for all post-2020 taxable years; and
- Provide clarification as to what is considered a “hybrid dividend” (a dividend that can qualify for tax benefits from both the U.S. and a foreign jurisdiction), which is ineligible for the IRC §245 100% dividends received deduction. (T.D. 9896)

New passthrough reporting requirements coming?

The IRS has released draft partnership forms for the 2021 tax year (that will be filed in 2022) to assist partners in determining their U.S. income tax liability for various international tax items, including deductions and credits.

The purpose of these forms is to assist partners in deciphering various items currently reported (or not) by the partnership on Schedules K, K-1, and in numerous attached statements.

The proposed simplified reporting includes:

- A new 20-page Schedule K-2 (Form 1065), which will replace portions of existing Form 1065, Schedule K (lines 16(a) through 16(r), which will be filed by the partnership with the IRS;
- A new 22-page Schedule K-3 (Form 1065), which will replace portions of Schedule K-1, Part III, and will be sent to the partner to assist the partners in completing a variety of forms in which international tax items are currently reported.

The draft forms can be viewed at:

Website
www.irs.gov/businesses/1065-form-changes

Once these forms are finalized, the IRS plans on developing similar forms for other passthrough entities, such as S corporations.

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. Which of these factors pertaining to qualified improvement property is correct?

    a) A taxpayer must file an amended return to claim retroactive benefits related to qualified improvement property
    b) Taxpayers may use Form 3115, Application for Change in Accounting Method, to claim bonus depreciation for 2018-2020
    c) The retroactive treatment of qualified improvement property as 15-year MACRS property will not affect other depreciation elections
    d) Bonus depreciation is not mandatory

28. Which statement is true regarding rental real estate under IRC §199A?

    a) Owners of rental real estate are considered to be in a trade or business and eligible for the deduction as long as they work 250 or more hours per year in each rental enterprise
    b) The taxpayer is required to perform at least 200 hours of rental services per year for each rental enterprise
    c) When dealing with a partnership, the determination as to whether rental real estate income is qualifying QBI is made by the partnership, not the partner
    d) For purposes of the safe harbor, the taxpayer is required to attach a statement to a timely filed return describing the rental real estate properties; multiple statements must be submitted if there is more than one rental real estate property

29. What is included in the IRS-provided relief for Qualified Opportunity Funds and their investors?

    a) QOZ businesses with working capital assets intended to be covered by the working capital safe harbor are provided with an additional 24 months to expend their working capital assets
    b) The 180-day investment deadline for investing capital gains into a QOF and qualify for tax deferment has been extended to December 15, 2020
    c) The period beginning April 1, 2020, and ending December 31, 2020, is disregarded for purposes of calculating the 36-month substantial improvement period for determining if tangible property used in a QOF's business is QOZ property
    d) QOFs have been provided an extra 24 months to reinvest Qualified Opportunity Zone property if the QOF's initial 12-month reinvestment period includes January 2020

30. Which choice correctly reflects up-to-date guidance from the IRS regarding the deduction for income from foreign sales?

    a) 5% U.S. shareholders of a controlled foreign corporation are taxed on their global intangible low-taxed income
    b) Final regulations confirm that individuals may make an IRC §962 election to be treated as a corporation for purposes of the GILTI deduction
    c) Individual owners of foreign corporations are not allowed the 50% GILTI deduction
    d) The U.S. will defer tax on a U.S. shareholder's deemed income from a controlled foreign corporation until it is distributed

SOLUTIONS TO REVIEW QUESTIONS

27. Which of these factors pertaining to qualified improvement property is correct? **(Page 6-4)**

    a) Incorrect. They may also use Form 3115 to claim bonus depreciation for qualified improvement property placed in service in 2018 or 2019.
    b) Correct. The use of Form 3115 is considered a simplified method from claiming bonus depreciation for qualified improvement property.
    c) Incorrect. Other elections affected include, for example, the election to use ADS instead of MACRS, the election to accelerate bonus depreciation, and the election out of bonus depreciation.
    d) Incorrect. It is mandatory unless the taxpayer elects out.

28. Which statement is true regarding rental real estate under IRC §199A? **(Page 6-14)**

    a) Incorrect. This is just one of the requirements of the safe harbor. The taxpayer must also keep contemporaneous records regarding their services, and separate books must be maintained pertaining to each rental real estate enterprise.
    b) Incorrect. The hourly minimum is 250.
    c) Correct. This is stated in the instructions to Form 1065.
    d) Incorrect. The statement must include the address of all the rental real estate properties and their rental category (commercial or residential), including all properties acquired and disposed of, and a representation that all the requirements of Rev. Proc. 2019-38 are met. One statement is enough for multiple rental real estate enterprises, but the required information must be stated separately for each one.

29. What is included in the IRS-provided relief for Qualified Opportunity Funds and their investors? **(Page 6-16)**

    a) Correct. Taxpayer may qualify for up to 86 months maximum for the working capital safe harbor.
    b) Incorrect. The extension is to December 30, 2020; previously July 15, 2020.
    c) Incorrect. The substantial improvement period is 30 months.
    d) Incorrect. The reinvestment period for QOFs has been increased by 12 months.

30. Which choice correctly reflects up-to-date guidance from the IRS regarding the deduction for income from foreign sales? **(Page 6-23)**

    a) Incorrect. 10% U.S. shareholders of a CFC are taxed on GILTI.
    b) Correct. Individuals may claim this deduction on an amended return.
    c) Incorrect. Individual owners qualify for the 50% GILTI deduction.
    d) Incorrect. The TCJA taxes the income (GILTI) on 10% U.S. shareholders as it is currently earned by the CFC.

Chapter 7

California Legislation and Filing Issues

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CALIFORNIA LEGISLATION AND FILING ISSUES

LEGISLATION

NEW LEGISLATION OF INTEREST

Tax Bills Enacted in 2020		
Bill No.	**Chapter No.**	**Description**
AB 85	Ch. 20-8	Enacts: • First-year exemption from $800 annual tax for LPs, LLPs, and LLCs for 2021–2023 tax years (see page 10-7); • NOL suspension for 2020–2022 tax years for businesses with income over specified levels (see page 8-6); • Business credit cap for businesses with more than $5 million in credits for 2020–22 tax years (see page 10-10); • An individual shared responsibility penalty cap for large families (see pages 7-3 and 9-1); • An extension of the carryover period for unused Film and Television credits (see page 7-3); • An extension of the sales and use tax exemption for diapers and feminine hygiene products (see page 7-4); and • A change in how used car dealers pay sales and use taxes (to the DMV rather than the CDTFA) (see page 11-13)
AB 89	Ch. 20-7	Sets collection and filing enforcement cost recovery fees; retains EITC 85% adjustment factor (see pages 11-11 and 9-23)
AB 102	Ch. 20-21	Shifts CalSavers penalty collection responsibility from EDD to FTB (see page 10-12)
AB 103	Ch. 20-22	Excludes unemployment benefits related to COVID-19 from being charged against employer's account (see page 11-15)
AB 107	Ch. 20-264	Enacts provisions that: • Authorize California Economic Improvement Tax Voucher Act; • Allows remote hearings for property tax appeals; and • Allows the FTB to share taxpayer information with the EDD for purposes of determining UI benefit eligibility and the DSS for EITC purposes (see page 11-11)
AB 276	Ch. 20-62	Conforms to the CARES Act treatment of COVID-related retirement account loans (see page 8-2)
AB 323	Ch. 20-341	Extends and expands the worker classification ABC test exemption for newspaper carriers (see page 7-10)
		(continued)

Tax Bills Enacted in 2020		
Bill No.	**Chapter No.**	**Description**
AB 1525	Ch. 20-270	Clarifies that it is not a crime to provide public accounting services to cannabis businesses (see page 10-22)
AB 1577	Ch. 20-39	Specifically requires a reduction in deductible expenses for the amount paid with forgiven PPP debt (see page 8-1)
AB 1731	Ch. 20-209	Eases the CDTFA's Workshare Program application requirements
AB 1867	Ch. 20-45	Requires large employers and employers of essential workers to provide supplemental COVID paid sick leave (see page 8-10)
AB 1872	Ch. 20-93	Suspends increases in cannabis taxes for the 2021 calendar year (see page 10-22)
AB 1876	Ch. 20-87	Expands eligibility for Earned Income Tax Credit to include taxpayers and their families with ITINs (see page 9-23)
AB 2013	Ch. 20-124	Allows property tax transfer of disaster-damaged or destroyed property's base-year value to reconstructed property (see page 11-3)
AB 2247	Ch. 20-99	Allows nonresident aliens unable to obtain a federal ITIN to provide alternative identifying information to qualify for the dependent exemption credit (see page 7-33)
AB 2257	Ch. 20-38	Enacts new and expands existing exemptions from AB 5's ABC test for purposes of classifying a worker as an independent contractor (see page 7-4)
AB 2660	Ch. 20-102	Prohibits the FTB from requiring a nonresident alien to provide a Social Security number or ITIN when filing a state return or statement under certain circumstances. These individuals may be included on a nonresident group return, and tax payments made on their behalf are excluded from their gross income
AB 3373	Ch. 20-57	Authorizes the creation of unlimited number of county assessment appeals boards
SB 592	Ch. 20-230	Mandates the FTB to include a space on the California return for a taxpayer's principal residence address and county so the FTB may provide juror information to county jury commissioners
SB 934	Ch. 20-59	Repeals the $25 exemption application fee and $10 annual filing fee for specified nonprofit organizations
SB 1305	Ch. 20-238	Extends the sunset date for issuing a revocable transfer on death deed to January 1, 2022 (see page 7-4)
SB 1447	Ch. 20-41	Authorizes up to a $1,000 credit per employee against personal income tax, corporation franchise or income tax, or sales and use taxes to small businesses for specified increases in full-time equivalent employees (see page 10-8)

Tax Bills Vetoed in 2020	
Bill No.	**Description**
AB 995	Would have repealed various hazardous waste fees
AB 1993	Would have expanded eligibility for unemployment benefits to IHSS workers
SB 972	Would have required the FTB to provide specified taxpayer information to legislative committees for taxpayers with gross receipts of $5 billion or more

Other Bills of Interest Enacted in 2020		
Bill No.	**Chapter No.**	**Description**
AB 1205	Ch. 267	Revises the composition of the California Cut Flower Commission
AB 1551	Ch. 156	Requires PACE financing and disclosure statements to be large enough to read
AB 2152	Ch. 96	Prohibits pet stores from selling dogs, cats, or rabbits

CALIFORNIA TAX INCREASES ON HOLD

The two bills to increase California taxes on high net worth individuals were not enacted this year. AB 1253 (Santiago) would have raised California's maximum income tax rate to a massive 16.8%, and AB 2088 (Bonta) would have enacted a "wealth tax" of 0.4% on Californians' net worth over $30 million. However, due to the limited time remaining in the legislative session, these proposals did not come up for a vote before the session ended.

Unfortunately, that doesn't mean these proposals are dead. Expect at least one, if not both, of these proposed increases to be brought back up for consideration early next year.

BUDGET BILLS

As part of the California budget, the California General Assembly passed AB 85 and AB 103, which include the following tax changes:

- An annual tax first-year exemption for LLCs, LLPs, and LPs (see page 10-7 for more information);
- NOL suspensions for certain taxpayers (see page 8-6 for more information);
- A $5 million business credit limitation (see page 10-10 for more information);
- A cap on the individual shared responsibility penalty imposed against taxpayers who fail to maintain minimum essential health care coverage for taxpayers with more than five household members (see page 9-1 for more information);
- A provision prohibiting the EDD from charging unemployment compensation benefits paid to employees against the employer's reserve account for the duration of all federal unemployment benefit programs specifically created to respond to the COVID-19 pandemic (see page 11-15 for more information);
- An extension of the carryover period from six years to nine years for unused Film and Television 2.0 Credits, which were available during the 2016–2020 taxable years (R&TC §§17053.95, 23695);

- An extension of the sunset date for the sales and use tax exemption for purchases of diapers and feminine hygiene products from January 1, 2022, to July 1, 2023 (R&TC §§6363.9, 6363.10);
- Requirement for used car dealers to remit sales tax to the Department of Motor Vehicles with the registration fees for sales occurring after 2020 (R&TC §6295); and
- An expansion of the Earned Income Tax Credit and Young Child Credit by eliminating the Social Security number requirement in specified instances. (AB 93 (Ch. 20-19); R&TC §17052) (See page 9-23 for more information on this provision.)

NO TAX PREPARER FEE NOTIFICATION REQUIRED

Assemblyman Stone, author of AB 1140, has shelved the bill that would have imposed new fee notification requirements on tax preparers and will no longer be moving this legislation along. However, it's not out of the realm of possibility that we will see this bill again in the future.

AB 1140 would have required CTEC-registered tax preparers (but not CPAs, lawyers, or Enrolled Agents) to:

- Provide taxpayers with the preparer's costs and fees upfront; and
- Refer taxpayers who may be eligible for the Earned Income Tax Credit (EITC) to free tax preparation services.

Tax preparers who repeatedly fail to comply with these requirements would have been subject to penalties of up to $750 per violation.

REVOCABLE TRANSFER ON DEATH DEEDS

SB 1305 (Ch. 238) extends the sunset date to issue a revocable transfer on death deed from January 1, 2021, to January 1, 2022. A revocable TOD deed is executed and recorded, designating beneficiaries who will take title to real property upon the owner's death without having to prepare a trust or a will. The owner may modify or revoke the designation by a later recording. (Probate Code §5600)

AB 5

CALIFORNIA ADOPTS ABC TEST FOR CLASSIFYING WORKERS

In 2019, AB 5 (Ch. 19-296) codified and expanded upon the California Supreme Court's ***Dynamex*** ruling, in which the court adopted the ABC test for determining whether a worker is an employee or an independent contractor for purposes of California's wage orders. (***Dynamex Operations West, Inc. v. Superior Court*** (2018) 4 Cal.5th 903) Effective September 4, 2020, AB 2257 (Ch. 20-83) provided further relief to certain industries, particularly in the entertainment, journalism, and multimedia industries.

At issue in ***Dynamex***, was whether Dynamex, a same-day shipping company, improperly reclassified all its former employee drivers as independent contractors. What was most significant about the ***Dynamex*** decision was not that the court found that the workers were employees, but it rejected application of the standard ***Borello*** ("right to control") test and applied the much stricter ABC test for purposes of determining whether an employer violated the Division of Labor Standards Enforcement, formerly the California Industrial Welfare Commission's wage orders.

AB 5 and AB 2257, however, continue to use the ***Borello*** test when determining the status of workers who qualify as independent contractors based on various exceptions and exemptions.

Comment

It is important to remember that the classification of workers as employees rather than independent contractors originates from wage and labor law.

What AB 5 does

Under AB 5 and AB 2257, most workers are presumed to be an employee for purposes of the Labor Code, the Unemployment Insurance Code, the Revenue and Taxation Code, and for most wage orders of the Division of Labor Standards Enforcement unless a hiring entity satisfies a three-factor test, referred to as the ABC test. (Labor Code §2775)

Under the ABC test, all three of these conditions must be met in order to treat the worker as an independent contractor:

A. The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact, commonly known as the ***Borello*** "control test" (***S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.*** (1989) 48 Cal.3rd 342);
B. The worker performs work that is outside the usual course of the hiring entity's business; and
C. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

This means that employers must ensure that these newly covered workers receive at least:

- Minimum wage;
- Required meal and break times;
- Workers' compensation
- Unemployment insurance;
- Paid sick leave
- Overtime pay;
- CalSavers enrollment option, if applicable; and
- Paid family leave.

While applying the ABC test to workers results in many more workers being classified as employees, California law provides for numerous exemptions to the application of the ABC test. If an exemption applies, then the standard for determining whether a worker is an employee or an independent contractor will continue to be the ***Borello*** right-to-control test.

Comment

Because the original legislation was passed quickly, there are many unknowns, and we are put in a position to interpret a law that was not completely thought through. AB 2257 answers some, but certainly not all questions. Practitioners should be careful when advising clients because there are potential penalties that apply to paid advisors when workers are misclassified. See page 7-31 for more information.

Quick Law: The Borello test

The ***Borello*** test has been the law of the land in California since 1989. (***S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.*** (1989) 48 Cal.3rd 342) The principal factor of the ***Borello*** test is "whether the person to whom services is rendered has the right to control the manner and means of accomplishing the result desired." Strong evidence of control is the principal's right to discharge the worker at will, without cause.

If the principal has the right to control the services performed by the worker, whether or not that right is exercised, an employer-employee relationship exists. The primary right of direction and control is discussed in 22 Cal. Code Regs. §4304-1. If it cannot be determined whether the principal has the right to control the manner and means of accomplishing a desired result, the following factors should be examined (22 Cal. Code Regs. §4304-1):

1. Whether the one performing the services is engaged in a separately established occupation or business;
2. The kind of occupation, with reference to whether, in the locality, the work is done under the direction of a principal without supervision;
3. The skill required in performing the services and accomplishing the desired result;
4. Whether the principal or the person providing the services supplies the instrumentalities, tools, and the place of work for the person doing the work;
5. The length of time for which the services are performed to determine whether the performance is an isolated event or continuous in nature;
6. The method of payment, whether by the time, a piece rate, or by the job;
7. Whether or not the work is part of the regular business of the principal, or whether the work is not within the regular business of the principal;
8. Whether or not the parties believe they are creating the relationship of employer and employee;
9. The extent of actual control exercised by the principal over the manner and means of performing the services; and
10. Whether the principal is or is not engaged in a business enterprise or whether the services being performed are for the benefit or convenience of the principal as an individual.

The factors weigh differently depending on the facts and circumstances of the case at hand.

The difference between ***Borello*** and the ABC test is that in ***Borello***, the factors are weighted, and not all factors must be met in order for a worker to be an independent contractor, while under the ABC test, unless a worker meets one of the exceptions, all three factors must be met or the worker is an independent contractor.

During the legislative process, many industries lobbied for their workers to be exempt from the ABC test. Enrolled agents, CPAs, barbers and beauticians, travel agents, and newspaper distributors (among many others) were ultimately successful. The exemptions discussed later are quite extensive (see discussion beginning on page 7-10).

Effective dates

Under AB 5, different effective dates apply for different programs:

- **Declaratory of existing law** for most wage orders of the Industrial Welfare Commission and violations of the Labor Code relating to wage orders. (Labor Code §2750.3(i))
  - The California Supreme Court has not yet ruled on whether the ***Dynamex*** ruling should be given retroactive effect. The Ninth Circuit originally held that the ***Dynamex*** ruling should be given retroactive effect but withdrew that ruling and sent the issue of retroactivity back to the California Supreme Court to decide. (***Vasquez v. Jan-Pro Franchising International, Inc.*** (May 2, 2019) U.S. Court of Appeals, Ninth Circuit, Case No. 17-16096) The California Supreme Court has agreed to rule on this issue but has not yet issued a decision.
  - A California court of appeal has ruled that ***Dynamex*** should be given retroactive effect and has also extended the ***Dynamex*** ruling to apply to violations of the Labor Code relating to wage orders. (***Gonzalez v. San Gabriel Transit, Inc.*** (October 8, 2019) Cal. Ct. App., 2nd App. Dist., Case No. B282377) The California Supreme Court has also agreed to review this decision.

  Note: If the California Supreme Court rules that ***Dynamex*** should be given retroactive effect, the upcoming described exemptions may also be applied retroactively to existing claims and actions to the extent permitted by law;
- **January 1, 2020**, for unemployment compensation coverage (UIC §621);
- **July 1, 2020**, for workers' compensation coverage (Labor Code §3351); and
- **Taxable years beginning on or after January 1, 2020**, for income tax purposes. (AB 2257 (Ch. 20-38); R&TC §§17020.12, 18406, 21003.5, 23045.6, 61001)

For AB 2257, the effective date is generally retroactive to January 1, 2020, so there should not be a problem with workers being classified one way for the first part of the year and another for the end of the year.

Legal challenges to AB 5

The ink wasn't even dry on AB 5 when the first legal challenges were filed against it.

Independent truckers' lawsuit

A federal district court temporarily blocked the application of AB 5 to any motor carrier, including truckers, operating in California, until the courts have had the opportunity to rule on whether AB 5 is preempted by federal law. (***California Trucking Association, et al. v. Becerra***, U.S. Dist. Ct., Southern Dist. of Calif., Case Nos. 2:19-cv-10645, 3:18-cv-02458-BEN-BLM)

On January 16, 2020, the court extended the preliminary injunction so the judge could further review the issue. There is no set date, and a ruling could come tomorrow or months from now. However, whatever the ruling, the losing side will appeal the decision.

The preliminary injunction order was appealed by the International Teamsters Union to the Ninth Circuit, where the union asked for a stay of the injunction. The Ninth Circuit denied the stay. So for now, California cannot enforce AB 5 against trucking companies. (***California Trucking Ass'n. v. Becerra*** (2020) No. 20-55107)

Journalists and photographers lose

In another case, the American Society of Journalists and Authors challenged the imposition of AB 5 as applied to journalists and photographers. The court denied the journalists'/photographers' request for a preliminary injunction. However, as discussed later, journalists and photographers were able to achieve success in negotiating an expanded exemption in AB 2257. (***American Society of Journalists and Authors, Inc. et al. v. Becerra***, U.S. Dist. Ct., Central Dist. of Calif., Case No. 2:19-cv-106)

Proposition 22: app-based drivers are independent contractors

Probably the most publicized case was a lawsuit against Uber and Lyft in San Francisco, seeking an order to compel them to treat their workers as employees and seeking damages and penalties. A San Francisco Superior Court ruled that Uber and Lyft must immediately begin treating their drivers as employees. (***People of the State of California v. Uber Technologies, Inc.*** (August 10, 2020) Cal. Sup. Ct., County of San Francisco, Case No. CGC-20-584402) However, a California court of appeal granted Uber and Lyft's request for a stay pending the results of Proposition 22.

With the passage of Proposition 22, this case may now be moot. In response to the California Legislature — and then the court's insistence that their drivers be treated as employees — Uber, Lyft, and Doordash placed Proposition 22 on the November 2020 ballot. Proposition 22, which was approved by the voters, classifies drivers for app-based transportation (rideshare) and delivery companies (referred to as "network companies") as independent contractors and not employees if the network company does not:

- Unilaterally prescribe specific dates, times of day, or a minimum number of hours during which the app-based driver must be logged into the network company's on-line app or platform;
- Require the app-based driver to accept any specific rideshare service or delivery service request as a condition of maintaining access to the network company's online-enabled application or platform;
- Restrict the app-based driver from performing rideshare services or delivery services through other network companies except during engaged time; and
- Restrict the app-based driver from working in any other lawful occupation or business. (B&PC §7451)

Other app-workers must go through AB 5 analysis

Proposition 22 only applies to app-based drivers, so other app-based workers (e.g., Rover, Taskeasy, etc.) will have to see if they qualify under the AB 5/AB 2257 exemptions and the ***Borello*** tests to see if they qualify as an independent contractor.

Although not "employees," the network companies must provide the following benefits to the drivers:

- Guarantee that the companies would pay a wage equal to 120% of the minimum wage of the jurisdiction in which the rider is picked up for each earning period, plus 30 cents per mile (adjusted for inflation after 2021) toward expenses (network company may not include any tips, tolls, cleaning fees, airport fees, or other customer passthroughs in this amount) (B&PC §7453);
- Prohibit companies from terminating drivers' contracts without cause and would provide terminated drivers an appeals process (B&PC §7452);
- Mandate companies to pay a health care insurance stipend to drivers working at least 15 hours per week. (B&PC §7454) **Note:** We believe the stipend would be taxable income but the driver could deduct self-employed health insurance to the extent premiums were paid; and
- Require companies to "carry, provide, or otherwise make available" specified minimum accident and automobile liability insurance on behalf of the drivers. (B&PC §7455)

In addition, the company is also required to develop a sexual harassment policy, provide safety training, and do criminal background checks on the drivers.

However, these workers are not entitled to:

- Unemployment insurance;
- Worker's compensation; or
- Retirement benefits.

According to the SOS website, Proposition 22 goes into effect on December 11, 2020.

Network company reporting responsibilities

The network companies are treated as "third party settlement organizations" (as defined in IRC §6050W(b)(3)). Applicable to reportable payment transactions occurring on or after January 1, 2021, the company must file information returns for each app-based driver with a California address that has a gross amount of reportable payment transactions equal to or greater than $600 during the calendar year (regardless of the amount number of transactions between the network company and the driver). The network company must report these amounts to the FTB and furnish a copy to the payee, even if there is no federal reporting obligation. (B&PC §7464.5)

This requirement can be met by submitting a copy of Form 1099-K or an FTB-provided form that includes the same information as that on the 1099-K. The form must be submitted to the FTB and the payee within 30 days following the date the return would be due to the IRS.

Reclassification to independent contractor prohibited

AB 5 prohibits employers from reclassifying an individual who was an employee on January 1, 2019, to an independent contractor due to the bill's enactment. (Uncodified Sec. 6, AB 5 (Ch. 19-296)) Even if a worker may qualify for an exemption, if they were treated as an employee as of January 1, 2019, they may not be reclassified.

Comment

We don't know if the prohibition would apply if the worker's function or job changed; for example, an employee becomes a partner or retires and works for the previous employer in a different capacity and qualifies under the ABC test.

Can I just form a corporation?

Although many industries are demanding that workers who have been previously classified as independent contractors form a corporation or an LLC and threaten not to hire them if they don't, this does not exempt workers from the AB 5 requirements.

The law is clear: The rules apply to any "individual acting as a sole proprietor, or a business entity formed as a partnership, limited liability company, limited liability partnership, or corporation." (Labor Code §2776(a) et seq.)

Businesses that do this could be subject to penalties for misclassifying their workers.

Multistate issues

California employee/out-of-state employer

AB 5 applies to all California employees. This means an out-of-state company that has a worker who lives and works in California is subject to AB 5.

California employer/out-of-state worker

However, AB 5 does not apply to the company's workers residing in other states. But this different classification of workers might raise a red flag with the Department of Labor if it sees the company is classifying workers who are performing the same functions differently.

If a California company hires a worker in another state, you must look to the other state's laws to determine how the worker is classified.

EXEMPTIONS FROM THE ABC TEST

To access a chart summarizing the various exemptions from the ABC test, organized by occupation, go to:

Website
www.caltax.com/files/2020/abcexemptions.pdf

Specific occupations exemption

Workers engaged in the following occupations are exempt from AB 5's ABC test:

- Licensed insurance brokers;
- Licensed physicians and surgeons, dentists, podiatrists, psychologists, and veterinarians, provided that the workers are not covered by a collective bargaining agreement;
- California licensed lawyers, architects, engineers, private investigators, and CPAs (licensed by the California Board of Accountancy);
- Registered securities broker-dealers, investment advisors, or their agents and advisors;
- A direct salesperson as defined under UIC §650 (essentially a person who performs in-person demonstrations and sales presentations of consumer products);
- Until January 1, 2023, commercial fishermen (with certain exceptions under UIC §609);
- Competition judges, such as amateur umpires or referees*;
- Persons who provide underwriting inspections, premium audits, risk management, or loss control work for the insurance and financial services industries*;
- Landscape architects*;
- Manufactured housing sales people*;
- Persons involved in an international exchange visitors program that meet specified criteria*; and
- Newspaper distributors working for a newspaper publisher or a newspaper carrier (extended through January 1, 2022, modified to repeal the requirement that the newspaper carrier be working for a publisher or distributor by AB 323 (Ch. 20-323)).
  (Labor Code §2783)

Occupations marked with an asterisk were added under AB 2257.

Borello still applies

This exemption does not mean these licensed individuals are automatically independent contractors. ***Borello*** continues to be the guideline for whether these professionals are employees or independent contractors.

Attorneys and CPAs

For information on what factors determine whether an attorney or a CPA is considered an independent contractor, see EDD Publication DE 38, Employment Determination Guide. For example, Publication DE 38 states:

"An attorney or accountant who has his or her own office, advertises in the yellow pages of the phone book under 'Attorneys' or 'Accountants,' bills clients by the hour, is engaged by the job or paid an annual retainer, and can hire a substitute to do the work is an example of an independent contractor.

"However, an attorney or accountant who is employed by a firm to handle their legal affairs or financial records, works in an office at the firm's place of business, attends meetings as needed, and the firm bills the clients and pays the attorney or accountant on a regular basis is an example of an employee."

Example of CPAs

Triplets Michelle, Nicole, and Olivia are CPAs.

Michelle is the chief accountant for Big Business, Inc. She is an employee of Big Business because Business controls her work, sets her hours, and has final say in negotiating her salary.

Nicole works during tax season for a large CPA firm. The firm sets her hours, controls what she works on, and determines what rates are charged for her work. Nicole is an employee of the firm.

Olivia has developed an expertise in the area of nonprofits. She has her own practice Olivia Triplet, CPA, Inc., but also does work on the side for a midsize CPA firm. The firm has no staff with expertise in nonprofits. Olivia sets her own hours and determines what he charges for the work she does. Olivia is an independent contractor of the firm.

Tax professionals

Note that enrolled agents will be subject to a different standard than attorneys and accountants to qualify for an exemption. All of these professionals must meet the ***Borello*** standards to qualify as an independent contractor. However, enrolled agents must also meet the additional tests listed immediately above.

Tax preparers (CRTPs) are not specifically excluded at all and presumably would be employees under the ABC test unless they qualify for the business-to-business contracting exemption.

Physicians

We believe the same criteria would hold true for a physician working in a medical clinic. We have heard that many medical facilities are changing their physician–workers from independent contractors to employees. In the EDD's eyes, the clinic–physician relationship would likely be considered an employer–employee relationship under the right-to-control test if, among other things, the clinic:

- Paid an hourly or daily amount to the worker;
- Set fees for services;
- Paid all of the overhead in the offices; and/or
- Established parameters for patient care.

Professional services exemption

The ***Borello*** right-to-control test will still apply to contracts for professional services, whether provided by a sole proprietor or other business entity, if specified conditions are met. (Labor Code §2778)

AB 5 provided that the following businesses could operate as professional services:

- Enrolled agents;
- Marketing services;
- Human resources administrators;
- Travel agents;
- Graphic designers;
- Grant writers;
- Fine artists — AB 2257 adds a definition of "fine artist": an individual who creates works of art to be appreciated primarily or solely for their imaginative, aesthetic, or intellectual content, including drawings, paintings, sculptures, mosaics, works of calligraphy, works of graphic arts, crafts, or mixed media;
- Payment processing agents through an independent sales organization;
- Still photographers or photojournalists (this clause is not applicable to individuals who work on "motion pictures," which includes television, internet streaming theater, commercials, broadcast news, music videos, and live shows);
- Registered professional foresters*;
- Specialized performers hired by a performing arts company or organization to teach a master class for no more than one week*;
- Appraisers*;
- Freelance writers, editors, or newspaper cartoonists (see upcoming section for additional requirements for these professionals).
  (Labor Code §2750.3(b)(7))

Occupations marked with an asterisk were added under AB 2257.

Qualifying for the professional services exemption

To qualify for the professional services exemption, the individual must:

- Maintain a business location (which may include the individual's residence) that is separate from the hiring entity. However, nothing prevents an individual from choosing to perform services at the location of the hiring entity;
- Obtain any required business and or professional license if work is performed on or after July 1, 2020;
- Have the ability to set or negotiate their own rates for services performed and to schedule their own hours outside of project completion dates and reasonable business hours;
- Be customarily engaged in the same type of work performed under contract with another hiring entity or hold themselves out to other potential customers for the same work; and
- Customarily and regularly exercise discretion and independent judgment in the performance of the services.

> ***Comment***
>
> Real estate licensees who are governed by B&PC §10037 or UIC §650 and Labor Code §8300 et seq., home inspectors, and repossession agents are also included under the professional services exemption statute. However, they are included under Labor Code §2778(b), which doesn't require that they meet these "requirements" that other professional services have to meet.

Freelance writers, editors, or newspaper cartoonists exemption expanded

The professional services exemption for photographers, photojournalists, freelance writers, editors, and newspaper cartoonists has been greatly expanded by repealing the 35 submissions per putative employer cap. This means individuals working in these professions may be treated as an independent contractor regardless of the number of submissions they provide to a single company as long as they meet the other professional services exemption criteria described below.

In addition, the photographer/writer professional services exemption is expanded to include:

- Videographers, photo editors, and digital content aggregators;
- Translators, copy editors, illustrators; and
- Individuals working as a content contributor, advisor, producer, narrator, or cartographer for a journal, book, periodical, evaluation, other publication or educational, academic, or instructional work in any format or media.

However, in addition to meeting the general professional services exemption criteria (previously listed, which must be met by most workers included in the "professional services" exemption under Labor Code §2778(a)) and the ***Borello*** test, AB 2257 added these additional criteria for these multimedia professionals:

- Be working under a written contract that specifies the rate of pay, intellectual property rights (this doesn't apply to photographers, photojournalists, videographers, or photo editors), and obligation to pay by a defined time;
- Not be directly replacing an employee who performed the same work at the same volume for the hiring entity;
- Not be primarily performing the work at the hiring entity's business location; and
- Not be restricted from working for more than one company.

Various salon workers

The following licensed workers may qualify for the professional services exemption previously discussed, provided additional requirements are met:

- Estheticians;
- Electrologists;
- Barbers;
- Cosmetologists; and,
- Until January 1, 2022, manicurists.
  (Labor Code §2778(b)(2)(L))

To qualify for the exemption, the worker must:

- Set their own rates, process their own payments, and be paid directly by clients;
- Set their own hours and have sole discretion over the number of clients and which clients they will see;
- Have their own book of business and schedule their own appointments;
- Maintain their own business license; and
- Issue a Form 1099 to the salon or business owner if the worker rents a space from the owner.

In the current version of EDD Publication DE 231C, Barbering and Cosmetology Industry, the EDD provides a table of determination elements. If the worker meets the independent contractor side of the test, the worker is not an employee for payroll tax purposes. Some key elements include that the licensed professional:

- Sets their own hours, prices, and collects their own money;
- Has a written contract which provides for rental payments, not an hourly payment or guaranteed hours;
- Is not required to attend staff meetings; and
- Provides their own supplies or pays for supplies, laundry, etc.

While these are just a few of the 16 factors discussed, a stylist and salon that follow these rules, in addition to the general ***Borello*** factors, should result in a determination that the stylist is an independent contractor.

Caution

The EDD publications have not yet been updated to include the AB 5 treatment. However, in this case it is a good guide for determining the status of salon workers.

Planning Pointer

One of the key factors here is the worker filing a 1099 to report space rent to the salon. While a determination that the worker is an independent contractor may not have a large impact on the worker, the cost and penalties to the salon owner could be large.

We suggest that the salon owner prepare the Form 1099, have the worker sign the Form 1096, Annual Summary and Transmittal of U.S. Information Returns, and the salon owner mail the Form 1099.

Unknown question

If the salon takes appointments online, does that mean the worker is not taking his or her own appointments?

It would seem that if the website offers a place for the client to request the worker, that might be okay. However, if the appointment can be assigned randomly to the worker, the requirement to set your own appointments might not be met. On the other hand, if the worker is required to collect their own payments and process through their own system, the EDD might say that using the salon's online booking service alone does not create an employer/employee relationship.

Music and entertainment industry exemptions

AB 2257 has provided new categories of exemptions from the ABC test to those workers involved in the music and entertainment industry. These workers will be evaluated under the

Borello test for purposes of determining whether the workers are employees or independent contractors.

The following workers are now exempt from the ABC test for their work performed in creating, marketing, promoting, or distributing sound recordings or musical compositions:

- Recording artists;
- Songwriters, lyricists, composers, and proofers;
- Managers of recording artists;
- Record producers and directors;
- Musical engineers and mixers;
- Musicians engaged in the creation of sound recording;
- Vocalists;
- Photographers working on recording photo shoots, album covers, and other press and publicity purposes;
- Independent radio promoters; and
- Any other individual engaged to render any creative, production, marketing, or independent music publicist services related primarily to the creation, marketing, promotion, or distribution of sound recordings or musical compositions. (Labor Code §2780)

Comment

One huge caveat regarding the treatment of those involved in the music industry: AB 2257 specifically states: "Notwithstanding Section 2775, paragraphs (1) and (2) and the holding in ***Dynamex***, the terms and conditions of any current or future collective bargaining agreements or contractual agreements between the applicable labor unions and respective employers shall govern the determination of employment status in all events. (Labor Code §2780(a)(3))

In other words, if one of the previously enumerated workers is a member of the Screen Actors Guild (SAG), any labor agreements between the labor union and the hiring entity control as to whether or not the worker is an employee or independent contractor.

This subdivision does not apply to any of the following:

- Film and television unit production crews, as such term is commonly used in the film and television industries, working on live or recorded performances for audiovisual works, including still photographers and cinematographers; and
- Publicists who are not independent music publicists.

Single event

In addition, musicians and musical groups are exempt from the ABC test if they perform at a single-engagement live performance event (excluding events as part of a tour), unless the musical group is performing:

- As a symphony orchestra;
- At a theme or amusement park;
- In a musical theater production;
- At a festival that sells more than 18,000 tickets per day; or
- Is an event headliner for a performance taking place in a venue location with more than 1,500 attendees.

A “single-engagement live performance event” means a stand-alone musical performance in a single venue location, or a series of performances in the same venue location no more than once a week. This does not include performances that are part of a tour or series of live performances at various locations.

Comment

The single-engagement live performance event exemption is different than the single-engagement event exemption discussed on page 7-17. The single-engagement live performance event exemption applies only to musicians and does not have nearly as many qualifying criteria as the single-event exemption.

Definitions

“Musical group” means a solo artist, band, or a group of musicians who perform under a distinct name.

“Musical theater production” means a form of theatrical performance that combines songs, spoken dialogue, acting, and dance.

“Venue location” means an indoor or outdoor location used primarily as a space to hold a concert or musical performance. “Venue location” includes but is not limited to a restaurant, bar, or brewery that regularly offers live musical entertainment.

“Single-engagement live performance event” means a stand-alone musical performance in a single-venue location, or a series of performances in the same venue location no more than once a week. This does not include performances that are part of a tour or series of live performances at various locations.

Performance artist exemption

Another new exemption category applies to individual performance artists, which includes, but is not limited to, comedians, improvisation artists, magicians, mimes, storytellers, and puppeteers. (Labor Code §2780(c)) The individual must be presenting material that is their original work and creative in character and the result of which depends primarily on the individual’s invention, imagination, or talent. In addition, they must:

- Be free from the control and direction of the hiring entity, both as a matter of contract and fact;
- Retain the rights to their intellectual property that was created in connection with the performance;
- Set their terms of work and have the ability to set or negotiate their rates; and
- Be free to accept or reject each individual performance engagement without being penalized by the hiring entity.

However, the exemption does not apply if the artist is performing in a theatrical production or as a musician or in a musical group.

Comment

Again, the terms and conditions of any current or future collective bargaining agreements between the applicable labor unions and respective employer govern the determination of employment status for these workers as well.

Single engagement exemption

A new exemption category is added for individuals (acting as either sole proprietors or as a business entity) who contract with one another to provide services (other than excluded services) at the location of a single-engagement event. (Labor Code §2782)

To qualify for the single-engagement event exemption:

- Neither individual is subject to control and direction by the other;
- Each individual can negotiate their rate of pay with the other individual; and
- The written contract between both individuals specifies the total payment for services provided by both individuals at the single-engagement event and the specific rate paid to each individual, and each individual must:
  - Maintain their own business location, which may include the individual's personal residence;
  - Provide their own tools, vehicles, and equipment;
  - Have any business license or business tax registration required by the jurisdiction where the work is performed;
  - Be customarily engaged in the same or similar type of work performed under the contract, or each individual separately holds themselves out to other potential customers as available to perform the same type of work; and
  - Be available to contract with other businesses to provide the same or similar services and maintain their own clientele without restrictions.

Comment

This "single-engagement" exemption is different than the "single-engagement live-performance event" exemption that is available to musicians discussed on page 7-15.

Definition of "single engagement"

For purposes of the exemption, "single engagement" means a stand-alone nonrecurring event in a single location, or a series of events in the same location no more than once a week.

Services excluded from this exemption include services performed in a high hazard industry, or janitorial, delivery, courier, transportation, trucking, agricultural labor, retail, logging, in-home care, or construction services other than minor home repair.

Comment

Noticeably absent from these new exemptions are exemptions for independent actors in television, movie, or stage production.

Loan-out corporations and the entertainment industry

There was much debate over whether loan-out corporations are dead. But information from SAG-AFTRA changes that.

There is case law going both ways for taxpayers in the entertainment industry and whether they are actually employees of the studio or of their corporations. Here are the two different opinions:

- Loan-out corporations have survived court challenges, and the IRS has turned a deaf ear to the issue. So, therefore, they will continue; or
- Loan-out corporations have never been legal, and the fact that the IRS doesn't do anything doesn't change that fact.

SAG-AFTRA speaks out

In 2019, SAG-AFTRA released a statement to the guilds and unions, stating that AB 5 does not undermine the use of loan-out corporations.

In pertinent part, the statement says:

"Members of our guilds and unions are not independent contractors; they are employees, whether or not they utilize loan-outs. Loan-out companies are employers and so they too do not have independent contractor status. AB 5 exempts the kind of business to business relationships which loan-out companies are set up to support. Furthermore, AB 5, by setting up rules applicable when one employer loans an employee to another employer, specifically contemplates that loan-outs will continue. Our collective bargaining agreements (CBAs) expressly allow members to use loan-outs. Our CBAs also protect your status as an employee. AB 5 does not undermine these legal or contractual rights. AB 5 is not directed at our industry, and we do not believe it will trigger a change to industry practices.

"This analysis is not a substitute for individualized tax advice. Some loan-out companies may have structural issues that put them at risk. This is not changed one way or the other by AB 5. Members should always consult their own professional tax advisors to ensure the optimal tax treatment of their earnings."

For more information, see:

Website
www.sagaftra.org/important-message-california-ab-5-and-loan-out-companies

Data aggregator exemption

AB 2257 also provides a new exemption category, which applies to individuals giving feedback to data aggregators (defined below). Under Labor Code §2782, the feedback provider's employment status is determined under ***Borello*** if:

- The individual is free from control and direction from the data aggregator with respect to the substance and content of the feedback;
- Any consideration paid for the feedback provided, if prorated to an hourly basis, is an amount equivalent to or greater than the minimum wage;
- The nature of the feedback requested requires the individual providing feedback to the data aggregator to exercise independent judgment and discretion; and
- The individual has the ability to reject feedback requests, without being penalized in any form by the data aggregator.

Definitions

"**Data aggregator**" is a business, research institution, or organization that requests and gathers feedback on user interface, products, services, people, concepts, ideas, offerings, or experiences from individuals willing to provide it.

"**Minimum wage**" is local or state minimum wage, whichever is greater.

Business-to-business contracting exemption

Not to be confused with the business construction exemption discussed on page 7-23, business service providers may be exempt from the ABC test where the business entity (the "business service provider") does work for another business entity. This includes a sole proprietorship that contracts to provide services to another such business (the "contracting business"), and when a manufacturing plant hires an efficiency expert. (Labor Code §2750.3(e))

AB 2257 altered rules for the business-to-business contracting exemption. In order to qualify for the exemption, the contract must be in writing, 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;
- Under AB 2257, the requirement that the business service provider provide services only to the contracting business rather than to the contracting business's customers is waived. However, the waiver only applies if the business service provider's employees are solely performing the services under the name of the business service provider, and the business service provider regularly contracts with other businesses (e.g., mobile notary publics hired by escrow companies);
- Have a required business license or tax registration if the work is performed in a jurisdiction that requires such;
- Maintain a business location, which can be a principal 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, and, as revised under AB 2257, can contract with other businesses to provide the same or similar services (previously had to "actually contract"), 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;
- Provide its own tools vehicles, and equipment to perform the service. AB 2257 eased this requirement by clarifying that the service provider must only provide their own tools, etc. if it is "consistent with the nature of the work" and allowing an exception if the contracting business's proprietary materials that may be necessary to perform the 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 B&PC §7000 et seq.
  (Labor Code §2776)

Exemptions applicable to construction contractors are discussed on page 7-22.

Referral agency exemption

What is a referral service?

It appears that a "referral agency" is meant for Craigslist, Rover, Lawn Love, and other online referral services where businesses post ads to connect services with customers. However, it would also apply to other more traditional referral agencies as well.

The ***Borello*** test, and not the ABC test, applies in determining the relationship between a service provider and a referral agency if the service provider:

- Has formed a business entity as a sole proprietor, partnership, LLC, limited liability partnership, or corporation;
- Is free from the control and direction of the referral agency as a matter of contract and fact;
- Has all required state, local, and or professional business licenses/registrations;
- Delivers services to the client under the service provider's name, rather than under the name of the referral agency;
- Provides its own tools and supplies to perform the services;
- Is customarily engaged in, or pursuant to AB 2257, was previously engaged in, an independently established business of the same nature as, or related to, that involved in the work performed for the client;

- Maintains a clientele without any restrictions from the referral agency, and the service provider is free to seek work elsewhere, including through a competing agency;
- Sets its own hours and terms of work and is free to accept or reject clients and contracts;
- Sets its own rates for services performed, without deduction by the referral agency; and
- Is not penalized in any form for rejecting clients or contracts, unless the service provider accepts a client or contract and then fails to fulfill any of its contractual obligations. (Labor Code §2777)

Under AB 5, a referral agency is a business that connects clients with service providers that provide the following services:

- Animal services related to daytime and nighttime pet care;
- Dog walking and grooming;
- Errands;
- Event planning;
- Furniture assembly;
- Graphic design;
- Home cleaning;
- Minor home repairs;
- Moving;
- Photography;
- Picture hanging;
- Pool cleaning;
- Tutoring; and
- Yard cleanup.

More industries qualify

AB 2257 eases these requirements by making numerous changes, including allowing almost any industry to qualify for the referral agency exemption and specifically listing additional industries as **illustrative** examples to include:

- **Consulting:** "Consulting" means providing substantive insight, information, advice, opinions, or analysis that requires the exercise of discretion and independent judgment and is based on an individual's knowledge or expertise of a particular subject matter or field of study (Labor Code §2777(b)(8));
- **Youth sports coaching:** "Youth sports coaching" means services provided by a youth sports coach who develops and implements their own curriculum, which may be subject to requirements of a youth sports league, for an athletic program in which youth who are 18 years of age or younger predominantly participate and that is organized for the purposes of training for and engaging in athletic activity and competition. Youth sports coaching does not mean services provided by an individual who contracts with a local education agency or private school through a referral agency for purposes of teaching students of a public or private school (Labor Code §2777(b)(6)(A));
- Caddying (no definition provided);

- Wedding planning, wedding and event vendors (no definition provided); and
- Interpreting services defined as services provided by a certified or registered interpreter in a language with an available certification or registration through the Judicial Council of California, State Personnel Board, or any other agency or department in the State of California, or through a testing organization, agency, or educational institution approved or recognized by the state, or through the Registry of Interpreters for the Deaf, Certification Commission for Healthcare Interpreters, National Board of Certification for Medical Interpreters, International Association of Conference Interpreters, United States Department of State, or the Administrative Office of the United States Courts and services provided by an interpreter in a language without an available certification through the entities listed above.
  (Labor Code §2777(b)(7)(A))

Caution

The referral exemption applies to the firm that is referring businesses to customers, not the customer. For example, a referral service that puts a worker and a customer together is not the employer of the worker. The worker may or may not be an employee of the customer.

Example of referral agency placing a nurse

Medical Needs, Inc. is a referral service for nurses. Medical has an online referral program and charges a fee to post a job ad for an ER nurse. Medical refers Jerome to a permanent position in the emergency ward at a local hospital. Neither Jerome nor the hospital is an employee of Medical. However, Jerome, taking the permanent position, is an employee of the hospital.

Other changes made by AB 2257 include:

- Limiting the intermediary services a referral agency can provide to the service provider to client referrals and other administrative services to the service provider's business operation;
- Prohibiting any fee that a referral agency charged from being deducted from the rate set or negotiated between the end user and the service provider; and
- Allowing the service provider to have been customarily engaged, or previously engaged, in an independently established business or trade of the same nature as, or related to, the work performed by the client. Previously, the requirement could only be satisfied if the service provider currently engaged in the same trade or business.

Excluded from referral agency exemption

The following industries are specifically excluded from eligibility for the referral agency exclusion: high hazard industries and janitorial, delivery, courier, transportation, trucking, agricultural labor, retail, logging, in-home care, or construction services other than minor home repair.

Definition of client

The definition of "client" for purposes of the referral agency exemption is limited to those businesses that utilize a referral agency to contract for services from a service provider that are:

- Otherwise not provided on a regular basis by employees at the client's business location; or
- Outside of the client's usual course of business.

Business and state licenses

AB 2257 also requires:

- That the service provider provide certification to the referral agency that they have required local business license or business tax registration and that the referral agency keep the certifications for a period of at least three years. Previously, there was no certification requirement; and
- A new certification from the service provider that they have all requisite professional state licenses, permits, certifications or registrations, as applicable. Again, the referral agency must keep the certification for at least three years.

Loaned employee

In circumstances which are in essence the loan of an employee from one employer to another employer wherein direction and control of the manner and means of performing the services changes to the employer to whom the employee is loaned, the loaning employer shall continue to be the employer of the employee if the loaning employer continues to pay remuneration to the employee, whether or not reimbursed by the other employer. If the employer to whom the employee is loaned pays remuneration to the employee for the services performed, that employer is considered the employer for the purposes of any remuneration paid to the employee by the employer, regardless of whether the loaning employer also pays remuneration to the employee. (UIC §606.5)

Household workers

A worker hired through an online referral service could be a household worker, and the hiring individual could be subject to the rules for household employees.

Temporary service employer or leasing employer

If an individual or entity contracts to supply an employee to perform services for a customer or client, and is a leasing employer or a temporary services employer, the individual or entity is the employer of the employee who performs the services.

If an individual or entity contracts to supply an employee to perform services for a client or customer and is not a leasing employer or a temporary services employer, the client or customer is the employer of the employee who performs the services. An individual or entity that contracts to supply an employee to perform services for a customer or client and pays wages to the employee for the services but is not a leasing employer or a temporary services employer pays the wages as the agent of the employer. (UIC §606.5)

Construction subcontractor exemption

The ***Borello*** standard would apply to classifying construction contractor/subcontractor relationships if the contract is in writing and the subcontractor:

- Is licensed by the California Contractors State License Board, and the work is within the scope of that license;
- Has a local business license or business tax registration if the subcontractor is domiciled in a jurisdiction that requires a license/registration;
- Maintains a business location that is separate from the business or work location of the contractor;

- Has the authority to hire and to fire other persons to provide or to assist in providing the services;
- Assumes financial responsibility for errors or omissions in labor or services as evidenced by insurance, legally authorized indemnity obligations, performance bonds, or warranties relating to the labor or services being provided; and
- Is customarily engaged in an independently established business of the same nature as that involved in the work performed.
(Labor Code §2781)

Unlicensed subcontractors

Under existing California law, if a contractor engages the services of any subcontractor or construction worker who does not have a valid license issued by the Contractors State License Board (CSLB), the worker is considered to be an employee, and the contractor is liable for all California payroll taxes. (UIC §§621.5, 13004.5)

These workers are "statutory employees" because California law requires most construction industry workers to have a license issued by the CSLB. (UIC §§621.5, 13004.5; Labor Code §2750.5; B&PC §7000 et seq.) If they do not have such a license, they must be treated as employees instead of independent contractors.

Labor Code §2750.5 states that any person performing any function or activity for which a license is required must hold a valid license in order to be considered an independent contractor. The term "valid license" means the license was issued to the correct individual or entity, the license was for the type of services being provided, and the license was for the entire period of the job.

When a contractor subs out a portion of a job to another contractor, they should verify that the subcontractor has a valid license to perform the services requested. Remember, the EDD has an ongoing effort to audit the construction industry based on the industry's history of noncompliance.

Before hiring or paying the subcontractor, contact the CSLB to determine whether the services to be performed require a license, and if so, verify that the contractor holds a valid license. Print a copy of the license verification.

You may verify the license online at:

💻 **Website** www.cslb.ca.gov

For questions, call the CSLB at:

☎ **Telephone** (800) 321-2752

Federal law

Federal law has no such requirement, and a construction industry worker frequently meets the common law test to be treated as a federal independent contractor but is an employee for California purposes.

Trucking industry

Construction trucking industry

Until January 1, 2022, an exemption also governs construction trucking services. However, for work performed after January 1, 2020, any business entity that provides construction services to a licensed contractor utilizing more than one truck is the employer for all drivers of those trucks. (Labor Code §2781(h))

Independent truckers

There continues to be discussion and disagreement between the independent truckers and the Governor and Legislature regarding what exemption might apply here.

The arguments are:

- Truckers who own their own trucks cannot afford to stay in business if they have no deduction for the cost of owning. Although for California purposes the cost is deductible on Schedule A, federal law no longer allows deductions for employee business expenses. If California treats the worker as an employee, it is likely the feds may follow suit;
- Truckers may leave California, contributing to a great increase in trucking costs, increasing the cost of goods purchased; and
- Those in favor of treating truckers as employees hope to unionize them.

Preliminary injunction

A federal district court temporarily blocked the application of AB 5 to any motor carrier, including truckers, operating in California, until the courts have had the opportunity to rule on whether AB 5 is preempted by federal law. (***California Trucking Association, et al. v. Becerra***, U.S. Dist. Ct., Southern Dist. of Calif., Case Nos. 2:19-cv-10645, 3:18-cv-02458-BEN-BLM) On January 16, 2020, the court extended the preliminary injunction so the judge could further review the issue. There is no set date, and a ruling could come tomorrow or months from now. However, whatever the ruling, the losing side will no doubt appeal the decision.

Motor club exemption

The ***Borello*** test will continue to apply to the relationship between a motor club (e.g., AAA) and individuals performing services pursuant to a contract between the motor club and a third party to provide motor club services utilizing the employees and vehicles of the third party that is a separate and independent business from the motor club. (Labor Code §2784)

Expanded enforcement mechanism

In addition to the current enforcement mechanisms available (e.g., actions by the California Division of Labor Standards Enforcement, the EDD, etc.), the state attorney general, district attorneys and city attorneys and prosecutors may bring an action against putative employers for injunctive relief to prevent the continued misclassification of workers. (Labor Code §2786)

CALIFORNIA EMPLOYEES AND FEDERAL INDEPENDENT CONTRACTORS

Prior to enactment of AB 2257, for income tax purposes, a worker who was an independent contractor for federal purposes was treated as such for income tax purposes as well. However, under AB 2257, that has changed. The worker who is an employee for labor law and payroll tax purposes is an employee for California personal income tax purposes as well.

You must use California numbers, not federal numbers, to compute income tax, the Earned Income Tax Credit, and the individual shared responsibility penalty.

This means their earnings must be treated as wages on their California return, and their expenses must be treated as employee expenses, not Schedule C expenses as had been allowed in the past.

Reporting the income

Under AB 2257, taxpayers who are independent contractors for federal purposes and employees for state purposes must recompute their California income tax returns as if they had filed a federal return as an employee rather than an independent contractor. This means that these taxpayers will be required to make Schedule CA adjustments to report their federal Schedule C income as wages on their California returns.

Here is how the instructions to the FTB forms direct you to deal with this major nonconformity issue. On the Schedule CA, in the federal column you will list the items as they appear on the federal return and then make the following adjustments.

Income

- Add the gross amount of independent contractor income as California wages (from the W-2) on Part I, Section A, line 1, column C; and
- Subtract the net Schedule C income reported on their federal return on Part I, Section B, line 3, column B.

Itemized deductions

- Add the amount subtracted for self-employed health insurance to medical and dental expenses on Part II, line 4. These will be deducted as medical expenses, subject to the reduction of 7.5% of federal AGI, without any California adjustments; and
- Take the deductions related to the Schedule C income reported as wages for California purposes, including wages paid to employees, as unreimbursed employee expenses on Part II, line 19. These are miscellaneous itemized deductions subject to reduction of 2% of federal AGI, without any California adjustments.

✐ Practice Pointer

If the taxpayer has some income treated as self-employment income and some treated as wages for California purposes, allocate expenses based on a reasonable method.

Adjustments to income

- Add back the deduction for self-employment tax on Part 1, Section C, line 14, column B; and
- Add the amount taken as a self-employed health insurance deduction on the federal return back into income on Part I, Section C, line 16.

Comment

California automatically conforms to federal pension law. Do not make an adjustment for the pension contribution as California conforms to federal pension laws, and the deduction is still allowable for California purposes.

Example of worker who is independent contractor for federal and employee for California

Jake, who is single, is a nonunion performer. He is an independent contractor for federal purposes, but under AB 5 he is an employee for California purposes.

Federal return

His income and expenses are reported on the federal return as follows:

Gross receipts		$250,000
Expenses:		
Agent fees	$25,000	
Entertainment	$20,000	
Auto expense	$18,000	
Depreciation	$5,000	
Total expenses		(68,000)
Net federal Schedule C income		$182,000
Adjustments to income:		
One-half SE tax		($10,366)
Medical insurance premium		($8,400)
Federal AGI		**$163,234**

California return

The California return will show $250,000 in AGI and itemized deductions of $62,735 for taxable income of $187,265.

Gross wages		$250,000
Itemized Deductions Business Expenses:		
Agent fees	$25,000	
Entertainment	$20,000	
Auto expense	$13,000[1]	
Depreciation	$7,000[2]	
Less 2% of Federal AGI	($3,265)	
Charitable contributions	$1,000	
Total itemized deductions		(62,735)
California taxable income		**$187,265**

[1] $13,000 under California law due to depreciation difference

[2] $7,000 under California law due to prior-year bonus depreciation

See the sample Schedule CA on page 7-27.

Note the following:

- His increased Schedule C deductions due to California differences do not show in Part 1 of Schedule CA but are taken into account on Schedule CA Part II, Itemized deductions, which are then reduced by 2% of federal AGI;
- Not only can he not take the self-employed medical insurance as an adjustment to income, the 7.5% medical expense threshold reduces his health insurance deduction to zero;
- The thresholds for California miscellaneous itemized deductions further reduce his business expenses from $68,000 to $ 61,735; and
- He loses the deductions for self-employment tax of $ 10,366.

TAXABLE YEAR **2019**

Advance draft as of 10/21/20

California Adjustments — Residents

SCHEDULE **CA (540)**

Important: Attach this schedule behind Form 540, Side 5 as a supporting California schedule.

Name(s) as shown on tax return | SSN or ITIN

Part I Income Adjustment Schedule

Section A – Income from federal Form 1040 or 1040-SR		A Federal Amounts (taxable amounts from your federal tax return)	B Subtractions See instructions	C Additions See instructions
1 Wages, salaries, tips, etc. See instructions before making an entry in column B or C	1			250,000
2 Taxable interest. a ______	2b			
3 Ordinary dividends. See instructions. a ______	3b			
4 IRA distributions. See instructions. a ______	4b			
c Pensions and annuities. See instructions. c ______	4d			
5 Social security benefits. a ______	5b			
6 Capital gain or (loss). See instructions	6			

Section B – Additional Income from federal Schedule 1 (Form 1040 or 1040-SR)		A	B	C
1 Taxable refunds, credits, or offsets of state and local income taxes	1			
2a Alimony received	2a			
3 Business income or (loss)	3	182,000	182,000	
4 Other gains or (losses)	4			
5 Rental real estate, royalties, partnerships, S corporations, trusts, etc	5			
6 Farm income or (loss)	6			
7 Unemployment compensation	7			
8 Other income.	8			
a California lottery winnings			a	a
b Disaster loss deduction from FTB 3805V			b	b
c Federal NOL (federal Schedule 1 (Form 1040 or 1040-SR), line 8)			c	c
d NOL deduction from FTB 3805V			d	d
e NOL from FTB 3805Z, 3806, 3807, or 3809			e	e
f Other (describe): ______			f	f
g Student loan discharged due to closure of a for-profit school			g	g
9 **Total.** Combine Section A, line 1 through line 6, and Section B, line 1 through line 8 in column A. Add Section A, line 1 through line 6, and Section B, line 1 through line 8g in column B and column C. Go to Section C	9	182,000	182,000	250,000

Section C – Adjustments to Income from federal Schedule 1 (Form 1040 or 1040-SR)		A	B	C
10 Educator expenses	10			
11 Certain business expenses of reservists, performing artists, and fee-basis government officials	11			
12 Health savings account deduction	12			
13 Moving expenses. Attach federal Form 3903. See instructions	13			
14 Deductible part of self-employment tax	14	10,366	10,366	
15 Self-employed SEP, SIMPLE, and qualified plans	15			
16 Self-employed health insurance deduction	16	8,400	8,400	
17 Penalty on early withdrawal of savings	17			
18a Alimony paid. b Recipient's: SSN ___ ___ ___ – ___ ___ – ___ ___ ___ ___ Last name ______	18a			
19 IRA deduction	19			
20 Student loan interest deduction	20			
21 Tuition and fees	21			
22 Add line 10 through line 18a and line 19 through line 21 in columns A, B, and C. See instructions	22	18,766	18,766	0
23 **Total.** Subtract line 22 from line 9 in columns A, B, and C. See instructions	23	163,234	163,234	250,000

Part II Adjustments to Federal Itemized Deductions

Check the box if you did NOT itemize for federal but will itemize for California . . . . ☐

		A Federal Amounts (from federal Schedule A (Form 1040 or 1040-SR))	B Subtractions See instructions	C Additions See instructions
Medical and Dental Expenses See instructions.				
1 Medical and dental expenses	8,400 1			
2 Enter amount from federal Form 1040 or 1040-SR, line 8b	163,234 2			
3 Multiply line 2 by 7.5% (0.075)	12,243 3			
4 Subtract line 3 from line 1. If line 3 is more than line 1, enter 0	4	0		
Taxes You Paid				
5a State and local income tax or general sales taxes	5a	10,000	10,000	
5b State and local real estate taxes	5b			
5c State and local personal property taxes	5c			
5d Add lines 5a through 5c	5d			
5e Enter the smaller of line 5d or $10,000 ($5,000 if married filing separately) in column A. Enter the amount from line 5a, column B in line 5e, column B. Enter the difference from line 5d and line 5e, column A in line 5e, column C	5e	10,000	10,000	
6 Other taxes. List type ______________	6			
7 Add lines 5e and 6	7	10,000	10,000	
Interest You Paid				
8a Home mortgage interest and points reported to you on Form 1098	8a			
8b Home mortgage interest not reported to you on Form 1098	8b			
8c Points not reported to you on Form 1098	8c			
8d Mortgage insurance premiums	8d			
8e Add lines 8a through 8d	8e			
9 Investment interest	9			
10 Add lines 8e and 9	10			
Gifts to Charity				
11 Gifts by cash or check	11	1,000		
12 Other than by cash or check	12			
13 Carryover from prior year	13			
14 Add lines 11 through 13	14	1,000		
Casualty and Theft Losses				
15 Casualty or theft loss(es) (other than net qualified disaster losses). Attach federal Form 4684. See instructions.	15			
Other Itemized Deductions				
16 Other—from list in federal instructions	16			
17 Add lines 4, 7, 10, 14, 15, and 16 in columns A, B, and C	17	11,000	10,000	

18 **Total.** Combine line 17 column A less column B plus column C 18 1,000

Job Expenses and Certain Miscellaneous Deductions

19	Unreimbursed employee expenses - job travel, union dues, job education, etc. Attach federal Form 2106 if required. See instructions.	19	65,000
20	Tax preparation fees.	20	
21	Other expenses - investment, safe deposit box, etc. List type ______	21	
22	Add lines 19 through 21	22	65,000
23	Enter amount from federal Form 1040 or 1040-SR, line 8b 163,234		
24	Multiply line 23 by 2% (0.02). If less than zero, enter 0.	24	3,265
25	Subtract line 24 from line 22. If line 24 is more than line 22, enter 0.	25	61,735
26	**Total Itemized Deductions.** Add line 18 and line 25.	26	62,735
27	Other adjustments. See instructions. Specify. ______	27	
28	Combine line 26 and line 27.	28	62,735

29 Is your federal AGI (Form 540, line 13) more than the amount shown below for your filing status?

Single or married/RDP filing separately **$200,534**

Head of household **$300,805**

Married/RDP filing jointly or qualifying widow(er) **$401,072**

No. Transfer the amount on line 28 to line 29.

Yes. Complete the Itemized Deductions Worksheet in the instructions for Schedule CA (540), line 29 . . . . . 29 62,735

30 Enter the larger of the amount on line 29 or your standard deduction listed below

Single or married/RDP filing separately. See instructions. **$4,537**

Married/RDP filing jointly, head of household, or qualifying widow(er) **$9,074**

Transfer the amount on line 30 to Form 540, line 18 . . . . . 30 62,735

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This space reserved for 2D barcode

Double reporting

Although there has been much concern over the FTB (or the IRS) receiving duplicate income reporting with the federal government issuing a Form 1099-NEC and California issuing a W-2, we believe it may not be as big a problem as anticipated.

The employers do not issue a W-2 to the state. State wages and withholding are reported on Form DE 9, which does not go to the IRS. And the IRS, which is now issuing Form 1099-NEC for nonemployee compensation, will not be sending the 1099-NEC information to the states, so it should not be double reported.

Caution

If the payor uses a Form 1099-MISC rather than a 1099-NEC, we believe that would be one situation where there is double reporting.

MISCLASSIFICATION PENALTIES

The EDD is as — or more — aggressive than the IRS when it comes to payroll tax audits, and California does not conform to the IRC §3509 relief (reduced withholding penalty), the Section 530 safe harbor (relief if misclassification was reasonable), or have a voluntary classification settlement program. So, if the EDD finds that the workers are employees, the business will be assessed fairly significant tax, penalties, and interest.

Employers who misclassify workers as independent contractors are liable for the unpaid withholding tax and payroll taxes. (UIC §§13052.5, 13070)

Unlike IRC §3509, California does not have a reduced withholding rate for employers. Rather the employer is liable for the full amount of unpaid withholding, unless the employer can show that the amount assessed was inappropriate (e.g., the worker did not use a single filing status and had personal exemptions) or that the worker actually paid income tax on the income earned. (UIC §§13070, 13071) However, the employer will not be relieved from any penalties (e.g., the 15% late-filing penalty or the $20 per-employee penalty for late reporting or unreported employee wages) or interest.

In an employee/independent contractor audit, for example, the EDD abates assessments for PIT withholding for any individual who files EDD Form DE 938P, Claim for Adjustment or Refund of Personal Income Tax. Form DE 938P certifies that the worker has included the amount of earnings on their California return or is otherwise subject to a reduced withholding amount.

Penalty for willful misclassification

In October 2011, Governor Brown signed SB 459 (Ch. 11-706), which declared the "willful misclassification" of employees as independent contractors "unlawful" and provided for severe penalties. The difference is these higher penalties are not just for the employer; they also apply to the employer's paid accountant, enrolled agent, CPA, or any paid person who advised them. The law exempts attorneys and employees of the business from being penalized.

The penalty, which is in addition to other assessments, penalties, or fines, is:

- $5,000 to $15,000 for each violation (a single misclassified individual); and
- $10,000 to $25,000 for each violation if the Labor Commissioner, or a court, determines there is a "pattern and practice" of these violations.
  (Labor Code §226.8)

Tax professional also liable

Any paid advisor, including a CPA, EA, or tax professional, who advises a client to treat workers as independent contractors can be held liable for the same penalties as the employer.

It also appears that if a nonattorney (or employee of the business) advises a client to treat workers as employees, but the business misclassifies the workers, the tax professional can be subject to a penalty if he or she prepares a return for the business, reporting the workers as independent contractors, even if the business went against the advice of the tax professional.

Only an attorney who provides legal advice that a worker is an independent contractor is exempt from the penalty. The law also exempts from the penalty a person who provides advice to his or her employer.

This means if your client treats consultants as independent contractors and requires them to pay their own business expenses, and the Labor Commissioner determines these consultants were willfully misclassified, the above penalties will apply. If you have advised your client to handle these workers as independent contractors, then you may also be assessed these same penalties even though the client was also charged. This rule also includes the higher dollar penalty for a "pattern and practice of the violations" ($10,000 to $25,000 for each violation).

FILING

NONEMPLOYEE COMPENSATION

In addition to creating the new Form 1099-NEC, Nonemployee Compensation, the IRS will not send copies of Form 1099-NEC to California or any other state. (IRS will continue to send all other Forms 1099 to the states.) So you must send a copy of each federal Form 1099-NEC to the FTB separately.

Paper returns

You may file up to 249 paper returns with the FTB. If filing 250 or more returns, you must file electronically. Mail paper copies of Form 1099-NEC (and other 1099 series) paper returns to:

Address
Franchise Tax Board
P.O. Box 942840
Sacramento, CA 94240-6090

Electronic submission

Businesses filing 250 or more of one type of information return must use Secure Web Internet File Transfer (SWIFT) to file. Information about SWIFT is available on the FTB's website. Go to:

Website
www.ftb.ca.gov/help/swift/help-with-swift.html

You must register with SWIFT and typically within one business day you will receive two e-mails: one with your login name and another with your temporary password.

If the 1099-NEC becomes part of the Combined Federal/State Filing Program, filers may use either this method or SWIFT.

Penalties

Taxpayers who fail to timely file the required state information return or who fail to include all the required elements in the information return are subject to the penalties imposed under IRC §§6721 and 6724, as modified by California. (R&TC §§18631.7, 19183) The California penalty is equal to $100 per return, $30 if filed within 30 days of the due date, $60 if corrected after 30 days but before August 1. (R&TC §19183)

PROBLEM FOR FIRST AND SECOND QUARTER ESTIMATES MADE IN ONE PAYMENT

The FTB did not grant an automatic waiver to the mandatory e-pay requirement for taxpayers who lumped their first and second quarter estimates into one payment for 2020 due to the COVID-19 extension relief. If the total of the first two estimated tax payments made with one check or one e-payment is greater than $20,000, your client must make all future payments to the FTB electronically. (R&TC §19011.5)

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Example of e-pay requirement

Betty's first quarter estimated tax payment is $13,500, and the second quarter payment is $18,000. The total is $31,500. If Betty made two payments, she will not be subject to mandatory e-pay. However, if she made one payment, she will become subject to mandatory e-pay even if she has no other payments in excess of $20,000 and her tax liability doesn't exceed $80,000.

Considering taxpayers were given until July 15, 2020, to make their first and second quarter estimates due to the COVID-19 pandemic, we expect that a number of taxpayers made those payments as one single payment and will unsuspectingly be subject to the FTB's mandatory e-pay requirements.

Mandatory e-pay requirement

All payments made by an individual, regardless of taxable year or amount, must be remitted electronically to the FTB after the individual either has:

- Made a single estimated tax or extension payment greater than $20,000; or
- Filed an original return with a tax liability greater than $80,000.
  (R&TC §19011.5)

Failure to make future payments electronically will result in a penalty of 1% of the amount paid. (R&TC §19011.5(c))

Request a waiver

Once a taxpayer meets the mandatory e-pay requirement, the FTB will send Form FTB 4106 MEO, Mandatory e-Pay Participation Notice, advising them that all future payments must be made electronically. However, the FTB has stated that taxpayers are required to make electronic payments once they meet either of the thresholds, even if they did not receive notification from the FTB.

According to the FTB, if your client made a single payment in excess of $20,000, they will have to request a waiver from the e-pay requirement, assuming the total tax liability for the year is $80,000 or less and there are no other payments of more than $20,000.

To request a waiver, use Form FTB 4107, Mandatory e-Pay Election to Discontinue or Waiver Request.

Compounding penalties

When the FTB says all payments, they mean it. We have seen situations where taxpayers pay the penalty with a check and are assessed another penalty.

Example of failing to file electronically

Jake filed his 2019 return and mailed a check for the $50,000 he owed. He was subject to the mandatory e-pay requirement based on his 2018 tax liability, so the FTB assessed a penalty of $500 ($50,000 × 1%), which he paid with a check.

The FTB will assess another penalty of $5 for failing to electronically pay the $500. Hopefully, Jake pays the $5 penalty electronically to avoid any further penalties. (**Note:** The FTB may or may not assess the $5 penalty because of the small amount.)

NEW FORM 3568

For each dependent being claimed that does not have a SSN or ITIN, a Form FTB 3568, Alternative Identifying Information for the Dependent Exemption Credit, must be provided along with supporting documentation. To claim the dependent exemption credit, attach the form and required documentation to the taxpayer's 540, and write "no ID" in the SSN field of Line 10, Dependents.

You may also amend prior year returns

Taxpayers may also amend their 2018 and 2019 tax returns to claim the dependent exemption credit for these dependents. Complete an amended Form 540, write "no ID" in the SSN field on the Dependents line, and attach Schedule X, California Explanation of Amended Return Changes.

To complete Schedule X, check box m for "Other" on Part II, line 1, and write the explanation "Claim dependent exemption with no ID and FTB 3568 attached" on Part II, line 2. Make sure to attach Form FTB 3568 and the required supporting documents in addition to the amended tax return and Schedule X.

WITHHOLDING ON PASSTHROUGH ENTITY NONWAGE PAYMENTS TO NONRESIDENTS

This year will be the first year that taxpayers may have to file the new Form 592-PTE, Pass-Through Entity Annual Withholding Return. For taxable years beginning on or after January 1, 2020, the Form 592-PTE must be submitted by passthrough entities (partnerships, LLCs taxed as partnerships or S corporations, S corporations, and trusts and estates) with California-source income if the entity has:

- Paid withholding on behalf of a nonresident owner; or
- Itself been withheld upon.
  (18 Cal. Code Regs. §18662-4(j))

In these cases, the Form 592-PTE will be filed in lieu of the Form 592, Resident and Nonresident Withholding Statement, which must be filed by all other taxpayers for nonwage payments to nonresidents who are not owners of the passthrough entity.

The Form 592-PTE must be filed by domestic passthrough entities with California-source income by January 31 of the year following the year for which such withholding was required to be remitted to the FTB. (18 Cal. Code Regs. §18662-8(c)(2)(B)) The payee's copy of Form 592-B, Resident and Nonresident Withholding Tax Statement, must also be sent to the payee, generally by January 31. (18 Cal. Code Regs. §18662-8(c)(2)(E))

Comment

This change switches passthrough entities from quarterly reporting to annual reporting. Historically, passthrough entities have had difficulty in timely filing Form 592 to allocate withholding to the ultimate owner.

Paying the withholding tax

Payments are due quarterly on the same dates as required for calendar-year federal estimated tax: April 15, June 15, September 15, and January 15. (18 Cal. Code Regs. §18662-8(c)(1)(B))

Beginning in 2020, passthrough entity withholding must be paid using Form 592-Q, Payment Voucher for Pass-Through Entity Withholding, if the payments are made by check or money order. This voucher is used to remit withholding payments reported on Form 592-PTE, including both nonresident and back-up withholding. No Form 592-Q is required if the payment is made electronically.

Who must file Form 592-PTE?

Lower-tier passthrough entities

All passthrough entities with California-source income must file a Form 592-PTE if they withheld tax on behalf of their nonresident owners. The Form 592-PTE is used to allocate the withholding to each nonresident owner in accordance with the owners' interest in the entity.

Upper-tier passthrough entities

An upper-tier passthrough entity is a passthrough entity owner that is itself a passthrough entity. If tax has been withheld on behalf of the upper-tier passthrough entity by a lower-tier passthrough entity, the upper-tier passthrough entity must file a Form 592-PTE to allocate withholding paid on its behalf to each owner, whether the owner is a California resident or nonresident.

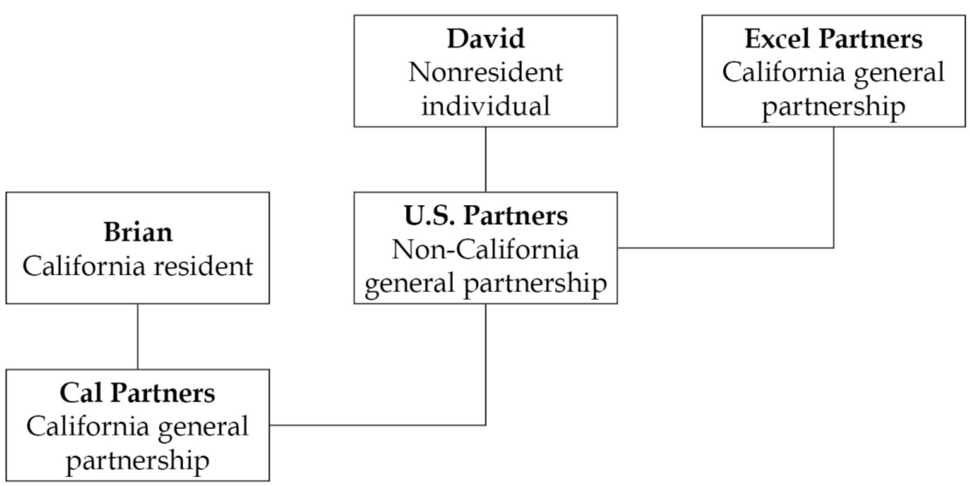
Example of upper-tier and lower-tier passthrough entities

Cal Partners is a California general partnership with two equal partners, Brian and U.S. Partners. Brian is an individual who is a resident of California. U.S. Partners is a non-California general partnership.

U.S. Partners has two equal partners, David and Excel Partners. David is a nonresident individual and Excel is a California general partnership.

Cal Partners is a lower tier passthrough entity because it has California-source income and it has an owner that is a passthrough entity.

U.S. Partners is an upper-tier passthrough entity because it is an owner of a passthrough entity, Cal Partners, and is itself a passthrough entity. Excel is also an upper-tier passthrough entity because it is an owner of a passthrough entity, U.S. Partners, and is itself a passthrough entity.



This means upper-tier passthrough entities must include withholding allocations for both their resident and nonresident owners, whereas lower-tier entities must only report the allocations for their nonresident owners.

NEW FORM 593

On January 1, 2020, the FTB released a revised version of FTB Form 593, Real Estate Withholding Statement, which is a consolidation of the prior Forms 593, 593-C, 593-E, and 593-I. (18 Cal. Code Regs. §18662-3) Since consolidating these forms, here are some of the most common questions the FTB has received regarding the new Form 593. (www.ftb.ca.gov/about-ftb/newsroom/tax-news/july-2020/top-questions-form-593.html)

FTB Publication 1016, Real Estate Withholding Guidelines, has also been updated to reflect the 2019 amendments to 18 Cal. Code Regs. §18662 et seq. The updated publication also provides a definition of the term “remitter,” outlines the responsibilities of the remitter, and describes how those responsibilities differ from those of the real estate escrow person and of the buyer.

Q: Can someone without a Social Security number (SSN) complete the new Form 593?

A: Yes, Form 593 can be completed without an SSN. However, if an individual does not have an SSN/ITIN, they cannot meet a full or partial exemption from withholding (claimed in Part III or IV of the form), and withholding is due. The seller will have to contact the FTB to provide an SSN/ITIN after they obtain one.

According to the FTB, a seller must have a valid SSN/ITIN to qualify for a withholding exemption. If a seller does not have an SSN/ITIN before the close of escrow, then Form 593, Part III (check boxes 1–9) and Part IV (check boxes 10 and 11) are void, and withholding is required.

Additionally, the FTB will not be able to credit the withholding to the taxpayer. Once the seller obtains an SSN/ITIN, they would contact the FTB’s Withholding Services and Compliance Section to get the withholding credit allocated to their SSN/ITIN. Without the SSN/ITIN, the real estate withholding credit cannot be tied to an income tax return. Upon filing the income tax return reporting income from the sale, a refund may be issued, if applicable.

Q: Why does Form 593 require the escrow company to be the remitter?

A: The remitter has been defined as the person who will send the tax withheld on any disposition from the sale or exchange of California real estate and file the prescribed forms on the buyer’s/transferee’s behalf. (18 Cal. Code Regs. §18662-2(v)) Typically, the real estate escrow person is the individual who remits the form and tax withheld to the FTB and should identify themselves as the remitter.

Q: Is the buyer’s signature required for every real estate transaction?

A: No, the buyer’s signature is required only when the transaction is an installment sale.

Q: Is the remitter required to send a Form 593 for every real estate transaction?

A: Yes, Form 593 must be submitted for every real estate transaction, unless an automatic exemption applies under 18 Cal. Code Regs. §18662-3(d)(1).

Q: In an installment sale, during escrow, would the remitter complete the buyer’s information in Part I as the remitter instead of real estate escrow person?

A: During escrow, the remitter would be the real estate escrow agent because he/she is the one submitting the payment and Form 593. The remitter is the person who will remit the withheld tax and file the prescribed forms on the buyer’s/transferee’s behalf. (18 Cal. Code Regs. §18662-2(v)) Post escrow, the buyer would likely be the remitter.

Q: Are electronic signatures accepted?

A: Yes. The FTB accepts DocuSign, wet signatures, and scanned/fax signatures.

Q: If the buyer is required to sign, can they sign in counterpart?

A: Yes, but the FTB asks that only one Form 593 be submitted per transaction.

Note: The only time a buyer is required to sign this form is when the buyer is using an installment sale, and the Form 593 instructions state that the seller is not required to sign in this situation. According to the FTB, signing in counterpart is only an option on the initial Form 593 during an installment sale transaction because the seller's signature is not required on subsequent forms.

Q: Under what circumstance is the seller's signature required?

A: The seller's signature is required on Form 593 in all situations at the time the initial real estate transaction occurs. The first Form 593 that is completed for an installment sale requires a seller's signature. However, for subsequent payments, the Form 593 does not require the seller's signature.

Comment

For more information on completing Form 593, see the FTB's Quick Reference Guide California Real Estate Withholding at:

Website
www.caltax.com/files/2020/ftb4064.pdf

HOW TO EASILY HANDLE FORM FTB 4734D

When tax returns come in for processing, the FTB uses a return analysis system. If the return looks suspicious, the FTB attempts to verify the taxpayer's identity by mailing Form FTB 4734D, Request for Tax Information and Documents.

The FTB will send the form within 30 days of the date the return is filed, and until the taxpayer responds to the form and the FTB can make a decision about whether to continue processing, the return is placed on hold.

To verify the taxpayer's identity and process the return, Form 4734D requests that copies of certain identifying documentation be sent to the FTB, such as:

- Driver's license;
- W-2s; and
- 1099s.

We say make a phone call

According to the FTB, the best way to respond to the notice is to fax that information to the number on the notice. However, we suggest you call the number on the notice instead because you may be able to resolve the situation more quickly on the phone than via fax. If you can't access the number on the notice, call the Tax Practitioner Hotline.

When you call, have a copy of the client's current- and prior-year returns and W-2 information, and in many cases, the FTB may be able to continue processing the return without the need to send additional documentation.

OTHER STATE TAX CREDIT: USE IT OR LOSE IT

Taxpayers who potentially pay taxes on the same income to two different states need to be aware of not only the filing requirements for the Other State Tax Credit (OSTC) for each state, but also any statute of limitations on making those claims. Taxpayers who don't take the credit in time for one state can't just claim the credit on the other state return.

In 2014, taxpayers who were California residents sold property in Arizona, which resulted in a $167,874 gain on the sale. (***Appeal of Jones***, 2020-OTA-013) They timely filed both the Arizona and California state returns, but they did not report the gain on the California return.

The taxpayers agreed that they owed California tax on the gain, but they argued that they were entitled to a credit for the taxes they had paid to Arizona on the gain. Arizona is a reverse credit state, meaning it allows an Arizona nonresident credit for income taxes paid to the nonresident's state of residence. (Arizona Revised Statutes §43-1096)

However, the taxpayers had not claimed the credit on their Arizona return since they hadn't reported the gain to California to begin with. At the time of their appeal, the statute of limitations had passed for amending their Arizona return to claim the credit for tax paid to California. They argued that alternatively they should be allowed to take the OSTC on their California return because they were prevented from receiving the benefit of the Arizona nonresident tax credit.

Unfortunately, this is not a solution for taxpayers who missed out on taking the OSTC on the other state's return, and the taxpayers were liable to California for the additional tax on the gain on the sale.

Other state bills the tax

However, California law allows additional time to amend the California return for tax paid to another state if the taxpayer failed to file a return for that state and subsequently is assessed tax. In this situation, a taxpayer who pays tax to another state has one year from the date the tax is paid to that state to claim an OSTC with the FTB, notwithstanding any other statute of limitations. (R&TC §19311.5)

Unfortunately, in the ***Jones*** case, the gain was omitted from the California return, and this provision does not apply.

Example of opening California statute

Opie, a California resident, has income from an oil well in Oklahoma. Although he had reported the income on his California return, he never filed Oklahoma tax returns to report the income. On December 15, 2020, the state of Oklahoma assessed $1,000 tax on $15,000 of Oklahoma income he earned in 2012, which he paid on January 15, 2021.

Even though the 2012 statute of limitations for California expired on April 15, 2017, he may claim a credit for tax paid to Oklahoma on his 2012 amended California return.

To claim the credit, he must file an amended 2012 return on or before January 14, 2022.

Claiming the credit

California allows individuals, estates, or trusts to claim a credit for net taxes imposed and paid to another state only on income that has a source within the other state under California law and is taxed by both California and the other state. (R&TC §§18001–18011)

Generally, you take the credit for double-taxed income on the taxpayer's resident return. However, there are a few exceptions. For certain states, the credit is taken on the nonresident return.

If you have income taxed by California and another state, use this chart to determine where to take the credit.

Other State Tax Credit — Where to Take It		
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
Taxpayer is:	**Resident of:**	**Credit is taken on:**
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

Note: Indiana was a reverse credit state for years prior to 2017

(Sources: R&TC §§18001 and 18002; California Schedule S)

FORM 3840 ISSUES

Reporting like-kind exchanges involving replacement properties

Taxpayers who replace California real property with property located outside California in a §1031 exchange must file an annual information return (Form FTB 3840, California Like-Kind Exchanges) until the individual owner is deceased or the gain is fully recognized at the federal level.

We continue to receive questions as to how to complete the Form 3840 when a taxpayer purchases multiple out-of-state replacement properties and only sells or exchanges one or some of the properties. The FTB has never updated form instructions to address this issue, but here is what they have told us.

Although the Form 3840 allows taxpayers to list multiple replacement properties purchased in a like-kind exchange on Schedule A, Part II of the form, it does not currently provide lines for taxpayers to report the gain or loss from subsequent disposition of one or some of the multiple replacement properties. Any gain or loss on the sale of real property recognized at the federal level is reported to California on the California Schedule D-1.

Different requirements for different transactions

If a property is exchanged for multiple out-of-state replacement properties, different reporting rules apply depending on the disposition of the replacement property:

- **Property sold at a loss:** If a replacement property is sold at a loss, the taxpayer should exclude the property from the list of properties on Form 3840 and attach a statement noting that the property was sold at a loss. The taxpayer must also report the loss on their California return; or

- **Property exchanged again:** If one of the replacement properties is exchanged again, that original replacement property should be removed from the Form 3840 filed in relation to the original exchange. A statement should be attached explaining that one of the original replacement properties was exchanged for a new replacement property, and that a new Form 3840 is being submitted with details concerning the second exchange. The new Form 3840 should have the "Initial FTB 3840" box checked on Question B and should list the property exchanged in the subsequent exchange as the relinquished property. The portion of the original deferred gain relating to that property should be reflected on the second Form 3840.

The taxpayer will continue to file multiple Forms 3840 in future years.

Example of how to report sales/exchanges of multiple replacement properties

Betty, a California resident, exchanges a San Diego apartment building in 2020 for $1 million. Her basis in the property is $900,000, resulting in a $100,000 gain. Betty purchases four replacement rental properties in Nevada (Rentals A, B, C, and D), each for $250,000. Her basis in each of the new rentals is $225,000 ($900,000 ÷ 4).

Betty attaches the Form 3840 with the "Initial FTB 3840" box checked to her 2020 return. She lists the San Diego property in Part I as the "Properties Given Up," and the four different replacement properties on Part II of the form under "Properties Received," and allocates $25,000 of deferred gain ($100,000 ÷ 4) to each property on line 10 of Schedule A.

In 2021, Betty sells Rental A in a fully taxable transaction for $200,000 at a $25,000 loss ($225,000 carryover basis - $200,000).

She also relinquishes Rental B for $300,000 in another §1031 exchange. After subtracting $30,000 in selling expenses, she realizes income of $270,000 and deferred gain of $45,000 ($270,000 - $225,000 carryover basis). This gain is comprised of the $25,000 gain from the original sale of the California property and $20,000 from the sale of Rental B. She uses the $45,000 gain to purchase a new property (Rental E) for $350,000 in another like-kind exchange.

When Betty files her 2021 return, she will attach two Forms 3840.

On the first Form 3840, she will check the "Annual FTB 3840" box and will only list Rentals C and D in Part II under "Properties Received." She will attach a statement to the first Form 3840 stating that:

- Rental A was sold at a loss, and therefore no gain will be reported; and
- Rental B was exchanged in another like-kind exchange and will be reported on a new Form 3840.

She will also complete and attach a second Form 3840 and check "Initial FTB 3840." The new Form 3840 will list Rental B as the "Property Given Up" on Schedule A, Part I, and the new property purchased (Rental E) as the "Property Received" on Schedule A, Part II. She should also answer Yes/No on Form 3840 Schedule A, Part 1, line 2 to note a prior tax-deferred exchange.

She will list both the $25,000 original gain deferred from the first transaction and the new $20,000 gain deferred from the second transaction on Part II of Form 3840 but will only list $25,000 on line 8 (representing the California-source deferred gain).

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. Under AB 2257, which expands exemptions from the ABC test, there is a new single-engagement event exemption. Which statement is accurate regarding this exemption?

   a) The category is for individuals or sole proprietors only
   b) Each individual must maintain their own business location, which may include their personal residence
   c) No business license or business tax registration is required
   d) For purposes of the exemption, a single engagement means a stand-alone event, or a series of events in one location occurring not more than twice a week

2. When filing a return for a worker who is an employee for California purposes and an independent contractor for federal purposes, which of the following applies?

   a) Workers must use federal numbers to compute their California income tax
   b) The IRS will send 1099 NEC information to California
   c) An adjustment must be made on the California return to account for a pension contribution
   d) Taxpayers must make Schedule CA adjustments to report their federal Schedule C income as wages on their California return

SOLUTIONS TO REVIEW QUESTIONS

1. Under AB 2257, which expands exemptions from the ABC test, there is a new single-engagement event exemption. Which statement is accurate regarding this exemption? **(Page 7-17)**

    a) Incorrect. Business entities may also qualify.
    b) Correct. In order to qualify for the exemption, all of the specified requirements must be met including that they maintain their own place of business.
    c) Incorrect. If the jurisdiction where the performance occurs requires such documentation, then they must be provided.
    d) Incorrect. If a series of events, they cannot occur more than once a week.

2. When filing a return for a worker who is an employee for California purposes and an independent contractor for federal purposes, which of the following applies? **(Page 7-25)**

    a) Incorrect. California numbers, not federal numbers, are used to compute income tax, the EITC, the individual shared responsibility payment, etc.
    b) Incorrect. The IRS issues the Form 1099 NEC reporting nonemployee compensation but does not send it to the states.
    c) Incorrect. California conforms to federal pension law, so no adjustment is made and the deduction is still allowed.
    d) Correct. The California income tax return is recomputed as if a federal return was filed with the taxpayer as an employee rather than an independent contractor.

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Chapter 8

California Conformity

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CALIFORNIA CONFORMITY

COVID-19 CONFORMITY

WHICH COVID-19 CHANGES DOES CALIFORNIA CONFORM TO?

The Governor has signed two bills that conform to specific provisions of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. (P.L. 116-136) Both bills are applicable to taxable years beginning on or after January 1, 2020. There are also several provisions in the CARES Act and the Families First Coronavirus Response Act (FFCRA) (P.L. 116-127) that California automatically conforms to.

PPP loan forgiveness

AB 1577 (Ch. 20-39) conforms to the CARES Act provisions that exclude any cancellation of debt income arising from Paycheck Protection Program (PPP) loan forgiveness. (R&TC §§17131.8, 24308.6; IRS Notice 2020-50)

The bill specifically prohibits taxpayers from claiming any deductions or credits for expenses that are paid with forgiven PPP loan amounts. Because of this, California does not conform to the new federal provision allowing deductions for amounts paid with forgiven PPP debt. Taxpayers will still be required to reduce their deductions on the California return because California enacted AB 1577 (Ch. 20-39), which specifically prohibits taxpayers from claiming any deductions or credits for expenses that are paid with forgiven PPP loan amounts.

Fiscal-year taxpayers

Because AB 1577 applies to taxable years beginning on or after January 1, 2020, it is unclear how fiscal-year taxpayers will report the COD income and related expenses. We asked the FTB the following questions and received the following responses.

Q: What should taxpayers do if they incurred the expenses during the 2019–20 fiscal year, but their PPP loan wasn't forgiven until their 2020–21 fiscal year? For instance, a September 30 year-end taxpayer took out a PPP loan on June 1, 2020, and had the loan forgiven on December 15, 2020. Would they exclude the COD income on their 2020–21 tax return even though they already filed and deducted their expenses on their 2019–20 tax return?

A: Yes, they should exclude the COD income on their 2020 return and include in gross income in 2020 the amount of deductions for expenses taken in 2019 to the extent that they reduced tax in that prior year.

Q: What should taxpayers do if they took out a loan and had their loan forgiven during the 2019-20 taxable year? For example, an October 31 year-end fiscal-year taxpayer took out a loan on May 1, 2020, and had it forgiven on October 15, 2020. Would they recognize the COD income and be able to claim the deductions for expenses that were covered by the PPP loan on their 2019-20 tax return?

A: Yes, because this taxable year begins on October 31, 2019, and this provision applies to taxable years beginning on or after January 1, 2020, the COD income resulting from PPP loan forgiveness would not be excluded from gross income.

Qualified retirement plan loans

In AB 276 (Ch. 20-62), California conforms to CARES Act §2202(b) that allows employees to take up to $100,000 rather than $50,000 in loan amounts from a qualified retirement plan without the loan being treated as a taxable distribution. However, the following conditions must be met:

- The loan is made on or after March 27, 2020, and before September 23, 2020 (180 days from March 27, 2020); and
- The employee certifies that one of the following is true:
  - The individual or their spouse has been diagnosed with COVID-19;
  - The individual, his or her spouse, or a member of the individual's household experienced a layoff, furlough, reduction in hours, or inability to work due to COVID-19 or lack of child care because of COVID-19;
  - The individual is experiencing adverse financial consequences due to their (or their spouse's) finances being affected by COVID-19;
  - The individual (or their spouse or household member) is a business owner who experienced closing or a reduction in hours due to COVID-19; or
  - The individual, their spouse, or a member of the individual's household had a reduction in pay (or self-employment income) due to COVID-19, or had a job offer rescinded or start date for a job delayed due to COVID-19.
    (R&TC §17085)

For purposes of applying these additional factors, a member of the individual's household is someone who shares the individual's principal residence.

The amount of loan that may be taken by employees that meet the aforementioned criteria is increased (generally speaking) as follows:

- From $50,000 to $100,000; and
- Up to the full present, nonforfeitable, value of the plan (previously only 50% of the nonforfeitable present value).

California also conforms to the CARES Act provision that delays by one year the due date for any repayment for an outstanding loan from a qualified employer plan if the due date falls during the period beginning on March 27, 2020, and ending on December 31, 2020. This same period is also not taken into account in determining the five-year repayment period and term of the loan.

Other conformity provisions

Economic impact payments

Economic impact payments are treated as an advance against a 2020 federal tax credit, and California conforms to federal law, which excludes these credits from income.

Early withdrawal penalty

California automatically conforms to the IRC §72(t) early withdrawal penalty, with a rate of 2.5% rather than the 10% federal rate. The CARES Act allows taxpayers to take up to $100,000 in penalty-free coronavirus-related distributions from their retirement accounts between January 1, 2020, and before December 31, 2020. (CARES Act §2202(a)) The COVID-19 early distributions are not subject to a California penalty if they are not subject to a federal penalty. (R&TC §17085(c))

Income spread

The taxpayer includes 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. California conforms. (IRC §§402(c), 403(a)(4), 403(b)(8), 408(d)(3), 457(e)(16); R&TC §17507) A taxpayer can make a different election for California purposes and, for example, report 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)

Example of making separate election

Tiffany and Jeremy were both laid off from their jobs in 2020 due to COVID-19. They took a $25,000 distribution from Tiffany's IRA to help tide them over until they were able to go back to work. While they were not working, they drew a combined $30,000 in unemployment benefits, which are taxable for federal purposes but not California purposes. Their wages prior to being laid off were $20,000. They have two children, ages 17 and 18, and do not itemize deductions.

For California purposes, they can claim the entire amount of the $25,000 distribution in 2020 and still owe no tax. For federal purposes, because their $30,000 of unemployment is taxable, they will owe over $3,000 in tax if they report the entire amount. They may want to consider reporting just one-third, or $8,333 in 2020, 2021, and 2022.

Recontribution to an IRA

Under the CARES Act, a taxpayer can, at their discretion, recontribute the 2020 coronavirus-related retirement plan distributions back into their retirement account within three years of their distribution. (CARES Act §2202(a)(5)) California conforms to this provision, but a taxpayer can make a separate election here. (IRC §§402(c), 403(a)(4), 403(b)(8), 408(d)(3), 457(e)(16); R&TC §§17024.5(e), 17507)

RMD waivers

The CARES Act amends IRC §401(a)(9) and waives the required minimum distribution rules for certain defined contribution plans and IRAs for calendar-year 2020. This provision provides relief to individuals who would otherwise be required to withdraw funds from such retirement accounts during the economic slowdown due to COVID-19. California conforms to this provision.

Under the IRS's extension relief provisions, taxpayers who took distributions from an IRA after February 1, 2020, were able to recontribute/roll over those distributions to an IRA by August 31, 2020. (CARES Act §2203; IRC §401(a)(9)(I); IRS Notice 2020-51) California conforms to this treatment. (R&TC §17501(b))

WHICH COVID-19 CHANGES DOES CALIFORNIA NOT CONFORM TO?

With California's specified date, we conform to the Internal Revenue Code as it appeared on January 1, 2015, with modifications — hundreds of them. (R&TC §§17024.5, 23051.5) When Congress enacts new laws, we must see if that specific law is a listed exception (meaning California will automatically conform) or if new legislation must be enacted.

Here are the changes in the FFCRA and the CARES Act that California does not conform to.

Charitable contributions and student loan payments

California does not conform to the following CARES Act provisions, which were extended to 2021 by the Consolidated Appropriations Act of 2021:

- Allowance of a partial above-the-line deduction for charitable cash contributions made in 2020;
- An increase in AGI and taxable income limits for cash contributions for individuals and corporations, respectively; and
- An exclusion for qualified employer payments of student loans up to the amount of the educational assistance program exclusion limits.
  (R&TC §§17024.5, 23051.5)

> ✐ **Practice Pointer**
>
> Taxpayers who exclude employer payments of student loans on the federal return are not permitted to claim a student loan interest deduction for those payments on the federal return. For California purposes, because the employer payments are taxable income to the employee and must be reported as taxable California compensation on the employee's W-2, the employee is entitled to a student loan interest deduction for the interest paid by the employer.

Medical expenses

Because of California's specified date, we do not believe that California conforms to the inclusion of certain over-the-counter medicines, drugs, and feminine hygiene products as qualified medical expenses for purposes of health flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs). Therefore, withdrawals from these accounts to cover these expenses will be treated as taxable distributions.

This treatment also applies for health savings accounts (HSAs) and Archer medical savings accounts (MSAs). Because California does not recognize HSAs and taxes the contributions to these accounts, withdrawals of earnings from these accounts to cover these expenses are not subject to California taxation.

> ☑ **Planning Pointer**
>
> California uses federal AGI to compute this threshold. (R&TC §17241)

Nonconformity to business provisions

California does not conform to:

- Five-year NOL carrybacks for 2018–2020 NOLs and temporary suspension of the 80% taxable income NOL carryover limitation (R&TC §§17024.5, 17276 et seq., 24416 et seq., 23051.5);
- Retroactive suspension of the excess business loss limitation for noncorporate taxpayers (R&TC §§17024.5, 17560.5);
- Retroactive modifications to the business interest expense limitations (California does not limit business interest expense deductions) (R&TC §§17024.5, 17201, 23051.5, 24344);
- Treating qualified improvement property as 15-year recovery period property eligible for bonus depreciation (California has never allowed shortened recovery periods for real property and does not allow bonus depreciation) (R&TC §§17250, 17255, 24349, 24356); and
- Acceleration of the refundable credit for prior-year minimum tax liability of corporations (California does not allow a refundable credit). (R&TC §§23051.1, 23453)

For all of the FTB's COVID-19 FAQs, go to:

Website
www.ftb.ca.gov/about-ftb/newsroom/covid-19/help-with-covid-19.html

SECURE ACT

CONFORMITY

California automatically conforms to changes to any provision that impacts the qualifications for retirement plans. (R&TC §17501) This means California automatically conforms to many of the SECURE Act provisions, including:

- Increasing the age for required minimum distributions (RMD) from age 70½ to age 72 for taxpayers who turn age 70½ after December 31, 2019;
- Tightening the RMD rules for inherited IRAs; and
- Expanded multiple employer plan rules.

For more information on SECURE Act changes, see the Retirement chapter starting on page 5-1.

NONCONFORMITY

California does not conform to the SECURE Act provision that allows individuals age 70½ or older to make deductible contributions to a traditional IRA, applicable to contributions made for taxable years beginning after December 31, 2019. (SECURE Act §107, repealing IRC §219(d)(1); R&TC §§17024.5, 17201) As a result, California taxpayers who are age 70½ or older and who make deductible contributions to an IRA on their post-2019 tax year federal returns will have to make an adjustment on their California return. They will also have to keep track of the resulting basis differences going forward. See page 5-13 for more information.

NET OPERATING LOSSES

NONCONFORMITY

California does not conform to the federal NOL carryback rules, or the 80% of AGI limitation in affect for the 2018–2020 taxable years as enacted in the TCJA and amended in the CARES Act. (R&TC §§17276, 17276.21, 17276.22, 24416, 24416.21, 24416.22) Additionally, California NOLs are suspended for taxable years beginning on or after January 1, 2020, and before January 1, 2023, for some taxpayers. The suspension does not apply to taxpayers:

- Subject to the personal income tax if they have net business income or modified adjusted gross income of less than $1 million; or
- Subject to the corporation income tax if their business income subject to California taxation is less than $1 million.
  (R&TC §§17276.23, 24416.23)

"Business income" is defined for purposes of the $1 million threshold as income:

- From a trade or business, whether conducted by the taxpayer or a partnership or S corporation owned directly or indirectly by the taxpayer;
- From a rental activity; or
- Attributable to a farming business.

"Modified adjusted gross income" for purposes of the $1 million threshold is the taxpayer's federal AGI without regard to the NOL deduction.

Example of taxpayers with no NOL suspension

Jane has a California NOL carryforward from 2019. On her 2020 return, Jane has modified adjusted gross income of $10 million (federal AGI excluding the federal NOL). However, her net business income is only $950,000.

Because her net business income is less than $1 million, Jane may apply her 2019 NOL carryforward on her 2020 California return, even though her modified adjusted gross income is much more than $1 million.

Extended NOL carryover period

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.

Example of NOL suspension considerations

Brian had a $1.2 million loss for California purposes in 2019. In 2020, his federal net business income is $1.2 million and his MAGI is $1.5 million. His NOL is suspended for California purposes in 2020. However he may add three years to his 20-year carryforward.

Evelyn had a $900,000 loss in 2019. In 2020 her federal AGI is $900,000. Her California AGI for 2020 is $1.2 million. She may claim an NOL for California purposes because, although her California AGI was over $1 million, her federal AGI was not.

In 2019, Greg had a California carryover loss of $300,000 and a federal carryover NOL of $400,000. For 2020, his federal AGI (including the 2019 NOL carryover) is $800,000 for 2020 — below the $1 million threshold. However, as he may not include the federal NOL to calculate his MAGI, his MAGI is $1.2 million. As a result, his California NOL is suspended and must be carried forward. However, he may also add three years to his 20-year carryforward.

CONSIDER NOL NONCONFORMITY WHEN PLANNING FOR ESTIMATES

For years there have been differences between California and federal net operating loss (NOL) deductions, especially when it comes to carryover and carryback provisions, and the 2020 tax year and beyond are no exceptions.

For federal purposes, the TCJA repealed NOL carrybacks beginning with the 2018 taxable year and allows unused NOLs to be carried forward indefinitely, subject to an 80% taxable income limitation. However, the CARES Act temporarily reinstated NOL carrybacks and allows taxpayers to carry back for five years NOLs incurred in 2018 through 2020. It also suspended application of the TCJA's 80% taxable income limitation until 2021. See page 4-23 for a discussion of federal NOL treatment.

Note: While larger taxpayers may want to consider some planning options to bring themselves down below the $1 million threshold, because California and federal NOLs are treated so differently, this may have a negative consequence for federal purposes.

Practitioners need to keep these key differences in mind when planning for estimated tax payments in future years. Below is a chart that summarizes these differences.

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 who 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)
Post-2020 taxable years (TCJA as modified by CARES Act) California suspends 2021 and 2022 NOL deductions for all taxpayers other than those who 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)

DOES CALIFORNIA CONFORM TO SMALL PARTNERSHIP PENALTY RELIEF?

Partnerships that fail to timely file a California partnership return can face significant penalties as a result of California's per-partner late-filing penalty. The penalty, which may be abated for reasonable cause, is imposed at a rate of $18 per partner per month for up to 12 months. (R&TC §19172)

However, in one nonprecedential decision (***Appeal of Too Fun Designs***), the OTA held that a partnership that filed its returns almost one year late was not liable for the penalty. (***Appeal of Too Fun Designs***, 2019-OTA-321) The OTA determined that California conforms to the IRS's small partnership penalty relief available under Rev. Proc. 84-35, which applies to partnerships with 10 or fewer partners as long as the partners timely file returns reporting their shares of the partnership's income deductions and credits.

Unfortunately, a precedential decision (***Auburn Old Town Gallery, LLC***) issued one day later, noted in passing that California did not conform to the IRS small partnership penalty relief. (***Appeal of Auburn Old Town Gallery***, LLC, 2019-OTA-319P)

THE TAXPAYER THAT WON

In ***Appeal of Too Fun Designs,*** the OTA found that because California's per-partner penalty was modeled after the IRS's per-partner penalty (IRC §6698), and small partnership penalty relief was available at the time California enacted the per-partner penalty in 1983, California incorporated the small partnership penalty relief provision of Rev. Proc. 84-35 and its predecessor, Rev. Proc. 81-11. Under these revenue procedures, reasonable cause for late filing is established for partnerships with 10 or fewer partners if the partners timely report their partnership income, deductions, and credits on their individual returns.

THE TAXPAYER THAT LOST

In ***Auburn Old Town Gallery, LLC***, the taxpayer timely paid its LLC fee and tax, but due to its accountant's "mere oversight," its return was filed almost one year late. Because the LLC had 60 members, the OTA upheld the FTB's imposition of a $12,960 per-partner late-filing penalty, finding that the accountant's "mere oversight" did not establish reasonable cause.

However, unlike the administrative law judges (ALJs) in the ***Too Fun Design*** appeal, the ALJs in ***Auburn*** ruled that small partnership penalty relief was not available because California does not conform to Rev. Proc. 84-35, and even if it did, the taxpayer was ineligible because the taxpayer's 60 members far exceeded the 10 or fewer partnership limit set forth in that revenue procedure.

DOES CALIFORNIA CONFORM TO REV. PROC. 84-35?

Given the OTA's precedential decision in ***Auburn Old Town Gallery***, it's unclear whether California conforms to Rev. Proc. 84-35. The conformity issue was not central to the decision in ***Auburn*** because the taxpayer partnership far exceeded the 10-partner limit, and the OTA decision really didn't analyze the conformity issue. However, in another nonprecedential decision issued in August 2020 involving three partners that filed a late partnership return, an ALJ panel cited the decision in ***Auburn*** for the proposition that California does not conform to the federal small partnership relief available under Rev. Proc. 84-35. (***Appeal of HMSS Investments***, 2020-OTA-100) So it appears that for at least this ALJ panel, the ***Auburn*** decision is precedential for small partnership penalty relief provisions, despite the fact that Auburn didn't meet the small partnership criteria.

CALIFORNIA CONFORMS TO IRS'S PAID LEAVE CHARITABLE DONATION TREATMENT

The FTB has stated that California conforms to IRS Notice 2020-46. The notice addresses these issues:

- An employee's income does not include paid vacation, sick leave, or other personal leave that the employee elects to forgo if the payments are made before January 1, 2021, to an IRC §170(c) organization under specified circumstances outlined in the notice;
- An employee who takes advantage of this program may not claim a charitable deduction for the donations; and
- The employer may claim a charitable or business expense deduction if the employer otherwise meets the requirements of IRC §162 (dealing with trade or business expenses) or §170 (dealing with charitable contributions).

Because California conforms to the federal definition of gross income as well as IRC §§162 and 170, California follows the determination in IRS Notice 2020-46 that the qualified leave donations would not be gross income for the employees.

CALIFORNIA MANDATES PAID SICK LEAVE FOR WORKERS NOT COVERED BY FFCRA

AB 1867 (Ch. 20-45) codifies and expands upon the California COVID-19 supplemental paid sick leave benefits that were mandated by Governor Newsom in Executive Order N-51-20. (Labor Code §248)

The executive order required hiring entities with 500 or more nationwide food service network employees to provide up to 80 hours of paid sick leave to qualified California employees.

Food sector employees are defined broadly and include workers involved anywhere in the food supply chain, including pickup and delivery workers.

AB 1867 codifies these provisions and expands the executive order's coverage to also include:

- All employees who leave their homes to perform work and who work for employers that have 500 or more employees nationwide; and
- Health care employees and emergency responders who were not extended Families First Coronavirus Response Act (FFCRA) paid sick leave by their employers because the employers claimed an essential worker exemption. **Note:** Businesses that claimed the FFCRA essential worker exemption may want to reconsider claiming the exemption so that they can claim the FFCRA credit for the paid sick leave benefits.
(Labor Code §248.1)

For complete information, the California Department of Industrial Relations has provided the following:

- A chart to summarize the key differences between the FFCRA and California's COVID-19 Supplemental Paid Sick Leave programs; and
- FAQs related to the California COVID-19 supplemental program.

The information is available at:

Website
www.dir.ca.gov/dlse/Coronavirus-(COVID-19)-Information.htm

Chart 21-2

Quick Guide to California Nonconformity for Taxable Year 2020

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));
- 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.); and
- CA does not conform to any of the provisions in the Disaster Relief and Airport and Airway Extension Act of 2017 provided to victims of Hurricanes Harvey, Irma, and Maria.

	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 married filing separate for CA and married filing joint 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.	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
California 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
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: 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.	FFCRA §7701(a)(20)	17020.12, 18406	18406, 21003.5, 23045.6

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
IHSS supplementary payments (CA sales tax): Excludable for CA, but not federal.	N/A	17131.9	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
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 is not taxable by California			
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
HSAs: Interest on HSAs included in CA income.	223	17215.4	N/A
Municipal bonds issued by a county, city, town, or other local government unit in a state other than CA.	N/A	17143	24272
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
State bonds issued by other states and the government of American Samoa.	N/A	17143	24272
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 assests 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

Dividends — continued	IRC §	PITL R&TC §	CTL R&TC §
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: Alimony is taxable/deductible for CA purposes no matter when court order was put in place.	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 California: Worldwide income included in nonresident's AGI from all sources; CA-source business income determined using an apportionment formula.	N/A	17951	N/A
FFCRA paid sick and leave benefit credits: Taxpayers may exclude on the CA return the employer credit for FFCRA paid sick and leave benefits that is included in income on the federal return.	FFCRA §7701(e)(1)	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
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 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
NOLs: CA conforms to federal except: ● CA suspends the deduction for NOLs incurred during the 2020–22 taxable years for businesses with business income/modified AGI of $1 million or more; ● CA does not allow NOL carrybacks after the 2018 taxable year; ● There is no post-2020 80% taxable income when claiming NOL carryovers on CA return; ● California limits the carryover to 20 years; and ● California 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 for buildings placed in service prior to 2021: CA does not conform. May create basis difference.	179D	17257.2	24349

Business Expensing and Depreciation — continued	IRC §	PITL R&TC §	CTL R&TC §
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-2021 productions: CA does not conform. May result in basis difference.	181	17201.5	24356
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 and before January 1, 2021: 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
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 California timber.	194	17278.5	24372.5
Depreciation that will create a basis difference			
Auto depreciation: CA does not conform to increased auto depreciation.	280F	17024.5, 17250, 17255	24349
Auto lease inclusion: CA has its own lease inclusion tables.			
Bonus depreciation (50%/100%), 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
Cellulosic biomass ethanol plant property placed in service before January 1, 2018: CA did not conform to additional first-year depreciation.	168	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 2021 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
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, 2021. 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 2015–2020. CA does not conform.	168	17250	24349
Small aircraft recovery method: CA does not conform.	168	17250	24349

Other Business Expense Differences — continued	IRC §	PITL R&TC §	CTL R&TC §
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. 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 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.	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
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
Payroll protection loans: According to the FTB, fiscal year taxpayers must include expenses as "additional income" on 2020 return if expenses were deducted on 2019 return and paid by PPP loan forgiven in 2020. Unclear how IRS will treat this situation.	162; IRS Notice 2020-32	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. CA requires expenses to be amortized over 15 years.	41, 280C, 174	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

Other Business Expense Differences — continued	IRC §	PITL R&TC §	CTL R&TC §
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	
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
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 for personal income taxpayers with federal AGI less than $250,000 ($500,000 MFJ) 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
Deemed sale election (2001) was different. (Tax Reform Act of 1997 §311(e))		17024.5	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
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

Capital Gains and Losses — continued	IRC §	PITL R&TC §	CTL R&TC §
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		23801, 23804
IRA Distributions			
Basis differences due to: ● CA doesn't allow deductible contributions to a traditional IRS 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. ● Lower CA AGI limitations in 2007–2009.	219	17501, 17203, 17024.5	N/A
Contributions: Pre-1987 IRA and SEP contributions commonly have a higher CA basis.	219	17203	N/A
COVID-19 -distribution recognition: Taxpayers may make different federal/state elections as to whether to recognize income from COVID-19 -related 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
Hurricane relief: Federal IRA distribution relief and penalty abatement due to 2017 DRAAE and 2018 BBA hurricane and fire relief do not apply for CA.	504(a)(4), 502(a)	17024.5	
Self-employment or farm income: Lower IRA deduction for CA purposes for 1987–1995.	219	17203	N/A
Pensions and Annuities			
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)			
Railroad retirement benefits: Tier 1 and Tier 2 are not taxable to CA.	86	17087	N/A
U.S. Social Security benefits: Not taxable to CA.	86	17081	N/A
IRA and Pension Basis Differences			
Canadian RRSP earnings: Taxable by CA in the year earned.	408	17501	N/A
Contribution deductions: Pre-1987 Keogh and SEP deductions may have been higher for federal than for CA purposes.	219	17085	N/A
MSA rolled into an HSA: Taxable by CA, provides basis for CA purposes.	220	FTB Pub. 1001	N/A
Self-employment or farm income: After 1986 and before 1996, if CA deductions for self-employment or farm income was lower.	219	17507	N/A
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

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	
Global intangible low-tax income (GILTI): CA does not conform and does not tax such income until actually distributed.	951A	N/A	N/A
Kast Property Tank Farm cleanup settlements: CA excludes settlement payments paid to 1,500 Carousel Housing Tract residents.	N/A	17138.4	24308.8
Paid family leave benefits: Not taxable to CA.	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
Unemployment compensation: Not taxable to CA.	85	17083	N/A
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
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: Federal does not allow COD on principal residence after 2017 unless an agreement was entered into in 2017; 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. ● 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

Other Income/Deductions/Exclusions — continued	IRC §	PITL R&TC §	CTL R&TC §
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			
Cash charitable deductions: CA does not allow an above-the-line $300 deduction for non-itemizer's 2020 cash charitable contributions.	62(a)(22)	17024.5, 17072	N/A
Educator expense $250 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.	N/A	17302	N/A
Self-employed health insurance paid on behalf of a nondependent RDP deductible for CA.	N/A	17021.7	N/A
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 (after 3/27/20 and before 1/1/21): Payment is excludable from wages for employee and deductible by employer. CA does not conform.	127(c)(1)(B); CARES Act §2206(a)	17151	N/A
Tuition and related expenses exclusion (pre-2018 tax years): Not excludable for CA purposes.	222	17204.7	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
Net Operating Losses			
Carrybacks: CA does not allow carrybacks for NOLs incurred after 2018 and limited carrybacks for 2013 through 2018 taxable years to two years.	172	17276(c), 17276.21(c), 17276.22	24416(c), 24416.21(c), 24416.22
Suspension: Businesses	N/A	17077	N/A
Taxable income limitation: CA does not limit the amount of NOL that may be carried forward.	172	17276, 17276.21	24416, 24416.21
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
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): 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			
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-2021 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
Charitable contributions			
Above-the-line deduction: CA does not allow an above-the-line deduction for charitable cash contributions.	62(a); CARES Act §2204	17024.5, 17072	N/A
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: For years beginning on or after 1/1/14, no contribution deduction complaints allowed for those 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 personal income tax deduction based on a percentage 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

Miscellaneous itemized deductions — continued	IRC §	PITL R&TC §	CTL R&TC §
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 deduction due to federal education credits/deduction as miscellaneous itemized deduction.			
Interest paid to public utility: Qualified interest is deductible for CA as a miscellaneous itemized deduction not subject to 2%.		17073, 17208.1	N/A
Provisions Applicable Only to Corporations			
AMT: California 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 TCJA modifications to definitions, so income may not be taxable to CA.	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
Dividend received deduction: CA does not have a general dividends received deduction.	243	N/A	24402
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

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. Which of these statements correctly characterizes loans made from qualified retirement plans for California purposes?

    a) To qualify for the loan, it is the individual account holder who must be experiencing adverse financial affects from COVID-19
    b) California does not conform to the CARES Act provision that allows employees to take up to $100,000 in loans from a qualified retirement plan without being treated as a taxable distribution
    c) California will delay the due date for repayment of an outstanding loan from a qualified retirement plan by one year if the due date is between March 27, 2020, and December 31, 2020
    d) The amount of loan that an employee may take is up to 50% of the nonforfeitable present value of the plan

SOLUTIONS TO REVIEW QUESTIONS

3. Which of these statements correctly characterizes loans made from qualified retirement plans for California purposes? **(Page 8-3)**

   a) Incorrect. The conditions for qualifying for the loan apply to the individual employee or their spouse or a member of their household.
   b) Incorrect. California conforms to this provision, which increased the distribution limit from $50,000 to $100,000.
   c) Correct. This conforms to the federal provision under the CARES Act.
   d) Incorrect. California conforms to the federal provision that allows for up to the full present, nonforfeitable value of the plan.

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SPIDELL

TAX • ANALYSIS • EDUCATION

Chapter 9

California Individuals

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CALIFORNIA INDIVIDUALS

CALIFORNIA'S INDIVIDUAL HEALTH CARE MANDATE

Beginning January 1, 2020, all California residents must have qualifying health insurance coverage unless they qualify for an exemption. Otherwise, nonexempt taxpayers without coverage must pay a penalty when they file their 2020 California tax return. (Gov't. Code §100705; R&TC §61010)

This could be a problem for millions of unemployed Californians who have lost their employer-provided health insurance. Remind your clients if they lose health insurance due to a job loss, they will likely be required to obtain other health insurance within three months in order to avoid facing significant penalties when they file their 2020 return in 2021.

However, with the loss of a job, chances are individuals and their families may be eligible for health care subsidies through the federal government and Covered California or might be eligible for Medi-Cal. Alternatively, individuals may be eligible for continued health care coverage through COBRA benefits provided through their former employers.

> ***Comment***
>
> California does not impose employer penalties for failure to provide health insurance.

California's new mandate mirrors the federal program adopted under the original ACA, ensuring that plans maintain certain baseline coverage and subjecting individuals to penalties if they fail to obtain health insurance. The bill also provides subsidies to keep the insurance "affordable" (see page 9-9).

The program is being jointly administered by the California Health Benefit Exchange (the agency that runs Covered California) and the Franchise Tax Board.

The following discussion highlights areas where there are differences between the federal program and the new California program.

INDIVIDUAL SHARED RESPONSIBILITY PENALTY

An individual whose income is above the state income tax filing threshold who goes without insurance for more than three consecutive months will be subject to a penalty, unless:

- The coverage is unaffordable (exceeds 8.24% of household income for 2020);
- The individual qualifies for one of the exemptions listed later; or
- The individual qualifies for a general hardship discussed on page 9-8.

The penalty is equal to the lesser of either of the following amounts:

1. The sum of the monthly penalty amounts for months in the taxable year during which the failure occurred; or
2. An amount equal to the monthly premium for a Bronze plan offered over the Exchange for the household size involved multiplied by the number of months in which the failure occurred ($289 per month per individual (up to five household member maximum) for 2020). (R&TC §61015)

The monthly penalty amount is equal to the greater of 1/12 of:

- A flat dollar amount equal to $750 per person ($375 for dependents) up to 300% maximum ($2,250). These figures are subject to annual inflation adjustments, and when the penalty was originally enacted, the published penalty amounts were $695 per person ($347.50 for dependents); or
- 2.5% of household income in excess of the state gross income filing threshold.

A typical family of four that goes uninsured for the whole year would face a penalty of at least $2,250. A penalty estimator is available on the FTB's website at:

Website
www.ftb.ca.gov/file/personal/filing-situations/healthcare/estimator/

The penalty must be reported on, and paid with, the responsible individual's tax return for the year that includes the month(s) of no coverage. (R&TC §61010)

Example of penalty calculation

Laurie is a single mom, with one child dependent. Her household income is $90,000 per year from her own business. She does not have health insurance for either herself or her daughter for all of 2020.

Flat dollar amount ($750 + $375)	**$ 1,125**
Income	90,000
Threshold amount	31,263
Excess	58,737
2.5% of excess	**$ 1,468**

Assume that the state average monthly premium for a Bronze plan is $300 ($3,600 for the year).

Laurie's penalty for 2020 would be equal to $1,468 because the $1,468 is greater than the flat dollar amount and less than the $3,600 average statewide price for the Bronze plan.

Penalty cap

Under AB 85, the penalty is capped for taxpayers with more than five household members. (R&TC §61015) The cap may not exceed the amount of the maximum monthly penalty that may be imposed against a responsible individual with a household size of five individuals. For larger households, this means that for 2020, the penalty will not exceed $3,750 ($750 × 5). However, a higher amount may be imposed for households with higher household incomes.

THE MANDATE

California residents must maintain monthly minimum essential health care coverage for themselves, their spouses/RDPs, and their dependents, as defined under R&TC §17056, unless they qualify for an exemption from the mandate (see page 9-4). (Gov't. Code §§100705, 100710)

> ***Comment***
>
> Individuals who qualify for an exemption are not subject to a penalty if they are not insured.

The individual mandate applies to California resident individuals of all ages, including children and senior citizens. The person claiming a child or other individual as a dependent is responsible for providing coverage for the dependent. Non-U.S. citizens or nationals who are not lawfully present in the U.S. are exempt from the mandate.

MINIMUM ESSENTIAL COVERAGE

Like the Affordable Care Act, minimum essential coverage includes:

- Eligible employer-sponsored coverage, including self-insured plans, COBRA coverage, and retiree coverage;
- Coverage purchased in the individual market, including a qualified health plan offered by Covered California (California's health insurance Exchange) and student health coverage, as long as it substantially meets all the requirements of Title I of the Affordable Care Act;
- Medicare Part A coverage and Medicare Advantage plans;
- Full-scope coverage under the Medi-Cal program;
- Medicaid;
- Children's Health Insurance Program (CHIP) coverage;
- Certain types of veterans health coverage administered by the Veterans Administration;
- Most types of TRICARE coverage under chapter 55 of Title 10 of the United States Code;
- Coverage provided to Peace Corps volunteers;
- Coverage under the Nonappropriated Fund Health Benefits Program;
- Refugee Medical Assistance supported by the Administration for Children and Families;
- University of California Student Health Insurance Plan and the University of California Voluntary Dependent Plan; and
- Other coverage recognized by the State Department of Health Services as minimum essential coverage.

Like the ACA, minimum essential coverage does not include coverage providing only limited benefits, such as the following:

- Coverage consisting solely of excepted benefits, such as:
    - Stand-alone vision care or dental care;
    - Workers' compensation; or
    - Accident or disability policies.
- Coverage for onsite medical clinics;
- Long-term care, nursing home care, home health care, community-based care, or any combination thereof; and
- Liability insurance (both general and auto) and liability insurance supplements.
  (Health & Safety Code §1345.5)

Coverage during a month

Under the ACA, an individual is treated as having coverage during a month if the individual has coverage for any one day of the month. An individual who is eligible for an exemption for any one day of the month is treated as exempt for the entire month.

The California provisions state that the federal regulations under the ACA will apply, so long as they do not conflict with any new regulations promulgated by the FTB. At a recent interested parties meeting on upcoming California regulations, the FTB stated this provision will apply for California purposes as well.

EXEMPTIONS FROM THE REQUIREMENT TO HAVE COVERAGE

The following individuals are exempt:

- Individuals with income below the filing threshold (see upcoming section for more information);
- Individuals for whom coverage is unaffordable;
- Individuals who have received a certificate of exemption from the Exchange for hardship or religious conscience (Gov't. Code §100705);
- 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.

Comment

An exemption is available for the whole month if the applicant qualifies for an exemption for at least one day of the month. (10 Cal. Code Regs. §6914)

Obtaining an exemption

The mechanism for obtaining an exemption depends upon the exemption for which the individual qualifies:

- The religious conscience exemption and general hardship exemptions (e.g., homelessness, domestic violence, etc.) may only be granted by Covered California. (10 Cal. Code Regs. §6910 et seq.) Individuals may apply for exemption online or by printing out an application form from the Covered California website and mailing it in;
- The hardship affordability exemption, which is based on projected income, is claimed either through Covered California or on the personal income tax return. This exemption may only be approved prospectively by Covered California but may be processed retroactively by the FTB when claimed on the personal income tax return; and
- All other exemptions previously listed are claimed on the individual's personal income tax return.

For exemptions claimed through Covered California, Covered California will determine an applicant's eligibility within 30 days of receipt and will mail a written notice to the applicant, along with an exemption certificate if approved, within five days of the determination. (10 Cal. Code Regs. §6916(g) and (i)) If the applicant provides insufficient information to make the determination, Covered California will provide the applicant an additional 30 days (more if needed) to furnish the information. (10 Cal. Code Regs. §6916(k))

LOW-INCOME EXEMPTIONS

Taxpayers may be exempt from the requirement to have health insurance and not be penalized. These exemptions mean that an individual who doesn't qualify for Medi-Cal but can't afford to purchase insurance based on the individual's/household's projected income for the calendar year will not be penalized for failure to have coverage.

Exemption for income below the filing threshold

If a taxpayer's income is below the tax return filing threshold, the taxpayer is not required to file a tax return to claim an exemption. No other form must be filed to claim the exemption.

There are two different filing threshold limits:

- An exemption if the applicable household income falls below the California *adjusted gross income* filing limit; and
- An exemption if the responsible individual's gross income falls below the California *gross income* filing limit (this is limited to the responsible individual and his or her spouse's income; dependent's income is not included) (see page 12-56 for the California filing limits). (R&TC §61020(b) and (c))

Applicable household income

Applicable household income is the modified adjusted gross income (MAGI) of all household members (the responsible individual, his or her spouse/RDP, and dependents) required to file a state tax return. (R&TC §61000(c))

MAGI is federal adjusted gross income plus tax-exempt interest (other than interest exempt under the U.S. or California Constitution), plus the amount of any foreign-earned income exclusion. (R&TC §61000(j))

Exemption because coverage is unaffordable

An individual is entitled to an exemption for himself or herself, or another member of his or her tax household, for any month when the lowest cost coverage is unaffordable through:

- An employer-sponsored plan; or
- If the individual does not have access to employer-sponsored coverage, Covered California.

Generally, coverage is unaffordable if an individual's required contribution exceeds 8.24% (for 2020; adjusted annually) of the applicant's projected annual household income for the taxable year. (R&TC §61020(a); 10 Cal. Code Regs. §6914(d)) Household income for this purpose includes any amount of the required contribution made through a salary reduction arrangement that is excluded from gross income.

Not eligible for employer coverage — the Exchange exemption

If neither the taxpayer nor another member of the household can purchase coverage under an employer plan, the individual's required contribution is based on:

- The premium for the lowest cost Bronze plan available in the individual market through Covered California serving the rating area in which the individual resides; less
- The maximum amount of any premium assistance for the taxable year determined as if the individual was covered for the entire taxable year by the plan.

All members of an individual's tax household who have not otherwise been granted an exemption through Covered California and who are not treated as eligible to purchase coverage under an eligible employer-sponsored plan must be included to determine the required contribution. (10 Cal. Code Regs. §6914(d))

> ***Example of Exchange exemption***
>
> Mary and Malcolm reside in San Diego and have household income of $80,000. Neither is eligible for coverage under an employer plan. Their required contribution after taking into account the subsidies provided for the lowest price Bronze plan would be $10,131 annually, which is more than 8.24% of their household income. They qualify for the unaffordable exemption and will not be subject to a penalty if they are not insured.

Coverage through employer

If one or more members of a household are eligible for self-only coverage through an employer, the employee's required contribution is the amount they would pay for the lowest cost self-only coverage in which they can enroll (without regard to whether paid through salary reduction or otherwise). (R&TC §61020(a)(2); 10 Cal. Code Regs. §6914(d))

Self-only coverage refers to a plan that offers an option that covers only the employee, not dependents. The plan may offer coverage for dependents, but if there is an option for self-only coverage, that premium is the amount used to determine eligibility for an exception.

> ***Example of unaffordable employer coverage***
>
> Frank and Franny file a joint return in 2020 claiming their daughters Felicity and Fae as dependents. Their household income is $90,000.
>
> Frank does not work. Franny is offered self-only coverage by her employer at a cost to her of $5,000 per year. She could purchase family coverage covering all four members of the family at a cost of $20,000.
>
> Self-only coverage for Franny is affordable because her required contribution of $5,000 is less than 8.24% of household income (8.24% × $90,000 = $7,416).
>
> Family coverage is not affordable because their required contribution of $20,000 is greater than 8.24% of household income.
>
> Therefore, Franny is not eligible for the exemption for unaffordable coverage for 2020, but Frank, Felicity, and Fae are eligible for the exemption.
>
> If Franny doesn't acquire qualifying coverage, she will be subject to the penalty (unless she qualifies for some other exemption).

Applying for this exemption

Applicants must apply to Covered California for the unaffordable coverage exemption prior to the last date on which the applicant could enroll in a qualified health plan through Covered California for the month or months of a calendar year for which the exemption is requested. The application is based on the taxpayer's projected income for the calendar year. (10 Cal. Code Regs. §6914(d)(7))

The exemption is only applied prospectively, and if approved, applies for all remaining months in a coverage year, notwithstanding any change in an individual's circumstances. (10 Cal. Code Regs. §6914(d)(8))

Employer exemption trumps Exchange exemption

A regulation makes clear that if an individual is *eligible* for qualifying employer coverage but the coverage is unaffordable, the individual is exempt from the requirement to have coverage even if affordable coverage is available through Covered California. (10 Cal. Code Regs. §6914(d)(5))

Therefore, in the case of employer coverage that covers some, but not all, members of a household, the covered members may qualify for the employer exemption, and those not covered by the employer must use the Exchange exemption.

> ***Example of employer and Exchange exemptions***
>
> Colleen is single and has a son, Spencer. Her employer only offers self-only coverage that is unaffordable to Colleen. Colleen is entitled to the employer exemption. However, in order for Spencer to be exempt, applicable coverage through Covered California less available subsidies would have to be unaffordable.

SHORT COVERAGE GAP

An individual is treated as exempt during the months of the year that represent a "short coverage gap." A short coverage gap is a period of three consecutive calendar months or less. If an individual has more than one short coverage gap during a year, the short coverage gap exemption only applies to the first gap. (R&TC §61023)

> ***Example of short coverage gap***
>
> Carla has minimum essential coverage in 2020 from January 1 through March 2. After March 2, she doesn't have coverage until she enrolls in an employer-sponsored plan effective June 15. She is under that plan for the rest of the year.
>
> She has coverage for January–March and June–December because she has coverage for at least one day in each of those months. Her coverage gap is less than three months (April and May). Therefore, she is treated as having coverage during those two months. She has no penalty for the year.

Under the ACA, if a coverage gap straddles more than one taxable year, the months in the second taxable year are not counted in computing the gap in the first taxable year. However, those months in the first taxable year are counted toward a coverage gap in the second year. Again, this provision would apply for California purposes as well, unless California drafts regulations that state otherwise. (Treas. Regs. §1.5000A-3(j)(4), Ex. 4; R&TC §61030) The proposed regulations currently conform to the federal provision.

Example of coverage gap straddling two taxable years

Trisha has coverage from January 1 through October 15, Year 1, when she loses coverage. She doesn't get new coverage until March 15, Year 2. Although she lacked coverage for three consecutive months, January of Year 2 is not counted in considering a short coverage gap in Year 1. Therefore, her coverage gap in Year 1 is only two months (November and December) and qualifies as a short coverage gap.

In Year 2, however, January and February are part of a coverage gap extending for more than three months (November, December, and January). Therefore, January and February of Year 2 are not part of a short coverage gap, and the penalty will apply to those months.

GENERAL HARDSHIP EXEMPTIONS

Covered California will grant a hardship exemption if it determines that the applicant:

- Experienced financial or domestic circumstances, including an unexpected natural or human-caused event, that resulted in an unexpected increase in essential expenses preventing the applicant from obtaining coverage;
- Would experience serious deprivation of food, shelter, clothing, or other necessities if required to purchase a qualified health plan; or
- Has experienced other circumstances that prevented them from obtaining coverage. (10 Cal. Code Regs. §6914(c))

The hardship exemption may be approved retroactively. An application for general hardship may be filed up to three years after the calendar month or months during which the applicant attests that the hardship occurred. (10 Cal. Code Regs. §6916(h)) To apply for a hardship exemption, go to:

Website
www.coveredca.com

CHANGES IN STATUS

An exemption for unaffordable coverage remains in effect for the remainder of the calendar year, even if the taxpayer's circumstances change. For all other exemptions, an exempt individual must notify Covered California of any change with respect to the eligibility standards within 30 days of such change via the same channels as previously outlined.

Reporting life and income changes to the Exchange

Covered California requires an individual to report midyear changes to income or family circumstances including:

- Marriage or divorce;
- Birth or adoption of a child;
- Change in income;
- Get health coverage through employment or government insurance;
- Change of residence;
- Change in disability status;
- Change in dependents;
- Change in filing status;
- Change in citizenship or immigration status;
- Incarcerated or released from incarceration;
- Change in tribal status;
- Correction to name, birth date, or Social Security number; and
- Any other changes that may affect income and household size.

These changes may affect an individual's eligibility for the advanced credit and/or the amount of the advanced credit. Individuals are instructed to not report these changes by mail but to report them either online (by logging in to a Covered California account) or by phone.

☎ **Telephone**
(800) 300-1506

APPEALS

Taxpayers may appeal an exemption denial as well as coverage denial, or premium subsidy reduction/disallowance (see upcoming discussion) by filing the form in the link to request a state fair hearing with the California Department of Social Services at:

💻 **Website**
www.coveredca.com/PDFs/Request-for-Appeal-English.pdf

AVAILABLE SUBSIDIES

Similar to the ACA, California's program will provide financial assistance to taxpayers below specified income levels to help them obtain affordable health care coverage through the Exchange. (Gov't. Code §100800 et seq.) Subsidies will only be provided to those taxpayers purchasing insurance through Covered California.

California's subsidy program is more expansive, however, in that federal law provides assistance to individuals and families with incomes at or below 400% of the federal poverty level, whereas California will be providing subsidies to California residents at or below 600% of the federal poverty level.

2020 Federal Poverty Levels			
Size of family	**Poverty line**	**400%**	**600%**
1	$12,490	$49,600	$74,940
2	$16,910	$67,640	$101,460
3	$21,330	$85,320	$127,980
4	$25,750	$103,000	$154,500
5	$30,170	$120,680	$181,020
6	$34,950	$139,800	$209,700

2021 Federal Poverty Levels			
Size of family	**Poverty line**	**400%**	**600%**
1	$12,760	$51,040	$76,560
2	$17,240	$68,960	$103,440
3	$21,720	$86,880	$130,320
4	$26,200	$104,800	$157,200
5	$30,680	$122,720	$184,080
6	$35,160	$140,640	$210,960

California's subsidies may be paid in advance directly to the health insurance plan. (Gov't. Code §100805) It is not a credit, although underutilized subsidies may be credited to the taxpayer as part of the reconciliation process described on page 9-11.

The subsidies are not included in the individual's gross income for California income tax purposes. (Gov't. Code §100805(c); R&TC §17141.1)

Comment

We also believe that the subsidies would not be included in a taxpayer's federal adjusted gross income under the general welfare exemption. This uncodified exemption applies in cases in which an individual receives a governmental payment based on need.

Only those California residents eligible for the federal Premium Tax Credit under IRC §36B (using California income restrictions) are eligible for the subsidies.

Caution

The California subsidies are scheduled to be repealed beginning in 2023.

Amount of subsidies

Covered California will automatically calculate the amount of the subsidies when taxpayers apply on their website. By using Covered California's "Shop and Compare" tool on their website, applicants can estimate the actual amount of subsidies they may receive:

> **Website**
> https://apply.coveredca.com/lw-shopandcompare/

Income determination

Initial determination of income eligibility is based on the individual's projected income for the calendar year. So an applicant's 2021 subsidies will be based on his or her projected income for the 2021 calendar year. This is different than the federal Premium Tax Credit, which is based on the individual's income from two years prior.

HOW THE SUBSIDY IS DETERMINED

The subsidy is capped at the applicable percentage of the taxpayer's household income and will be reduced by any federal Premium Tax Credit received. The "applicable percentage" will rise from 6.24% for taxpayers with household income greater than 200% of the poverty line for the family size involved to 18% for those at 600% of the poverty line.

RECONCILIATION

Like the advanced federal Premium Tax Credit, individuals who receive premium subsidies must reconcile the amount of the subsidies received based on their projected income with the amount they were actually entitled to receive based on actual household income, family size, and other factors for the coverage year. (Gov't. Code §100805)

The reconciled amount must be reported on the responsible individual's tax return for the covered year. (Gov't. Code §100810) Individuals who must reconcile the amounts received versus the amount they were actually entitled to must file a return even if the individual is below the filing thresholds.

> **Practice Pointer**
>
> The FTB has created a new Form 3849, Premium Assistance Subsidy, to report these reconciliations with the California return. The form basically mirrors the federal Form 8962, Premium Tax Credit (PTC).

If the amount of the year's allowable subsidies exceeds the amount advanced, the responsible individual will receive a "premium assistance subsidy reconciliation refund" from the FTB (less any taxes, fees, and penalties owed by the participant to the state).

If the advanced subsidies exceed the amount the participant was actually entitled to, the participant must pay the liability, up to a limit (discussed in the next section) along with their California tax return.

Refunds/overpayments of subsidies may be required because:

- The taxpayer doesn't apply for the advanced subsidies or doesn't apply until after he or she begins paying premiums for which the taxpayer is eligible for subsidies;
- The taxpayer's income wasn't what was expected — i.e., the income was different from the income used to compute the advanced payment (the advanced payment is based on the individual's/household's projected income);
- The taxpayer's number of dependents changes; or
- The taxpayer's marital status changes.

Repayment caps

If the advanced payments exceed the credit allowed, the income tax liability imposed for the tax year is increased by the difference.

California Limitation of Payback of Excess Advanced Premium Subsidies		
Household income relative to poverty line	**All filing statuses except single**	**Single**
Less than 200%	$600	$300
At least 200% but less than 300%	$1,550	$775
At least 300% but less than 400%	$2,600	$1,300
At least 400% but less than 500%	$4,000	$2,000
At least 500% but less than 600%	$6,000	$3,000
At least 600% but less than 700%	$8,400	$4,200
700% or more	No limit	No limit

2019 Federal Poverty Levels							
Size of family	**Poverty line**	**200%**	**300%**	**400%**	**500%**	**600%**	**700%**
1	$12,490	$24,980	$37,470	$49,600	$62,450	$74,940	$87,430
2	$16,910	$33,820	$50,760	$67,640	$84,550	$101,460	$118,370
3	$21,330	$42,660	$63,990	$85,320	$106,650	$127,980	$149,310
4	$25,750	$51,500	$77,250	$103,000	$128,750	$154,500	$180,250
5	$30,170	$60,340	$90,510	$120,680	$150,850	$181,020	$211,190
6	$34,950	$69,900	$104,850	$139,800	$174,750	$209,700	$244,650

2020 Federal Poverty Levels							
Size of family	**Poverty line**	**200%**	**300%**	**400%**	**500%**	**600%**	**700%**
1	$12,760	$25,520	$38,280	$51,040	$63,800	$76,560	$89,320
2	$17,240	$34,480	$51,720	$68,960	$86,200	$103,440	$120,680
3	$21,720	$43,440	$65,160	$86,880	$108,600	$130,320	$152,040
4	$26,200	$52,400	$78,600	$104,800	$131,000	$157,200	$183,400
5	$30,680	$61,360	$92,040	$122,720	$153,400	$184,080	$214,760
6	$35,160	$70,320	$105,480	$140,640	$175,800	$210,960	$246,120

Practice Pointer

The limit does not apply if the individual's/household's actual income is below 400% of the federal poverty line when they had projected the income to be above 400%.

In this case, the individual/household will be entitled to a federal Premium Tax Credit on their federal return, which may then be used to pay back the amount of any advanced premium assistance received from the state (see the following examples).

Example of reconciliation with actual income above 400% of federal poverty line

Jenny and Joe purchased their health plan through Covered California and projected their 2020 income would be 310% of the federal poverty line. Based on their projected income, they received:

- $17,748 in federal advanced Premium Tax Credit; and
- $420 in California premium subsidies.

When they filed their 2020 tax return, they reported final income equal to 410% of the federal poverty line. As a result they were:

- Ineligible for the advanced Premium Tax Credit; and
- Eligible for $15,576 in California premium subsidies.

Reconciling the amounts

On the federal return, because the household had a final income over 400% of the federal poverty line, there is no federal cap on repayment, and Jenny and Joe must repay the entire $17,748 in Premium Tax Credit received.

On the state return, there is no repayment of the California premium subsidy because the household is eligible for a subsidy refund of $15,156 ($15,576 - $420 previously received).

Bottom line, Jenny and Joe will wind up owing a total net amount of $2,592 ($17,748 - $15,156).

Practice Pointer

Not many people are going to have the $17,000 plus available to pay back the federal credit, so you should make sure you see your clients who are receiving the federal Premium Tax Credit and the California subsidies early in the tax season to estimate their reconciliation payments.

Also note, the ACA prohibits the IRS from using traditional tax enforcement tools such as liens, levies, or criminal prosecution to collect these repayments. The California mandate does not have this limitation and will use normal collection procedures. According to the FTB, the repayment is simply part of the tax debt.

Example of reconciliation with actual income below 400% of federal poverty line

In 2020, Bob and Betty purchased their health plan through Covered California based on a projected household income of 410% of the federal poverty line.

Based on their projection Bob and Betty received:

- $0 in advanced Premium Tax Credit; and
- $15,576 in California premium subsidies.

In actuality, their 2020 income was 310% of the federal poverty level, which means they were actually entitled to:

- $17,748 in advanced Premium Tax Credit; and
- $420 in California premium subsidies.

Reconciling the amounts

On the federal return, Bob and Betty may claim a Premium Tax Credit of $17,748.

On the state return, Bob and Betty must repay the entire $15,156 due ($15,576 – $420). Because their actual income fell below 400% of the federal poverty line, there is no limit on the amount they must pay back.

Example of repayment cap

In 2020, Cathy purchases a health plan through Covered California for herself and her son. Her projected income is 410% of the federal poverty line.

Based on this estimate she receives:

- $0 in advanced Premium Tax Credit; and
- $15,576 in California premium subsidies.

However, her 2020 income was equal to 590% of the federal poverty line. As a result she was actually entitled to:

- $0 in advanced Premium Tax Credit; and
- $5,136 in California premium subsidies.

Reconciling the amounts

On the federal return, there is no reconciliation requirement because she was not eligible for and did not receive any federal Premium Tax Credit.

On the state return, Cathy received $10,440 in subsidies that she was not eligible to receive ($15,576 - $5,136). However, because her actual income received was between 500% and 600% of the federal poverty line, her repayment is capped at $6,000.

Note: If Cathy's income was 610% of the federal poverty line, she would still qualify for a repayment cap, but the cap would be increased to $8,400.

Example of reconciliation with projected and actual income below 400% of federal poverty line

In 2020, Mary receives health insurance through covered California for herself and her mom, who she claims as a dependent on her return. Her projected income for 2020 was equal to 310% of the federal poverty level. Based on this estimate she received:

- $17,748 in advanced Premium Tax Credit; and
- $420 in California premium subsidies.

In actuality, her 2020 household income was only 205% of the federal poverty line. Consequently, she was entitled to:

- $20,568 in advanced Premium Tax Credit; and
- $108 in California premium subsidies.

Reconciling the amounts

On the federal return, Mary is entitled to a $2,820 Premium Tax Credit ($20,568 - $17,748).

On the state return, Mary must repay $312 ($420 - $108). Because the cap for her household is $1,550 for households with incomes between 200% and 300% of the federal poverty level, she must repay the entire amount.

EMPLOYERS MUST FILE INFORMATION RETURNS

Employers must file information returns with the FTB by March 31 each year, beginning March 31, 2021, reporting the coverage provided for its employees and their dependents for the prior calendar year if a return is not filed by a licensed insurance carrier that provides health care insurance to the employee. (R&TC §61005) A statement must also be provided to the covered individual by January 31 following the covered year.

Covered California will report information about coverage and financial assistance to the FTB and enrollees via the new Form FTB 3895, California Health Insurance Marketplace Statement. This is the California version of Form 1095-A, Health Insurance Marketplace Statement. The statute states that the current IRS Forms 1095-B, Health Coverage, and 1095-C, Employer-Provided Health Insurance Offer and Coverage, satisfy the employer's California information return requirement. California will accept the federal versions of these forms.

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.

MOVING OUT OF CALIFORNIA

THE FTB CONTINUES TO GO TO THE MAT OVER RESIDENCY ISSUES

As the Legislature threatens to increase the taxes for millionaires, we'll see many more clients who want to leave the state.

The FTB's most active individual audit program is the nonfiler program. And the biggest piece of this pie is finding nonresidents who should be filing returns — maybe California resident returns.

Auditor's arsenal

When a nonresident taxpayer comes into the FTB's sights, even before the taxpayer knows an audit is happening, the auditor will have pulled numerous documents from other government databases and built the residency case. The auditor will likely know:

- If returns were filed in other states;
- What business entities and partnership/LLC investments are owned by the taxpayer both inside and outside California;
- Where bank accounts are located;
- When the taxpayer obtained a new driver's license;
- What property is owned in California and other states;
- If and when property was purchased or sold in California and another state; and
- Where the taxpayer claimed a homeowner's exemption.

It is also possible that the auditor will have visited Facebook, LinkedIn, Instagram, and generally searched the web for information about the taxpayer. Remember, we all love digging for dirt about people on the web, and the FTB is looking for tax pay dirt. They will likely also have credit information and information available on paid websites like Spokeo.

Contacting the taxpayer

As a part of the residency audit, the FTB will request:

- Credit card statements/receipts;
- Bank statements with cancelled checks, including ATM and debit transactions;
- Utility bills;
- Homeowners/rental insurance policies;
- Rental agreements;
- Information on pets owned during the audit period;
- Proof of voter registration;
- Information on investments and other businesses to add to or verify what they have already discovered; and
- Telephone records to determine the point of origin of outgoing calls.

The FTB will also request calendar information and verify with credit card statements how much time the taxpayer spent in California.

From this information, the auditor will build a case that the taxpayer was a resident for the year involved, or on the date that a large capital gain or other income not taxable to a nonresident was received.

Example of resident's timeline

Tony had been a California resident for 20 years when he moved to his family hometown in New Hampshire. Tony sold stock that resulted in a capital gain of $1 million.

Timeline of Events	
Date	**Activity**
January 10	Tony purchases a new home in New Hampshire
March 1	Tony puts his California house on the market. On the advice of his realtor, Tony leaves his furnishings in the house so it will show better
April 1	Tony goes to New Hampshire and stays with his sister while painting and preparing his new home to move into
May 1	Tony's California house sells
May 15	Tony "moves into" his New Hampshire home, with clothes and new bed purchased to sleep in
June 1	Tony sells his stock
June 10	Tony returns to California to sign escrow papers on his home and begins preparing to move all his possessions to New Hampshire
June 15	Escrow closes on the California house
June 16	Movers come and pick up his furnishings and move them to New Hampshire
June 20	The furniture arrives, and Tony is all moved in

The question is: When did Tony become a New Hampshire resident?

The FTB will assert that Tony did not abandon his California domicile and become a resident of New Hampshire until June 20, when he completely moved into his New Hampshire home. It will be up to you to argue that he made the move on May 15, but it will be difficult because he was still somewhat in transition.

The FTB will always fight for residency

In the example above, the FTB will argue that the taxpayer remained a resident. However, if Tony were moving from New Hampshire to California, the FTB would argue he became a California resident earlier.

How the FTB finds nonfilers

The FTB uses occupational license information to identify nonfilers. If the individual has a California address and a license, such as a contractor's license, real estate license, cosmetology license, etc., and does not file a return, the FTB sends a nonfiler notice.

The FTB also sends filing enforcement notices to individuals who:

- File a federal return with a California address;
- Have income reported on W-2s, 1099s, and K-1s — if reported as California-source income or with a California address; and
- Made sales of California real property.

We have heard of the FTB contacting former residents with large amounts of income after the individual leaves California. And of course, don't forget disgruntled former spouses or employees!

How will the OTA handle residency?

In ***Appeal of Mazer***, the OTA ruled that, although the taxpayer had signed a two-year contract to work in Malaysia, he was subject to California tax on all his income because he returned after only 13 months and was therefore still a California resident/domiciliary. (***Appeal of Mazer***, 2020-OTA-263P)

Prior to taking the job, the taxpayer signed a contract stating that the duration of the work contract was two years and it "may be renewable." The contract also provided that the company would provide the taxpayer-husband with a leased car, leased apartment, petrol/toll allowance, a cell phone, and payment of the phone bill. The contract also required the taxpayer to obtain a Malaysian work permit, which he did. His wife remained in California and lived in their California home.

For reasons that were not stated in the appeal, the taxpayer returned to California 13 months after he began.

He filed a joint California resident return with his wife, and they excluded one half of the income he earned in Malaysia, which was his community property share, not taxable because he was not a resident of or domiciled in California.

I was never coming back

The taxpayer argued that his intention was to move permanently to Malaysia, and as such, he was no longer domiciled in California. However, the FTB and OTA determined otherwise, based on among other things, the taxpayer lived in quarters provided by the employer and he and his wife never took any steps to move permanently to Malaysia.

Once it was determined that the taxpayer never abandoned his California domicile, the next step was the residency issue, which the FTB handled handily.

Safe harbor

In determining whether the taxpayer is out of state for a temporary or transitory purpose, there is a safe harbor provision under R&TC §17014(d), which provides that a California domiciliary absent from this state for an "uninterrupted period" of at least 546 consecutive days (i.e., 18 months) under an employment-related contract shall be considered outside the state for other than a temporary or transitory purpose and thus a nonresident of California. Unfortunately, the taxpayer did not qualify for protection under the safe harbor provision because he was only outside of California on an employment-related contract for 13 months.

Case was precedential

As the case is precedential, the FTB and the OTA can rely on it and it seems clear that the taxpayer must not only have an employment related contract of at least 546 days, but the terms of the contract must be met in order to be treated as a nonresident.

More nonprecedential decisions

The Office of Tax Appeals also released a number of decisions on residency and taxability of income to California residents.

Taxpayer fails due to lack of evidence

In ***Appeal of Donovan***, after living in California for a few years, the taxpayer's employer allowed him to relocate to Florida in 2014. He lived there for five months before accepting a new job and moving back to California. The OTA held that he retained his California residency. (***Appeal of Donovan***, 2020-OTA-102)

The FTB said the move was temporary. The taxpayer claimed the move was intended to be permanent. When filing the 2014 California return, the taxpayer subtracted the income earned in Florida from California AGI. Despite requests from the FTB, the taxpayer was not able to produce records such as bank accounts, driver's license, etc., to support his claim.

Because of the lack of evidence, other than the act of relocating to Florida under his employer's authorization, there were no other acts that supported the taxpayer's intention to abandon his California domicile and residence.

Using California address for "certain things"

In ***Appeal of Dakers***, a Texas resident received a demand to file a return for California because he used his California address on his federal return and on a contract with a California company. The taxpayer claimed that he used a California address "for certain things including correspondence with the IRS" but resided in Texas and did not owe California tax. (***Appeal of Dakers***, 2020-OTA-096)

It turns out that, although he was not a resident of California, he was providing staffing services to a California company for the purposes of 18 Cal. Code Regs. §17951-4. The OTA assigned the income to California because the income was derived from a California source.

Under ***Appeal of Bindley***, income for services provided to a California customer is taxable to California. (***Appeal of Bindley***, 2019-OTA-179P)

Taxpayer is part-year resident

In ***Appeal of Alexander***, additional income as determined by an IRS audit was not California-source income, and the taxpayer was able to prove he was a part-year resident who lived in Texas for the first part of the year at issue. (***Appeal of Alexander***, 2020-OTA-088)

The taxpayer was able to prove that the unreported income was earned from sources outside of California while he was a Texas resident. Nevertheless, because the increase in his total income affects the computation of California tax liability, his assessment was not completely reversed but reduced from $1,213 to $455.

Taxpayer not domiciled in California

In ***Appeal of Lin***, a resident of North Carolina working in California was married to a resident of North Carolina. (***Appeal of Lin***, 2020-OTA-155P)

In its opening brief, the FTB acknowledged that the taxpayer's spouse was a nonresident and had no California-source income in 2013. However, the FTB continued to maintain that the taxpayer did not qualify for the nonresident spouse exception of R&TC §18521(c)(2) because "married individuals do not qualify for the nonresident spouse exception if one spouse is earning California-sourced income and is domiciled in California, a community property state."

After the taxpayers presented evidence establishing that both husband and wife were neither residents nor domiciliaries of California during 2013, the FTB took the position that this fact made no difference in the computation of the appellants' tax liability for 2013. However, because neither of the spouses were domiciled in California or another community property state during 2013, the income was not community property, and she was able to file married filing separate.

10 TIPS FOR THE UNWARY IN CHANGING CALIFORNIA RESIDENCY/DOMICILE

Here are 10 items (in no particular order) that clients need to be aware of if they want to survive a residency audit.

1. **You must break meaningful ties with California.** It is not enough to build new ties with another state if your ties with California do not decrease — significantly. If you are a California resident/domiciliary, it will be presumed you continue to be a California resident/domiciliary, and you need to overcome that presumption. For example, keeping the family home in California, the business office in California, and/or continuing to use long-time professionals in California, even if acquiring a new home, new office, and new professionals in the "new" state, can cause significant problems in an audit and should be carefully thought out.
2. **You must build solid new ties with another state that are, at a bare minimum, comparable to the ties you had in California.** It is not enough to break California ties if you do not reestablish yourself permanently somewhere else. The analysis in an audit by the FTB is going to be California ties versus ties to a single new state where residence/domicile is claimed. For example, if you spend 40% of your time in California, 30% in the new state, and 30% travelling and in miscellaneous other states, that is not a strong factual scenario, even though you spend less time in California than elsewhere in total.
3. **The times you do return to California after the move need a solid case for being for a temporary or transitory purpose.** You can become a resident/domiciliary of another state and still spend time in California as long as that time in California is for a "temporary or transitory purpose." Returning back to California to visit family, for vacations, for business trips, for a course of medical treatment, etc., should all be fine as a nonresident as long as they are carefully managed and fall within that standard.
4. **Watch the timing of the change.** It is one thing to move out of California and successfully change your residency/domicile to another state. But precisely when did that change take place? For example, buying a home in Nevada on July 1 and having a large income realization event on September 1 will accomplish nothing in terms of changing your California tax situation if the FTB on audit agrees that you moved from California to Nevada, but that the date of the move is October 1 when all factors are taken into consideration. Although one is perfectly free under the law to change their residence/domicile to achieve tax savings, remember that auditors often take a dim view of changes that are claimed to occur very soon before a large income event, often resulting in a tougher burden to show a genuine move took place. Pick your move date carefully.

5. **Watch out for California–source income issues.** Carefully consider and understand if there is income that has a California source, a change of residency will not keep that income from being taxed by the FTB. For instance, stock options that vested while a California resident, rent from California real property, and income from passthrough entities that have a California source are all taxable to a nonresident of California. It is very common for the FTB to take alternative positions in residency audits, i.e., the individual is still a California resident, but even if they became a nonresident, some/all of the income is still taxable because it has a California source. Nonresident sourcing was a major issue on appeal in the infamous ***Hyatt*** residency case, even though the FTB did not even rely upon that argument at audit. (***Appeal of Hyatt*** (January 14, 2019) Op. on Pet. For Rehearing)
6. **Watch your conduct — for several years — after the move.** California has a four-year period to audit after the filing of the return. (R&TC §19057) For example, assume you move in Year 1, but in Years 2 and 3 you begin to spend significantly more time back in California. If you are audited during Year 3 (or 4) for the change of residency/domicile in Year 1, it is extremely likely that your conduct in Years 2 and 3 (or 4) are going to be examined as part of that audit, even if the audit is technically only for Year 1. (It is also likely those later years will be added to the audit.) That is because the FTB may see subsequent conduct reflecting on prior conduct, i.e., maybe you really did not move in Year 1 after all, if you increased your ties back to California in the immediate subsequent years.
7. **Watch for different treatment of spouses.** It is possible, although not frequent, that spouses may have different residences/domiciles, either as filed or as a result of audit. If this is the case, keep in mind that community property must be divided between them. (***Appeal of Misskelley*** (May 8, 1984) 84-SBE-077)
8. **Be prepared for an audit. Then be pleasantly surprised if it does not happen.** The larger the potential tax effect from a change on audit, the more likely the audit because of the way the FTB allocates audit resources. Much of the audit selection process is done by computer programs. A California resident who moves and then stops filing returns (i.e., not filing nonresident returns to report California-source income) might generate audit interest, especially involving a high wealth individual. A part-year return that shows a move during a calendar year might generate audit interest. A subsequent nonresident return that shows large amounts of income but with little of it reported to California is very likely to generate audit interest. Remember also that for tax years in which no return is filed, the FTB has an open, unlimited, period in which to audit and assess a deficiency.
9. **Do your best to document your case contemporaneous with the move.** The FTB's strong preference is for "contemporaneous" documentation, as opposed to documentation created at a later time, e.g., at audit. So try to give the FTB what it wants. However, there is no legal limitation that documentation in a residency case must be "contemporary," and, for instance, it is common practice to obtain affidavits/declarations from the taxpayer, his or her friends, employers, or business associates in responses to issues raised by the FTB at audit. (18 Cal. Code Regs. §17014(d)(1))
10. **Live your life.** Life is short and one should not live it constantly looking over their shoulders and worrying about the threat of an FTB audit or assessment. Taxes are simply an expense that is a part of life, so maintain perspective. For example, do you really want to give up your family doctor (or specialist) in California whom you have seen for 20-plus years to start a new relationship with a new doctor elsewhere, simply because it might incrementally strengthen to some degree your argument that you moved out of California? Choosing the best tax-driven decision may not be the same as the best life-driven decision.

> ***Comment***
>
> These tips were provided by Eric J. Coffill, who has nearly 40 years of experience counseling clients on state and local tax controversy and litigation matters at the administrative, trial, and appellate levels, particularly those involving the California Franchise Tax Board and the California Department of Tax & Fee Administration. His practice includes advising high-net-worth individuals on their most significant matters, including California residency and sourcing issues. He can be contacted at: ericcoffill@eversheds-sutherland.com.

EARNED INCOME TAX CREDIT

AB 1876 (Ch. 20-87) expands eligibility for California's Earned Income Tax Credit and Young Child Tax Credit by easing the taxpayer identification number requirements, effective beginning with the 2020 taxable year. Previously, California conformed to the federal Earned Income Credit provision that limited eligibility for the credit to those taxpayers who had a valid Social Security number. A "valid Social Security number" is limited to those Social Security numbers that authorize an individual to work in the United States. If the taxpayer has a spouse or a qualifying child, the taxpayer could only claim the credit if they, their spouse, and all qualifying child(ren) all have valid Social Security numbers.

AB 1876 allows taxpayers otherwise eligible for the EITC/Young Child Tax Credit to claim the credits if they have a federal individual taxpayer identification number (ITIN) rather than a Social Security number. Upon request, a taxpayer must provide the following information to the FTB:

- Identifying documents acceptable for purposes of obtaining a California driver's license; and
- Identifying documents used to report earned income for the taxable year.

A taxpayer utilizing an ITIN must also identify the FTB if they are issued a valid Social Security number. (R&TC §17052)

CALCULATING THE STATE CREDIT

California requires the use of different phaseout percentages, maximum earned income amounts, and phaseout amounts. The California amounts are subject to annual inflation adjustments.

California EITC Figures for 2020 (Based on Draft Form 3514 Instructions)

In the case of an eligible individual with	Credit percentage	Maximum credit amount for 2020	Credit begins to phase out at income of	Credit phases out entirely at income of
No qualifying children	7.65%	$243	$3,757	$30,000
1 qualifying child	34.00%	$1,626	$5,642	$30,000
2 qualifying children	40.00%	$2,691	$7,920	$30,000
3+ qualifying children	45.00%	$3,027	$7,920	$30,000

To determine a taxpayer's California EITC, use the tables in the instructions for Form FTB 3514, California Earned Income Tax Credit, or the FTB's credit calculator at:

Website
www.ftb.ca.gov/file/personal/credits/EITC-calculator/Home

MISCELLANEOUS

ELECTRIC VEHICLE REBATES ARE TAXABLE

A question from our Message Board asked whether California electric vehicle rebates are taxable for federal or California purposes. The question mentions that 1099s usually are not issued for these rebates. While that is normal, the rebates are still taxable. California conforms to the federal definition of gross income from IRC §61 for both personal and corporate income tax purposes. (R&TC §§17071, 24271)

California's electric car rebates are not specifically excluded from gross income by law for either federal or California purposes, so they are includible in gross income for both.

California electric car rebates

The California electric vehicle rebates are issued through the California Clean Vehicle Rebate Project (CVRP), which is administered by the California Center for Sustainable Energy (CSE) for the California Air Resources Board. Taxpayers can get a rebate of up to $7,000, as long as funds are available, for the purchase or lease of a new plug-in hybrid electric vehicle, battery electric vehicle, or a fuel cell electric vehicle.

Californians must apply for the rebates directly from the CVRP. In other words, the rebates are not state tax credits, and they are issued in a transaction wholly separate from the purchase price of the vehicle. As such, the rebates do not represent a reduction in the purchase price of the vehicle because they do not come from the seller of the vehicle, directly or indirectly.

Caution

Note the following excerpt from the CVRP website: "CSE does not issue a 1099 for your rebate. We cannot offer tax advice of any kind, and advise you to contact a certified public accountant or tax professional regarding the taxability of the CVRP rebate." (See, e.g., PLRs 9623035, 201027015, 199939021, 200142019, 200816027)

Just because the CSE, or any other source, does not issue a 1099 does not mean the rebate is not taxable.

Federal rulings on this issue

The IRS has ruled in multiple private letter rulings that rebates and discounts that represent purchase price reductions are not included in gross income. (PLR 201004005) Rebates and discounts that are considered purchase price reductions are those that are offered directly or indirectly from the sellers of goods and services.

In another private letter ruling, the IRS ruled that rebates, nontax credits, and other incentives provided by state agencies are not purchase price reductions and are therefore includible in gross income. (See https://cleanvehiclerebate.org/eng/faqs)

Preapproval program

Through a pilot CVRP program launched in 2018, San Diego County residents can get preapproved for rebates to help pay for eligible vehicles. The pilot program is limited to San Diego County residents for now, but will be available statewide in the future.

According to the CVRP website, "The dealerships listed on this page have agreed to participate in the CVRP Rebate Now Preapproval Pilot. If you've applied for a preapproved CVRP rebate and are currently shopping for a clean vehicle, the dealerships below can apply your preapproved rebate amount toward your purchase or lease, reducing the amount you pay for your vehicle up front."

If the rebate is applied to reduce the upfront cost of the vehicle, this appears to meet the requirement that the rebate be obtained "from the seller of the vehicle directly or indirectly," and it would therefore not be taxable.

More rebate information

For information on vehicle eligibility and rebate amounts, go to:

Website
https://cleanvehiclerebate.org/eng/eligible-vehicles

VOLUNTARY PLAN PAID FAMILY LEAVE BENEFITS EXCLUDABLE FROM INCOME

In a precedential decision, the OTA has ruled that over $22,000 in paid family leave benefits received from a voluntary plan administered by a third party, rather than the EDD, was excludable from gross income. (***Appeal of Jindal***, 2019-OTA-372P)

What is paid family leave?

Under California law, paid family leave is a family temporary disability insurance program that provides up to six weeks of wage replacement benefits in a 12-month period for individuals to care for a seriously ill family member or bond with a new child. (UIC §3301(a)(1) and (d)) Paid family leave is a component of the state's unemployment compensation disability insurance program and is treated as excludable unemployment compensation under California law (but is taxable on the federal return). (UIC §3300(g); R&TC §17083)

While most paid family leave benefits are received from the EDD, California law allows an employer to use a voluntary plan as a legal alternative to the program administered by the EDD. (UIC §3251 et seq.) If amounts are paid into a voluntary plan by the employee, it will be entered as "VPDI" rather than "SDI" on the W-2.

VPDI qualifies for the exclusion

While there is no question that paid family leave benefits received from the EDD are excludable from gross income, in ***Appeal of Jindal*** the FTB took the position that paid family leave benefits received from an employer-administered voluntary plan rather than directly from the EDD did not qualify for the exclusion. In this case, the taxpayer's employer was Google, which had contracted with Prudential to administer its voluntary program that had been approved by the EDD.

The FTB argued that only benefits paid from voluntary plans administered by the EDD for which a Form 1099-G is issued qualify for the exclusion. However, the OTA ruled that there was no legal authority for the FTB's assertion. The EDD approved Google's voluntary plan, and therefore the benefits were excludable compensation paid pursuant to a governmental program.

Consider filing a refund claim

It appears from the decision in ***Jindal*** that it has been the FTB's policy to include paid family leave benefits received from a third-party–administered voluntary plan in taxable income. If you have clients who previously paid tax on paid family leave benefits received directly from a third-party voluntary plan and not from the EDD, consider filing a claim for refund for all open tax years.

CAN'T OPT OUT OF TAX LIABILITIES

A taxpayer responded to the FTB's request for a tax return by saying he was "opting out" and had no tax due, contrary to information from the EDD. (***Appeal of Briscoe***, 2020-OTA-116) He then requested that the FTB "close this account." At appeal, he requested to be relieved of his tax through a settlement; this request was denied, and the late-filing penalty applied.

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.*

4. Which statement accurately describes how to obtain an exemption from the individual health care mandate?

   a) The religious conscience exemption must be claimed on a personal income tax return
   b) The hardship affordability exemption must be claimed through Covered California
   c) For exemptions claimed via Covered California, Covered California will determine if an applicant is eligible within 30 days of receipt of the exemption request
   d) The hardship affordability exemption is approved prospectively by Covered California but cannot be processed retroactively by the FTB

5. California's health insurance program provides subsidies to taxpayers who are below specific income levels to help them obtain affordable coverage. Which of the following is correct regarding these available subsidies?

   a) Subsidies are available to anyone purchasing insurance either privately or through Covered California as long as they qualify
   b) California provides subsidies to California residents at or below 400% of the federal poverty level
   c) California subsidies are paid directly to the individual requiring them
   d) Subsidies are not included in a person's gross income for California income tax purposes

6. What are among the details of California's electric vehicle rebates?

   a) The rebates are not state tax credits
   b) California electric car rebates are taxable only if the issuer provides a 1099 to the purchaser
   c) The IRS has ruled that rebates and other incentives provided by state agencies are not included in gross income
   d) Californians may get preapproved for rebates prior to purchasing a vehicle

SOLUTIONS TO REVIEW QUESTIONS

4. Which statement accurately describes how to obtain an exemption from the individual health care mandate? **(Page 9-4)**

   a) Incorrect. It can only be granted by Covered California.
   b) Incorrect. This exemption may be claimed either through Covered California or when filing a personal income tax return.
   c) Correct. If approved, Covered California will mail a written notice to the applicant with an exemption certificate within five days of the decision.
   d) Incorrect. The FTB may process the exemption retroactively when it is claimed on the personal income tax return.

5. California's health insurance program provides subsidies to taxpayers who are below specific income levels to help them obtain affordable coverage. Which of the following is correct regarding these available subsidies? **(Page 9-10)**

   a) Incorrect. Insurance must be purchased through Covered California to qualify for subsidies.
   b) Incorrect. The 400% level applies to federal law for providing assistance to individuals and families. For California, subsidies are provided to California residents at or below 600% of the federal poverty level.
   c) Incorrect. They may be paid in advance to the health insurance plan.
   d) Correct. This is true. Although it is not a credit, any subsidy may be credited to the taxpayer in the reconciliation process.

6. What are among the details of California's electric vehicle rebates? **(Page 9-24)**

   a) Correct. They are issued through the California Clean Vehicle Rebate Project (CVRP) to the taxpayer upon approval of the taxpayer's application and are entirely separate from the vehicles purchase price.
   b) Incorrect. They are taxable whether or not a 1099 is issued, and typically a 1099 is not provided.
   c) Incorrect. Rebates and discounts provided by the seller that reduce the purchase price are not included in gross income, but those from a state agency are included.
   d) Incorrect. There is a pilot program administered through the CVRP, but it is limited to San Diego County residents.

Chapter 10

California Business

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CALIFORNIA BUSINESS

CORPORATIONS

FTB REVERSES POSITION ON CALCULATING S CORPORATION SHAREHOLDER'S BASIS

The FTB will follow federal guidance (IRS Technical Advice Memorandum 200619021) that requires S corporation shareholders to reduce their basis in an S corporation in open tax years to account for improperly deducted S corporation losses and deductions in a closed year(s). (FTB Technical Advice Memorandum 2020-01)

The FTB's guidance came in response to an FTB Audit Division request for guidance by the FTB's Legal Division. This is a reversal from the FTB's prior position taken in 2005 (FTB Technical Advice Memorandum 20030305) when the FTB refused to follow previously issued federal guidance that reached a similar conclusion. This means we may be seeing this issue arising in audits for open tax years.

Comment

Unfortunately, the previously issued guidance was a technical advice memorandum, which is considered informational only and may not be relied upon by taxpayers as published guidance. Therefore, taxpayers may not be able to raise the prior-issued technical advice memorandum as a defense on audit.

Loss limitations

Under both California and federal law, shareholders may not claim losses from an S corporation in excess of the shareholder's basis in the same S corporation. (IRC §1366(d)) Any passthrough losses in excess of a shareholder's basis must be held in a suspense account and carried over. The suspended losses can be used in future open years when there is sufficient basis to use the excess loss.

But what happens if a shareholder improperly claims losses in excess of their basis in a closed tax year? In other words, how do we calculate our client's basis today when they improperly claimed losses in excess of basis years earlier?

No double deductions

According to both the IRS and now the FTB, in order to prevent a double benefit to the S corporation shareholder, the shareholder must treat any losses improperly claimed, even in a closed year, as a suspended loss solely for purposes of computing the shareholder's basis in any open tax year. These improper losses must be separately tracked in the shareholder's suspended loss account. The improperly claimed loss allocated to the suspense account cannot be claimed again as an actual loss in a subsequent tax year.

Example of suspended loss

In 2015, SmallCo., an S corporation, borrowed $100,000 from BigBank. SmallCo.'s sole shareholder, Sam, personally guaranteed the loan, but he did not make any payments out of his own pocket.

Sam mistakenly believed his personal guarantee increased his basis in the S corporation. He therefore improperly increased his basis from $0 to $100,000 and claimed a $25,000 loss on his 2015 income tax return.

The FTB audited Sam's 2016 income tax return in 2020 and discovered Sam's 2015 basis error. However, 2015 was a closed tax year so the FTB could not issue a Notice of Proposed Assessment for 2015. Instead, the FTB took the $25,000 tax loss Sam improperly claimed in 2015 and turned it into a loss carryover into 2016.

In 2016, SmallCo. passed through $10,000 of ordinary income to Sam. As of December 31, 2016, Sam's basis in his S corporation is calculated as follows:

Loss carryover from 2015 (as determined by the FTB audit)	($25,000)
Income flowing through to Sam in 2016	10,000
Ending basis as of December 31, 2016	($15,000)

Sam must report the $10,000 income flowing to him in 2016 because his loss carryover from 2015 is greater than his 2016 income. Sam's negative basis of $15,000 at the end of 2016 will carry over to 2017.

The FTB refused to extend the same treatment to a shareholder who improperly failed to recognize income from a distribution in excess of stock basis in a year closed by the statute of limitation because the previously issued IRS guidance did not address this issue. (IRS TAM 200619021)

CLOSING A BUSINESS

With a number of businesses being forced to shut their doors permanently as a result of the COVID-19 pandemic, it will be important to make sure those businesses have properly completed the dissolution process. Simply filing a final tax return is not enough to terminate the business.

For California purposes, a corporation, LLC, or LLP is dissolved by filing required documents with the Secretary of State (SOS), or the entity (and maybe the entity owner) will be liable for the annual $800 minimum franchise or annual tax until the dissolution is complete.

WHEN TO DISSOLVE WITH THE SOS

The FTB will not assess the $800 minimum franchise tax or the $800 annual tax if a business entity meets these three conditions:

- The entity files a timely final tax return on or before the extended due date for the preceding taxable year;
- The entity does not do business in California after the end of that year; and
- The entity files a Certificate of Dissolution, Surrender, or Cancellation with the SOS before the end of the 12-month period beginning with the date the final return was filed. (R&TC §§17937, 17947, 17948.3, 23332)

Beware of midyear dissolutions

If a corporation or SMLLC dissolves with the SOS midyear, the entity has a short year, and the return is due on the 15th day of the third month after the month of dissolution. (R&TC §18601(c)) If an LLC taxed as a partnership or an S corporation dissolves with the SOS midyear, the return is due on the 15th day of the second month after the month of dissolution. However, there is a six-month extension (seven months for LLCs taxed as partnerships) for these returns. Failure to file the return on or before the extended due date could result in penalties.

Example of dissolution

Wrap-it-Up, Inc., a calendar-year S corporation, sold its assets and distributed cash to the shareholders on July 3, 2020. Wrap filed cancellation documents with the SOS on July 20, 2020. Wrap has a short year and must file its final federal and California returns on or before the extended due date for a July year-end, March 15, 2021, or be subject to late-filing penalties.

On the other hand, Wrap could instead file its final 2020 full-year return on or before September 15, 2021, and could then file dissolution paperwork within 12 months of filing the timely California final return.

ADMINISTRATIVE DISSOLUTIONS

Voluntary administrative dissolution

Luckily, taxpayers that fail to properly dissolve now have a more viable relief alternative than taxpayers did in the past to avoid paying outstanding taxes, penalties, and interest. California corporations and LLCs that ceased doing business (or never started) but failed to properly dissolve with the SOS may apply to the FTB for voluntary dissolution. If approved, the FTB will abate all outstanding $800 minimum/annual tax liability, plus any applicable penalties or interest on those liabilities, for the periods that the entity was not conducting business.

According to the FTB, the related penalties and fees that will be abated include the:

- Demand penalty;
- Estimated tax penalty;
- Late-filing and late-payment penalties; and
- Filing enforcement fee (if the demand penalty is abated).

However, if these penalties are imposed in relation to an outstanding LLC fee or corporation income or franchise tax other than the $800 annual or minimum tax, the penalties are not related to qualified taxes so cannot be abated. Other examples of penalties that will not be abated are tax preparer penalties or withholding-at-source penalties.

Example of ineligible entity

Homegrown Beauty, LLC organizes in California in 2010 and obtains a FEIN. Homegrown grows flowers and sells them at local flower markets. It operates in California for three years and files all its applicable returns. It decides to relocate to Oregon in 2012. It marks its 2012 Form 568 as "final" but does not dissolve with the SOS. It retains its name and FEIN but after 2012 conducts all of its activities and makes all of its sales in Oregon. The taxpayer is ineligible for administrative dissolution because it has retained its name and FEIN and is actively engaging in activities for profit. Homegrown would continue to be liable for the $800 California minimum/annual tax, penalties, and interest for 2013 through the present.

Example of some penalties not forgiven

Real Wheels, LLC was a bike-on-demand rental company that formed in 2015. Wheels rented warehouse/office space and purchased bikes and vans to transport the bikes. Unfortunately, the city banned the practice of leaving bikes on the sidewalks, and Real Wheels was forced to close its operations. It filed the 2016 return, marking the final return box, but failed to pay the LLC tax and fee for 2016 and never formally dissolved with the SOS. In 2016, it sold all of its equipment.

Wheels can request voluntary dissolution in 2020 and have the $800 annual tax and associated penalties and interest abated for 2017 to present. However, it remains liable for the LLC annual tax and fees for 2016.

Who is eligible?

Only those entities that have no assets are eligible for administrative dissolution. An entity does not need to be suspended by either the SOS or the FTB before applying for voluntary dissolution.

Corporations or LLCs formed outside California but doing business in California are also not eligible for administrative dissolution. These entities will have to apply for an offer-in-compromise or use the ***Ralite*** process.

✐ **Practice Pointer**

Go to page 12-44 to view a copy of Spidell's Walking Away From a Corporation/LLC Qualifier checklist, to see if your clients qualify for ***Ralite***.

Is it too late for relief?

We also asked the FTB if it's possible for an entity whose appeal was denied by the OTA to file for voluntary dissolution. Their response: "FTB would have to review the OTA decision to determine whether the entity is still a qualified entity for voluntary administrative dissolution." In other words, yes, it's possible.

How to apply

To apply, taxpayers that have been registered for more than 12 months with the California SOS may submit either a:

- Form 3715 PC, Domestic Corporation Request for Administrative Dissolution; or
- Form 3716 PC, Domestic Limited Liability Company Request for Administrative Dissolution.

If they have not already done so, before they are approved, the entity must also:

- Submit all tax returns for tax years up to the date the entity ceased conducting business in California; and
- Pay all taxes, penalties, and interest up to the date the entity ceased doing business in California.

Voluntary dissolution by the numbers

We asked the FTB to give us a sense as to how many entities have applied for voluntary dissolution and their "success rate." Below is what they released. To be honest, we were surprised by the low percentage of approvals, but it appears that many of the entities did not follow through with the information requested or were disqualified for other technical reasons.

Voluntary Dissolution	
Total requests received since 1/1/19, as of 10/10/20	12,724
Total approved	1,146
Conditionally approved	2,578
2020/2021 fiscal year total requests received, as of 10/10/20	1,562
Total approved	103
Conditionally approved	268

Here are the top five reasons why voluntary dissolution requests were not approved for the 2020–2021 fiscal year as of October 10, 2020:

1. Business entity is still conducting business, has assets, and/or an active bank account:
   a. Requests are received with no tax to abate, the entity is up-to-date, and business entity or business entity representative is confused as to how to close;
2. The entity owner/owner/representative does not follow through/respond:
   a. No call back as requested;
   b. Requested documents not received (i.e., bank statement, FEIN letter, etc.);
   c. Business entity does not file and or pay or defaults on installment agreement;
3. Duplicate requests:
   a. 130 duplicate requests received in 2020–2021 fiscal year (1,697 in total since start of program);
   b. Business entity or business entity representative mails request and then faxes request creating duplicates;
4. Business entity submits request, cannot file and pay, withdraws request and engages, for example, in the OIC process:
   a. 12 total for 2020–2021 fiscal year (462 requests in total since start of program) were referred to another area within the FTB; and
5. Original form filled out inaccurately:
   a. Signature on request is not authorized representative;
   b. Business submits wrong entity-type request form (i.e., LLC files on corporation form);
   c. Request is on incorrect form (i.e., nonprofit makes request on for-profit form). A total of seven for 2020–2021 fiscal year (231 total since start of program) were referred to another area within the FTB.

Involuntary administrative dissolution

The FTB will involuntarily administratively dissolve a domestic corporation or LLC if, as of January 1, 2020, or at any time thereafter, the entity has been suspended by the FTB for a period of at least 60 consecutive months and has no outstanding liabilities for LLC fees, corporate income tax, or tax on unrelated business income. (Corp. Code §§2205.5, 17713.10.1)

Prior to administratively dissolving the entity, the FTB must:

- Mail a written intent notice to the entity's last known address (if no valid address is on file, the SOS notice discussed here is deemed sufficient notice). The notices are:
  - FTB 5125 C, Administrative Dissolution — Intent Notice for Corporations; and
  - FTB 5126 C, Administrative Cancellation — Intent Notice for LLCs; and
- Transmit the entity's name and corporation or LLC file number to the SOS.

Once the SOS receives the information from the FTB, the SOS must provide 60 days' notice of the pending administrative dissolution on its website at:

Website
www.sos.ca.gov/business-programs/business-entities/ftb-admin-notice/

During that time the entity may file a written objection with the FTB to the administrative dissolution. If no objection is received, the entity will be administratively dissolved at the end of the 60-day period.

Example of involuntary dissolution

Freddy's Faux Furs, LLC operated in San Diego in 2008 and closed in 2009. It filed its 2008 and 2009 returns, paid the tax and fee due, and marked the 2009 return as "final" but never formally dissolved with the SOS. The SOS suspended Freddy's in 2012 for failing to file its Statement of Information, and the FTB also suspended Freddy's in 2012 for failing to file tax returns.

On January 1, 2021, the FTB sends a Notice FTB 5126 C to Freddy's last known address. Freddy's doesn't respond by March 1, 2021, so the FTB sends Freddy's name to the SOS, which posts Freddy's name and file number on its website. If no objection is filed within 60 days of posting, the FTB will administratively dissolve Freddy's, and Freddy's will be relieved of liability for the $800 annual tax and associated penalties and interest for 2010–2020.

The FTB has not yet sent any notices for involuntary dissolutions. They are scheduled to begin the administrative dissolution process in January 2021.

Avoiding involuntary administrative dissolution

If a qualified entity is still engaging in a business activity or has assets in the business name and received an intent notice, the qualified entity has 60 days to provide the FTB with a written objection to the pending administrative dissolution/cancellation. Instructions as to how to submit the written objection are contained in the notices.

Entities that want to avoid involuntary dissolution must, within 90 days (up to 180 days with the approval of the FTB) from the FTB's receipt of a written objection:

- File all outstanding returns;
- Pay or otherwise satisfy all accrued taxes, penalties, and interest;
- File a current Statement of Information with the SOS;
- Fulfill any other requirements with the SOS; and
- Apply for a revivor.

Penalties

For either a voluntary, or involuntary dissolution, all abated taxes, penalties, and interest will be reinstated, and a 50% penalty plus interest will be imposed if the entity:

- Continues to do business after it is dissolved or cancelled; or
- Has any remaining assets that were not disclosed when it applied for administrative dissolution. (R&TC §23311)

Other liabilities

Although a dissolved entity is relieved of qualified back taxes, the administrative dissolution does not discharge the entity's liability to any other creditors, or relieve the entity's directors, shareholders, transferees, or other related persons from their liabilities. Nor does the dissolution impact the attorney general's ability to enforce any other liabilities.

NEW ANNUAL TAX FIRST-YEAR EXEMPTION

For years beginning on or after January 1, 2021, and before January 1, 2024, AB 85 provides a first-year exemption from the $800 annual tax imposed against:

- An LLP or LP that files a certificate of limited partnership or registers with the SOS; or
- An LLC that organizes or registers with the SOS. (R&TC §§17935, 17941, 17948)

Previously, only corporations were exempt from the $800 minimum franchise tax.

Nonfilers ineligible for exemption

An out-of-state entity that conducts business in California but did not register with the SOS's office in the first year it conducted business will be ineligible for the exemption.

The exemption will only be available in years where at least $1 is appropriated in the California budget for the FTB's costs associated with the administration of the exemption. This must be done each year that the exemption is available, and the funding has been appropriated for the 2021 taxable year.

This appears to be a way the Legislature can undo the exemption by simply not allocating any funds to the FTB to implement it. The politicians would not call it a tax increase, just a budget cut.

Caution

The $800 exemption does not apply if a business changes its entity type.

CREDITS

NEW SMALL BUSINESS HIRING CREDIT

SB 1447 (Ch. 20-41) enacts a new small business hiring credit. The credit may be claimed against personal income or corporation franchise and income taxes, or at the election of the taxpayer, against state and local sales and use taxes. Governor Newsom has referred to it as the "Main Street Hiring Credit."

The aggregate total credit that may be claimed by all taxpayers is capped at $100 million and, as discussed later, taxpayers must reserve their credits between December 1, 2020, and January 15, 2021, in order to qualify.

We have created a client letter on this topic. See page 10-24.

Who qualifies?

The credit is only available during the 2020 taxable year and may only be claimed by businesses that reserved the credit (see upcoming discussion) and:

- Employed 100 or fewer employees as of December 31, 2019; and
- Experienced a 50% decrease in gross receipts when comparing 2020 second calendar quarter gross receipts with 2019 second calendar quarter gross receipts, "if it would have met the requirement of having a significant decline in gross receipts for that quarter" for purposes of the federal Employee Retention Credit.
(R&TC §§17053.72, 23627)

The credit may not be claimed for employees whose wages are included in calculating any other California personal income tax or corporation franchise tax credit (e.g., New Employee Credit).

Taxpayers included, or includable, in a combined report are ineligible for the credit.

Credit amount

The amount of the credit is equal to $1,000 for each net increase in qualified employees, up to a $100,000 maximum per taxpayer.

The net increase is measured by comparing the taxpayer's average number of monthly full-time equivalent (FTE) employees for the second quarter of 2020, with the average number of monthly FTE employees for the five-month period beginning July 1, 2020, and ending November 30, 2020. All employees of related businesses under IRC §§267, 318, or 707 are treated as employed by a single qualified small business employer.

For purposes of this credit, a monthly FTE is:

- **For hourly employees:** the total number of hours worked per month, not to exceed 167 hours per month per employee, divided by 167; and
- **For salaried employees:** the total number of weeks worked per month divided by 4.33, multiplied by the fraction of full-time employment that the qualified employee works (e.g., 50% for a half-time employee).

Reserving the credit

Taxpayers must apply for a tentative credit reservation from the California Department of Tax and Fee Administration (CDTFA) in order to claim the credit. (R&TC §6902.8) The application must be turned in to the CDTFA even if the employer is only claiming the credit against its income or franchise tax liability.

The tentative credit reservations will be awarded on a first-come, first-served basis. The CDTFA will notify the applicant of the tentative credit reservation amount within 30 days of receipt.

Taxpayers must file the request during the period beginning December 1, 2020, and ending the earlier of:

- January 15, 2021; or
- The date the maximum cumulative total allocation ($100 million) is reached.

Note: The CDTFA will provide updated information on its website as to how much credit has been allocated and credit amounts still available.

Claiming the credit

Taxpayers may claim the credit against their personal income tax, corporation income and franchise taxes, or sales and use tax liability. The credit against personal income taxes or corporation franchise taxes may only be claimed on a timely filed original return. Unused credit may be carried forward for up to five succeeding taxable years.

Wage deductions claimed by the employer must be reduced by the amount of credit claimed, whether taken as a credit against income, franchise, or sales and use tax.

Taxpayers must make an irrevocable election to claim the credit against sales and use taxes in lieu of claiming the credit against their income or franchise tax liability (details as to how to make this election have yet to be provided).

The credit may not reduce the $800 minimum or annual tax.

Comment

The FTB has stated the form to claim the Small Business Hiring Credit will be Form 3866, Small Business Hiring Credit. However, at press time, the FTB had not yet released a draft of the form.

In lieu sales and use tax credit

Being able to claim the credit against sales and use taxes will be a welcome relief for many retail and restaurant businesses whose income tax liability may be greatly reduced or nonexistent for the 2020 tax year (and possibly beyond) due to COVID-19.

The sales and use tax credit may be applied by:

- Monthly filers against amounts due and payable for the month of March 2021 and due by April 30, 2021;
- Quarterly filers against amounts due and payable for the first calendar quarter in 2021 and due on April 30, 2021; and
- For all other filers (e.g., annual or fiscal-year filers) against amounts due and payable on the first return due on or after April 30, 2021.
  (R&TC §6902.7)

Excess credits may be claimed on subsequently filed returns up until April 30, 2026. Any remaining excess credit amount after April 30, 2026, will be forfeited.

Example of credit against sales and use tax

The Good Kitchen had a total of 25 employees at the end of December 2019 but temporarily closed its operations on April 1, 2020, due to COVID-19. It reopened its operations on August 1, 2020.

During the period August 1, 2020, through November 30, 2020, Good Kitchen had five average monthly FTE employees. Because Good Kitchen was closed during the second quarter of 2020, it had no employees during the second quarter. Therefore, its five FTE employees are all counted as a "net increase" in FTEEs, and Good Kitchen will qualify for up to $5,000 in credits.

Because Good Kitchen was not in operation for four months and reopened under COVID rules, the owners expect to have a loss for 2020. They should elect to have the credit applied against sales and use tax.

BUSINESS CREDIT LIMITATION

The total amount of business credits against personal income and corporation franchise and income taxes are limited during each taxable year beginning on or after January 1, 2020, and before January 1, 2023. For those years, business credits 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. (R&TC §§17039.3, 23036.3) For unitary businesses, the limitation is applied on a combined reporting group basis.

The carryover period for any credit not used as a result of this limitation is increased by the number of taxable years the credit, or portion thereof, was not allowed.

A similar $5 million annual cap also applies to the Film and Television Credit against sales and use taxes that taxpayers may elect in lieu of the personal income tax and corporation franchise and income tax credits for taxable years beginning on or after January 1, 2020, and before January 1, 2023. Credits in excess of the $5 million cap may be carried over and applied against sales and use taxes for the following five years, including the reporting period beginning on and after January 1, 2024. (R&TC §6902.5)

R&D CREDIT

Research must follow the scientific method

Whether a taxpayer qualifies for the credit hinges on whether they can provide the experimentation to show how their activities involved a scientific method of documentation. (***Appeal of Swat-Fame, Inc.***, 2020-OTA-046P, pet. for rehear. denied 2020-OTA-045P) And keep in mind that R&D credits are a favorite FTB audit program.

✐ **Practice Pointer**

This is a complicated area of the law, and the FTB is actively searching for improper R&D Credit claims. Practitioners who are not well-versed in these credits should ensure that their clients are working with reputable advisors if they are considering taking these credits.

And, the IRS and the FTB have been prevailing over cases where the taxpayers were sold credits that didn't qualify.

The research projects

The taxpayers/shareholders were an apparel design company that created women's and girls' clothing. They filed amended California returns for years 2008–2012 claiming close to $2.5 million in Research Credits after undergoing an R&D product development study. The study was undertaken to determine whether activities related to creating new and improved silhouettes and fabrics for each of the taxpayer's brands constituted qualified research eligible for the Research Credit.

For the purposes of the appeal, the FTB audited the following four sample projects from the study and disallowed all of the credits claimed based on the findings from these audits:

1. **Bermuda shorts:** testing for optimal design specifications because the wash process caused the material to shrink more than usual;
2. **Party slip dress:** testing for optimal design of a dress with spaghetti straps, which per the customer's request was made out of heavy fabric and a different-fabric cummerbund;
3. **Ruffle skirt and leggings:** testing to determine how to maximize the number of ruffles on the skirt without causing the seams to split; and
4. **Sundress and shrug:** testing for optimal design of a known dress pattern using a new, flimsier fabric, and for avoiding ripped shrug fabric during the stonewashing process.

The proof is in the process

The main issue being decided in this appeal was whether the taxpayer met the "process of experimentation" test for these four projects (see later under "Qualified research" for a list of all the tests that must be met to qualify for the credit).

The taxpayer argued that their entire design and sewing process for the sample projects constituted a process of experimentation. The FTB countered that the taxpayer's projects were not for a qualified research purpose but instead were only adjustments made for aesthetic purposes.

An important part of the process of experimentation test is that there must be uncertainty about the product that the research aims to eliminate. The taxpayer argued their projects were qualified research aimed at eliminating uncertainty regarding the construction and function of the garments they manufactured, but the OTA found that their product design research did not rise to the level of the scientific method.

A process of experimentation involves the identification of:

- Uncertainty concerning the development or improvement of a business component; and
- One or more alternatives intended to eliminate that uncertainty; plus
- The conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology).

Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation. (Treas. Regs. §1.41-4(a)(5)(i)) Furthermore, at least 80% or more of the taxpayer's activities for each component must constitute a process of experimentation for a qualified purpose.

In this case, the OTA found that:

- There was little evidence of methodical experimentation beyond some trial and error to solve the particular issue each project faced;
- Much of the research was conducted for aesthetic purposes, which is not considered a "qualified purpose"; and
- Even if there was some scientific experimentation regarding a sample project, it didn't rise to the 80% threshold requirement.

Because the taxpayers failed this test for all four projects, the OTA did not analyze the other tests that must be met to qualify for the credit.

Qualified research

For California purposes, qualified research is research that is conducted in California and satisfies the following four tests under IRC §41:

- **Section 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;
- **Technological in nature test:** The research must be undertaken for the purpose of discovering technological information;
- **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
- **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. Research relating to style, taste, cosmetic, or seasonal design factors is not for a qualified purpose under the process of experimentation test and is thus not qualified research.
(IRC §41(d); R&TC §23609(c)(2)(A))

CALSAVERS

California has begun mandating employer participation in the CalSavers program. The program is being phased in over a three-year period. Employers with:

- More than 100 employees were required to register by September 30, 2020;
- More than 50 employees must register by June 30, 2021; and
- More than 5 employees must register by June 30, 2022.

Under the CalSavers program, private employers that don't already offer a retirement plan must enroll their employees in a CalSavers account (essentially a Roth IRA), unless:

- The employees opt out; or
- The employer has less than the requisite number of employees.
(Gov't. Code §100000 et seq.; 10 Cal. Code Regs. §10000 et seq.)

HOW THE PROGRAM WORKS

The CalSavers program will notify employers of their requirement to register in the program or claim an exemption from the registration requirements. Once registered, the employer must provide CalSavers enrollment information packets to employees who are age 18 or older during an annual enrollment period.

The law does not provide any exceptions for short-term or part-time employees. So, it appears that any employee age 18 or older must begin funding the plan at the first paycheck.

For employees who do not opt out, the employer must collect, remit, and report contributions for each payroll period.

An employee's initial default contribution rate is 5% the first year the employee is enrolled, increasing by 1% each year, up to 8%. Employees choose how their money is invested and have the option to:

- Opt out at any time; or
- Pay lower or higher contribution rates.

Employer liabilities

Employers who fail to comply with the program requirements will be subject to a $250 per employee penalty after receiving a notice of noncompliance. (UIC §1088.9) The penalty will be increased to $500 per employee if the employer does not comply within 180 days.

Employers do not have any liability for an employee's decisions to participate in the program, for their investment decisions, or for the performance of those investments. (Gov't. Code §100034)

Comment

AB 102 (Ch. 20-19) shifts the authority to collect these penalties from the EDD to the FTB. The bill requires the FTB to establish criteria, including a minimum dollar amount subject to referral and collection.

Additional information

More details about the program are available on the CalSavers website at:

Website
www.calsavers.com

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 has been deferred until the 2021 taxable year for federal purposes, California still imposes this limit for taxable years beginning after December 31, 2017. (IRC §461(l); R&TC §17560.5)

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 2020 taxable year is $261,359 ($522,717 in the case of a joint return). For 2021 the threshold amount is $262,000 ($524,000 in the case of a joint return).

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

Treat 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)

Example of limitation calculation

Luke and Laura are married. Laura owns a restaurant as a sole proprietor and reports her business income and expenses on Schedule C. In 2019, her revenue from the restaurant is $5 million and her expenses are $6.5 million. Luke is an attorney and earns a salary of $850,000.

Laura's excess business loss for 2019 is calculated as follows for both California and federal purposes:

Total business expense	($6,500,000)
Less: Gross business income	5,000,000
Less: Luke's W-2 income	850,000
Less: Threshold amount	510,000
Excess business loss	($ 140,000)

Luke and Laura may only claim $510,000 of the losses from her business against Luke's $850,000 salary. For both federal and California purposes, their taxable income is $340,000 ($850,000 - $510,000).

For California purposes, the $140,000 will be treated as a prior-year carryover excess business loss and will be used to compute her California excess business loss in 2020.

Example of carryover differences in 2020

In 2020, Laura's revenue from the restaurant is $6 million and her expenses are $6.41 million.

Laura's California excess business loss for 2020 is calculated as follows:

	California calculation
2020 business expense	($6,410,000)
Prior year excess loss carryover	(140,000)
Less: Gross business income	6,000,000
Less: Threshold amount	522,717
Excess business loss	$ 27,283

For California purposes, because their 2019 excess business loss carryover of $140,000 is added to their 2020 losses, this $550,000 ($410,000 + $140,000) amount is above the $522,717 threshold amount, and the $27,283 excess will be carried over to 2021 as an excess business loss carryover for California purposes.

For California purposes, their taxable income is calculated as follows:

Luke's wages	$850,000
Less Laura's limited business loss	(522,717)
Taxable income	$327,283

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.

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 2020 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 2020 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**
Wage income	$300,000	$300,000
Distributable share of passthrough business loss	($1,000,000)[1]	($250,000)[2]
Less: Threshold amount	$261,359	$261,359
Excess business loss	$438,641	$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 2021.

Because Fred's excess business loss is less than the $261,359 limitation, he may claim the entire loss on his California return.

MULTISTATE BUSINESS ISSUES

FTB ADDRESSES NEXUS AND WORKERS TELECOMMUTING DUE TO COVID-19

In an FAQ, the FTB has clarified that taxable nexus will not be established for an out-of-state corporation whose only connection to California is the presence of an employee who is currently teleworking in California due to Governor Newsom's "Stay at Home" Executive Order N-33-20.

However, the FAQ does not address whether nexus is created if an employee teleworks in California due to another state or local jurisdiction's shelter-in-place order, so we believe this situation will still create nexus.

To view the FTB's FAQ "Teleworking and the 'Stay at Home' order," go to:

Website
www.ftb.ca.gov/about-ftb/newsroom/covid-19/help-with-covid-19.html

Several states have released guidance on remote teleworking, and we have compiled the information in a chart. Go to:

Website
www.caltax.com/files/2020/telework.pdf

Employees working in California

According to the FTB, an individual who comes to California and teleworks from California as an employee is taxable to California even though the individual is only temporarily in California. That means the wages earned while working in California are taxable to California, even if the worker is a nonresident and is only here temporarily. (18 Cal. Code Regs. §17951-1)

> ***Example of wages taxable to California***
>
> Luz is a teacher employed in Washington state. She comes to California to help care for her elderly parents during the COVID-19 pandemic. She teaches fifth grade and her school is closed, so she works remotely teaching her pupils in Washington.
>
> She will return to Washington when things get back to normal, so she is not considered a California resident. However, she is subject to tax on the wages she earns while remote teaching in California. Unfortunately for Luz, there is no tax in Washington, so she won't get a credit for tax paid to California.

FTB CONTINUES TO PURSUE NONRESIDENT SOLE PROPRIETORS

Citing its precedential decision in ***Appeal of Bindley*** the OTA once again ruled that a nonresident sole proprietor with a California customer was required to source that income to California even though the work was performed outside California. (***Appeal of Bindley***, 2019-OTA-179P) In ***Appeal of Moro***, a Texas resident sole proprietor who performed services for a California pharmaceutical company was liable for tax on all nonemployee compensation paid to the taxpayer and reported on the 1099-MISC filed by the pharmaceutical company, even though the vast majority of the work was performed by the taxpayer in Texas. (***Appeal of Moro***, 2019-OTA-381)

> ***Comment***
>
> Many taxpayers are confused as to when a nonresident sole proprietor must file a return and pay tax if it sells its services to California customers. This is an issue that we can all personally relate to, as we frequently get questions from our customers about whether they will be required to file a California tax return if they move to another state but retain some of their California clients. Nonresident individual sole proprietors are not subject to the "doing business" standard applied to corporations and LLCs. Rather, their taxation is governed by 18 Cal. Code Regs. §17951-4 and -5.
>
> Not surprisingly, the FTB has taken the position that if a self-employed nonresident has any California customers, it must file a California return and pay tax on income from their California customers.
>
> At issue in the ***Bindley*** case was whether California could tax income received by an Arizona resident for screenplays he wrote and sold to two California LLCs that produced film and television shows. When the FTB received two Forms 1099-MISC from the LLCs showing that the taxpayer had received $40,000 for his work, the FTB sent the taxpayer a Request for Tax Return. The taxpayer responded that he did not have a filing requirement claiming that because all of his services were performed in Arizona, he did not have any California-source income.

Multistate sole proprietorships

The ***Moro*** decision did not state what type of services were provided by the taxpayer, but simply stated that the taxpayer was a sole proprietorship that carried on a unitary business within and outside of California and therefore California's apportionment provisions and sourcing rules applied.

In ***Bindley***, the OTA found a sole proprietor who performed services in Arizona but rendered those services to customers in California was a unitary business conducting business inside and outside California. Therefore, the sole proprietor was subject to California's apportionment rules, including the market-based sourcing rules. (18 Cal. Code Regs. §17951-4(c))

Market-based sourcing

Because the taxpayer in ***Moro*** failed to provide a contract or books or records showing that the pharmaceutical company received the benefit of the services outside California, under California's cascading sourcing rules (18 Cal. Code Regs. §25136-2(c)), it was reasonable for the FTB to presume the benefit was received in California because that was where the pharmaceutical company was located.

Under California's cascading market-based sourcing rules for services sold to business customers, receipts will be sourced to California if:

- The contract or the taxpayer's books and records show that the benefit was received in California;
- The contract/books and records do not show where the benefit was received, if it can be "reasonably approximated" that the benefit was received in California;
- The location where the benefit was received cannot be determined above, if the customer placed the order from California; and
- The location where the benefit was received cannot be determined above, if the customer's billing address is in California.

What's next?

This means that going forward the FTB will be monitoring 1099-NEC forms to determine if out-of-state sole proprietors have received income from California customers. If the nonresident's total income from all sources exceeds the nonresident filing thresholds, they must file a California return and pay California tax on the income received from California customers that is sourced to California under the market-based sourcing rules. This applies regardless of how little income they receive from their California customers.

Comment

Because the IRS is no longer sharing 1099 information with the states, this is one of the main reasons we expect payors will be required to file copies of Form 1099-NEC with the FTB.

Not only must the sole proprietor pay California tax on their California-sourced income, the sole proprietor must use total worldwide taxable income to determine the tax rate that is applied.

Example of nonresident sole proprietor filing requirements

Sam is a former California tax professional who moved to Nevada. He retained five of his California clients, whom he charged a total of $2,500 for preparing their returns. He also prepared returns for clients in Nevada and other states, for whom he charged $5,000. His expenses for his Schedule C were $1,500, so his net Schedule C income was $6,000. He must apportion the income to California as follows:

$6,000 × ($2,500 California income ÷ $7,500 total income) = $1,999

Comment

This means that the "economic nexus" thresholds for sole proprietors may be substantially lower than other business entities.

Under California law, a nonresident is subject to taxation if they have $1 of California-source income and meet the nonresident filing thresholds, which are based on a specified level of gross income and/or adjusted gross income from **worldwide** sources after applying California adjustments. For 2019, these thresholds were as low as $18,241 and $14,593, respectively, for single taxpayers with no dependents. In contrast, the 2020 economic nexus threshold for other out-of-state business entities is currently over $610,395 in sales.

We question if the factors applied by the FTB would pass judicial scrutiny. Unfortunately, unless this issue is brought before the courts and a court of appeal overturns the ruling, this is now the law of the land.

Roadmap for analyzing nonresident sole proprietor cases

A nonresident sole proprietor must file a California nonresident return and pay California taxes if they have:

- Total income that exceeds the gross income filing thresholds for filing a California tax return (using worldwide income);
- A tax liability; and
- $1 or more of California-source income.

To determine if they have California-source income:

- The taxpayer must be conducting business as a sole proprietor — not an employee;
- The taxpayer's business must be conducted both inside and outside of California. Under the OTA's precedential ***Bindley*** decision, if an out-of-state business has a customer inside California, it is considered to be conducting business inside California even if all the services are performed outside California; therefore, it is conducting business both inside and outside California;
- The taxpayer must be carrying on a unitary business. Under the ***Bindley*** decision, the OTA determined that a nonresident sole proprietor that sells their services to a California customer is considered to be doing business in both states, and the multistate business operations are considered unitary under either the three unities test (common ownership, operations, and use) or the contribution and dependency test; and
- The taxpayer must derive California-source income. This is determined by using California's allocation and apportionment rules, including the market-based sourcing rules to determine where the benefit is received. If the benefit is received in California, then the income is California-source income.

GENERAL PARTNER WAS DOING BUSINESS IN CALIFORNIA

In a precedential decision, the OTA ruled that a Washington corporation that was a general partner in two California limited partnerships was "doing business" in California pursuant to R&TC §23101(a) even though the taxpayer may not have met the economic nexus thresholds under R&TC §23101(b). (***Appeal of GEF Operating, Inc.***, 2020-OTA-057P) Therefore it was liable for the $800 minimum franchise tax as well as close to $500 in additional penalties and fees.

The taxpayer argued that it was not required to file a return or pay the minimum tax because it had neither physical presence nor economic nexus in California. It was located in Washington, and all of its management services rendered to the California partnerships were performed in Washington. Because the $400,000 earned for the management services was below the $500,000 economic nexus threshold, it claimed it also did not have economic nexus in California.

General partner nexus

However, long-standing case law in California holds that a general partner of a limited partnership is "doing business" wherever the limited partnership is conducting business. (***Appeal of Ahmanson***, 65-SBE-013; ***Appeals of Amman & Schmidt Finanz AG, et al.***, 96-SBE-008; ***Appeal of Custom Component Switches, Inc.***, 77-SBE-009) As the general manager, the taxpayer had the right to manage and conduct the activities of the limited partnerships and was liable for their debts. Therefore the limited partnerships' activities were attributable to the taxpayer, and the taxpayer was engaging in transactions in California for the purpose of financial or pecuniary gain or profit and satisfied the "doing business" test under R&TC §23101(a).

Mutually exclusive "doing business" tests

The OTA also rejected the taxpayer's argument that the economic nexus thresholds under R&TC §23101(b) provide a safe harbor from the general definition of "doing business" under R&TC §23101(a). The legislative history of the economic nexus threshold legislation indicated that the purpose of the economic nexus thresholds was to expand the definition of "doing business" under R&TC §23101(a), not limit or revise its prior application.

Taxpayer benefited from California's services

The taxpayer had sufficient taxable nexus with California because it received the benefits of California's economic marketplace and the services provided by the California government.

The taxpayer and one of the limited partnerships employed 12 employees during the tax year. The taxpayer also had two California resident directors who provided on-site services to the California limited partnerships. Therefore, the taxpayer and its limited partnerships were utilizing the services California offers to any business operating in the state, and the taxpayer, as the sole general partner, benefited from the services California provided to the limited partnerships it managed.

DON'T FORGET ECONOMIC NEXUS THRESHOLDS

An out-of-state LLC was "doing business" in California and therefore was required to file a franchise tax return and the $800 annual tax, even though its only connection to the state was a 0.783% nonmanaging membership interest in a California entity. (***Appeal of Aroya Investment, LLC***, 2020-OTA-255P) Because the California entity had over $64 million in California property holdings, the taxpayer-LLC's flowthrough property ownership interest equated to over $480,000, which far exceeded the $50,000 economic nexus property threshold for the taxable year pursuant to R&TC §23101(b).

Similarly, an out-of-state limited partnership receiving California-source income far in excess of the $500,000 gross receipts economic nexus threshold (adjusted for inflation) from various passthrough entities was required to file a California return and pay the $800 annual tax. This was required even though it was only a limited partner in the passthrough entities and exercised no management or control over them. (***Appeal of LCP VIII Holdings LP***, 2019-OTA-399)

Practice Pointer

Under California law, a limited partnership doing business in California must file a partnership return and pay an annual $800 tax even though the partners, and not the partnership, pay taxes on the partnership's net income. (R&TC §§17935, 18633)

The taxpayers in both of the previous cases failed to file California returns, mistakenly believing that as a result of the ***Swart*** decision they were not required to file a return or pay the tax. In ***Swart***, a California court of appeal held that an out-of-state corporation whose only connection to California was its 0.2% ownership interest in a California investment fund LLC was not doing business in California because it had no ability to manage or control the LLC. Therefore, the corporation was not required to file a return and pay the $800 minimum tax. (***Swart Enterprises, Inc. v. FTB*** (2017) 7 Cal.App.5th 497)

Doing business

However, ***Swart*** only addressed one component of California's "doing business" statute. R&TC §23101, California's "doing business" statute, has two distinct components, and a taxpayer that meets either of those components will be found to be doing business in the state.

Under R&TC §23101(a), an entity is doing business in California if it is "actively engaging in any transaction for the purposes of financial or pecuniary gain or profit" (the issue in ***Swart***).

Under R&TC §23101(b), an entity is considered to be doing business if it has economic nexus with California, which is defined as:

- Being organized or commercially domiciled in the state;
- Having California gross receipts in excess of $500,000 (adjusted for inflation; $610,395 for 2020) or 25% of the taxpayer's total sales;
- Having California real and/or tangible property in excess of $50,000 (adjusted for inflation; $61,040 for 2020) or 25% of the taxpayer's total property; or
- Having California payroll compensation in excess of $50,000 (adjusted for inflation; $61,040 for 2020) or 25% of the taxpayer's total payroll.

Swart's limits

The ***Swart*** case only addressed the doing business standard under R&TC §23101(a) and found that a limited partner's interest in a California passthrough entity in which the limited partner had no management or control over the passthrough entity did not constitute being actively engaged in a transaction for financial or pecuniary gain or profit.

However, as the OTA found in ***LCP***, even if the limited partner has no management or control over the passthrough entity, if its share of the passthrough entity's gross receipts, property, or payroll exceeds the economic nexus thresholds under R&TC §23101(b), it is doing business in California and must file a return and pay the $800 tax. Ignorance of the filing requirement is no excuse, and the per-partnership late-filing penalties will be imposed if the taxpayer fails to comply with the filing and payment requirements.

Factors are aggregated

It's also important to note that if an out-of-state entity has interests in multiple passthrough entities, the distributive share of the passthrough entities' gross receipts, property, and payroll will be aggregated to determine if the out-of-state entity meets the economic nexus thresholds.

CANNABIS BUSINESSES

ACCOUNTANTS CAN PROVIDE SERVICES WITHOUT FEAR OF CRIMINAL CHARGES

AB 1525 (Ch. 20-274) clarifies that an individual or a firm that practices public accounting does not commit a crime under California law solely for providing professional accounting services to persons licensed to engage in commercial cannabis activity in California. (B&PC §2620) The relief from criminal prosecution also applies to entities that receive deposit, extend credit, conduct fund transfers, transport cash or financial instruments, or provide other financial services.

CANNABIS BUSINESSES MAY DEDUCT EXPENSES

Noncorporate licensees engaged in commercial cannabis activities to deduct their ordinary and necessary business expenses on their California, but not their federal, returns for taxable years beginning on or after January 1, 2020, and before January 1, 2025. (R&TC §17209) They will also be able to claim California credits related to their cannabis business activities.

Previously, only corporate taxpayers engaged in cannabis activities were able to claim deductions and credits for their ordinary and necessary business expenses, as long as they were not convicted of specified illegal activities, including drug trafficking, in a criminal proceeding or other proceeding in which a governmental agency was involved. (R&TC §24436.1)

This was because California's Personal Income Tax Law incorporated IRC §280E, but California's Corporation Franchise Tax Law did not. IRC §280E prohibits taxpayers who traffic in controlled substances from claiming any deduction or credit related to that business other than COGS, and federal law still lists cannabis as a Schedule I controlled substance.

Beginning with the 2020 taxable year, businesses, regardless of their entity structure, will be on a more equal footing for California tax purposes. However, unlike corporate cannabis businesses, noncorporate cannabis businesses must be licensed through the appropriate state agency in order to claim the business expenses, and the personal income deductions are only available through 2024.

New form for claiming deductions and credits

The FTB has created a new Form 4197, Information on Tax Expenditure Items, to report the total deductions, credits, exclusions, and exemptions related to cannabis activities. The form is to be filed with the taxpayer's franchise or income tax return, and the instructions state that it is to be filed in addition to any other credit forms or expense schedules that are required to be filed with the tax return. However, there does not appear to be any penalty for failing to file the form.

CANNABIS TAX RATES FROZEN FOR 2021

AB 1872 (Ch. 20-93) freezes state cannabis excise and cultivation taxes for the 2021 fiscal year by prohibiting:

- The cultivation tax rates that are imposed in the 2021 calendar year from being adjusted for inflation unless the adjustment is for an inflation rate that is less than zero; and
- The CDTFA from adjusting the mark-up amount (currently set at 80%) for the period beginning September 18, 2020, and before July 1, 2021.

Excise tax

A 15% excise tax is imposed on purchasers of cannabis or cannabis products but not cannabis accessories such as pipes, vapes or rolling papers. The tax is based on an average market price base that is set by the CDTFA every six months. (R&TC §34011)

The average market price is the average retail price determined by the wholesale cost of the cannabis or cannabis products sold or transferred to a cannabis retailer, plus a markup, as determined by the CDTFA (currently set at 80%).

Cultivation tax rate

Effective January 1, 2020, the cannabis cultivation tax rates are:

- $9.65 (increased from $9.25) per dry-weight ounce of cannabis flowers;
- $2.87 (increased from $2.75) per dry-weight ounce of cannabis leaves; and
- $1.35 (increased from $1.29) per ounce of fresh cannabis plant.
  (CDTFA Special Notice L-720)

MISCELLANEOUS

BUSINESS LOSS RELATED TO FORMER RESIDENCE DENIED

Taxpayers were not entitled to take a business loss on their former personal residence that they claimed they attempted to rent prior to sale. (***Appeal of Vardell***, 2020-OTA-190P) The taxpayers claimed almost $430,000 in losses for the two years at issue and zero rental income for the house.

The FTB argued that the property was never converted to a business use, evidenced by the lack of rental income, the absence of documentation of rental efforts, the fact the property was listed for sale prior to the alleged rental efforts, the property's availability for personal use due to its asserted vacancy, and the significant utility costs incurred on the property. The taxpayers presented no evidence of *bona fide* efforts to rent out the home prior to sale, such as advertisements on websites or in newspapers or broker listings, or any offers to rent.

SHAREHOLDERS COULD NOT RECLASSIFY INCOME RECEIVED FROM S CORPORATION

In a precedential opinion, the OTA held that S corporation shareholders must apportion business income received from the S corporation's sale of its subsidiary's goodwill rather than allocate it to the shareholders' state of residence as income from the sale of an intangible. (***Appeals of the 2009 Metropoulos Family Trust, et al.***, 2019-OTA-385P) Under the applicable regulation, an S corporation's business income distributed to its shareholders is sourced at the S corporation level, not the shareholder level. (18 Cal. Code Regs. §17951-4(d))

SMALL BUSINESS HIRING CREDIT CLIENT LETTER

To download the following client letter, go to:

Website
www.caltax.com/files/2020/cl-smallbusiness.doc

Dear [CLIENT NAME]:

To help small businesses that are climbing back from financial devastation caused by COVID-19, California is providing a new credit for small businesses for the 2020 tax year only. The credit, also referred to as the Main Street Hiring Credit, is targeted to those businesses that had to lay off employees or dramatically reduce their employees' hours earlier this year and are now rehiring these employees, hiring new employees, and/or increasing their workers' hours.

Only a limited amount of money is available for the credit. To be eligible, taxpayers must reserve the credit with the California Department of Tax and Fee Administration. Reservations are being taken on a first-come, first served basis starting December 1, 2020, and will only be taken until the earlier of January 15, 2021, or when the $100 million credit allocation is reached.

We believe the $100 million set aside for this credit will be completely reserved well before January 15, 2021, so we recommend making credit reservations as early in December as possible.

The credit is equal to $1,000 for each net increase in qualified employees, up to $100,000 maximum per taxpayer, but can only be claimed by businesses that:

- Employed 100 or fewer employees (all employees, including part-time employees) as of December 31, 2019; and
- Experienced a 50% decrease in gross receipts from April 1, 2020–June 30, 2020, as compared to April 1, 2019–June 30, 2019.

The net increase is measured by comparing the taxpayer's average number of monthly full-time equivalent (FTE) employees for the second quarter of 2020 with the average number of monthly FTE employees for the five-month period beginning July 1, 2020, and ending November 30, 2020.

And what's even better, if you will owe little or no income tax, you can claim this credit against state and local sales and use taxes instead.

Call our office today to make sure you can take advantage of this credit. We'll make sure you qualify for the maximum amount of credit available by counting your gross receipts and full-time employees accurately.

Sincerely,

Your tax professional

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.*

7. Which of the following statements is correct regarding calculating an S corporation shareholder's basis?

    a) Under federal but not California law, shareholders may claim losses from an S corporation that exceeds the shareholder's basis in that corporation
    b) Passthrough losses that exceed a shareholder's basis cannot be carried over
    c) A shareholder must treat improperly claimed losses from a closed tax year as a suspended loss only for the purpose of computing the shareholder's basis in an open tax year
    d) A shareholder's personal guarantee on a loan to an S corporation increases the shareholder's basis

8. What is true about the new small business hiring credit?

    a) The credit is for businesses that employed 100 or fewer employees as of December 31, 2019, and who have experienced a 50% decrease in gross receipts when comparing the second quarter of 2020 with the second quarter of 2019
    b) The combined credit that may be claimed by all taxpayers is capped at $50 million
    c) The credit is claimed only against personal income or corporation franchise and income taxes
    d) Taxpayers included in a combined report are eligible

9. What is an accurate feature of the CalSavers state-mandated retirement program?

    a) There is an exception for short-term or part-time employees
    b) Employers have some liability for their employee's decisions regarding whether to participate in the program
    c) Employers must register with the CalSavers program, and if employees don't opt out, contributions will be deducted from their paychecks
    d) The employee's default contribution is 8% per year

SOLUTIONS TO REVIEW QUESTIONS

7. Which of the following statements is correct regarding calculating an S corporation shareholder's basis? **(Page 10-1)**

   a) Incorrect. Under both federal and California law, shareholders may not claim losses that exceed their basis.
   b) Incorrect. Such losses are required to be held in a suspense account, separately tracked, and carried over.
   c) Correct. These losses are tracked separately in a suspended loss account and cannot be claimed again as a true loss in a later tax year.
   d) Incorrect. A personal guarantee will not increase basis; there must be an actual outlay of funds.

8. What is true about the new small business hiring credit? **(Page 10-8)**

   a) Correct. The 50% decrease in gross receipts applies if, for purposes of the Employee Retention credit, it would have met the requirements for having a significant decline in gross receipts.
   b) Incorrect. The cap is $100 million.
   c) Incorrect. The taxpayer may elect to claim the credit against state and local sales and use taxes.
   d) Incorrect. Whether these taxpayers are included or includable, they are ineligible.

9. What is an accurate feature of the CalSavers state-mandated retirement program? **(Page 10-13)**

   a) Incorrect. There are not exceptions provided in the law, so any employee age 18 or older must fund the plan beginning with their first paycheck unless they opt out.
   b) Incorrect. There is no liability for the employer.
   c) Correct. The CalSavers program will notify the employer of their requirement to register, and if the employee doesn't opt out, the employer must collect, remit, and report contributions for each payroll period.
   d) Incorrect. The default contribution is 5% the first year of enrollment, increasing by 1% each year, up to 8%.

SPIDELL

TAX • ANALYSIS • EDUCATION

Chapter 11

California Miscellaneous

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CALIFORNIA MISCELLANEOUS

PROPERTY TAXES

PROPERTY TAX CHANGES ON THE NOVEMBER BALLOT

Of the 12 propositions that were on the California ballot in November, two of them proposed big changes to long-standing property tax laws.

Proposition 15 (split-roll measure) — failed

Proposition 15, also called the "split-roll measure," would have repealed Proposition 13 protections for nonresidential commercial and industrial properties. These property owners would have been required to pay property tax based on market value, instead of on the original purchase price indexed by no more than 2% per year. Residential properties, agricultural land, small businesses, and commercial and industrial properties with combined fair market values of $3 million or less would have been exempt.

Proposition 19 — passed

Parent–child transfers

With the passage of Proposition 19, we will see an increase in property taxes for transfers of California real property between parents and children or vice versa.

Under current law, a transfer of ownership in California real property generally results in a reassessment for property tax purposes with certain exceptions, including two exclusions from reassessment that can apply for transfers between parents and children:

- The principal residence exclusion allows the transfer of a principal residence of unlimited value between parents and children; and
- The $1 million lifetime non-principal residence exclusion allows the transfer between parents and children of up to $1 million of assessed value of all other types of property (for example, second homes or rental properties). For a married couple, this would be a combined $2 million lifetime exclusion. **Note:** Starting in 2023 this amount will be indexed for inflation.

Under Proposition 19, for transfers on or after February 16, 2021:

- In order to qualify for the principal residence exclusion, the receiving child must use the residence as their own principal residence, and only the first $1 million of additional assessed value is excluded (Sec. 2.1(c)(1)); and
- The non-principal residence exclusion has been completely eliminated. However, the principal residence exclusion will apply to transfers of family farms.

Comment

There are currently no R&TC sections for these new laws. Sections listed in the materials are cites are from the proposition language.

Questions about the principal residence exclusion: While it is clear that the children must use the home as the principal residence to maintain their parents' property tax base, the following issues are still unclear:

- The transferee children are required to use the property as their own principal residence and are required to claim the homeowner's exemption at the time of the transfer, or no later than one year after the date of transfer. However, for transfers that vest immediately upon the death of a parent (e.g., for properties held in a trust), it is unclear whether the clock for filing the homeowner's exemption claim starts to run upon the date of death or on the recording of a deed; and
- In some cases, parents gift their principal residence to multiple children, which presents no issue under current law since there's no requirement that the children reside in the property. Under Proposition 19, however, it is not clear whether these transfers would continue to qualify for the parent–child exclusion, since in most cases, only one child would use the property as their own principal residence. Further guidance is needed to clarify this issue.

Complicated reassessment formula: Proposition 19 requires assessors to calculate the new taxable value, or new assessed value, of the property using the following formula:

- If the FMV immediately before the transfer is less than the assessed value plus $1 million, then the new assessed value = assessed value + $0; and
- If the FMV immediately before the transfer is equal to or more than the assessed value plus $1 million, then the new assessed value = assessed value + FMV immediately before the transfer – (assessed value + $1 million).
(Sec. 2.1(c)(1)(B))

Example of no reassessment

Judy dies, and her daughter Jessica inherits her home. At Judy's death the home has a FMV of $1.25 million and an assessed value of $500,000.

The $1.25 million FMV is less than $1.5 million (the $500,000 assessed value + $1 million).

As a result, the assessed value remains at $500,000 when Jessica inherits the property.

Example reassessment

Lucy dies, and her son Leon inherits her home. At Lucy's death, the home has a FMV of $2 million and an assessed value of $500,000.

The $2 million FMV is more than $1.5 million (the $500,000 assessed value + $1 million).

As a result, the new assessed value is $1 million ($500,000 + ($2 million - $500,000 - $1 million)).

☑ Planning Pointer

Families with real estate that they are planning to pass from parent to child may want to make transfers before February 16, 2021, to preserve low property tax bases. If the children plan to keep the property to rent or use as a second home, this could save a tremendous amount of property tax in the future. However, if the children will likely sell the property, consider that making a lifetime gift will preserve the property tax base, but it will eliminate the step-up in basis that the children would get if they inherited the property at their parent's death.

Base-year transfers

For transfers on or after April 1, 2021, Proposition 19 also 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 (currently this benefit is limited to counties that have authorized the base-year property transfer). (Sec. 2.1(b)) Taxpayers who are over age 55 or disabled will be able to 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.

Example of higher FMV

Jane is age 65 and has decided she wants to move closer to her grandchildren. She sells her home in Orange County, with an assessed value of $400,000, for $650,000. Jane purchases a new home in San Diego for $750,000.

The assessed value of Jane's new home is $500,000 ($400,000 + ($750,000 - $650,000)).

PROPERTY DAMAGED IN DISASTERS

AB 2013 (Ch. 20-124) also adds a new construction exclusion for comparable property that is reconstructed on the site of the damaged or destroyed property, for property that has been substantially damaged or destroyed by a Governor-declared disaster on or after January 1, 2017. (R&TC §70.5) The exclusion applies to replacement property reconstructed on the site of damaged or destroyed property within five years after the disaster but only if the reconstructed property is comparable to the substantially damaged or destroyed property. Taxpayers who receive this property tax relief are ineligible for the base-year property transfer relief available for property purchased to replace property destroyed by a disaster. (R&TC §69)

Property is substantially damaged or destroyed if the improvements sustain physical damage amounting to more than 50% of the improvements' full cash value immediately prior to the disaster.

Comment

See page 11-17 for a list of 2020 California disasters and the corresponding deadline extensions.

Reconstructed property limitations

Reconstructed property is comparable if it is similar in function, size, and utility.

Property is similar in function if it is subject to similar governmental restrictions, such as zoning.

Size and utility are interrelated and associated with value. Property is similar in size and utility if it is used or intended to be used in the same manner, and its full cash value does not exceed 120% of the full cash value of the damaged original property, determined just prior to the date of damage/destruction.

If the full cash value of the reconstructed property is less than the original property's adjusted base-year value, then the lower value will become the reconstructed property's base-year value.

Only the owner(s) of the property substantially damaged or destroyed is eligible to receive relief under this section.

Partial relief

If the full cash value of the reconstructed property exceeds the 120% threshold, the amount above 120% will be added to the transferred base-year value.

> ***Example of available relief***
>
> Luisa's Sonoma home was destroyed in the 2017 Tubbs fire. Her original home was 2,000 square feet. She decides to rebuild her home and adds a 750-square-foot workshop that she will rent out to a local carpenter. The reconstructed home will be 1,500 square feet and will have a full cash value equal to 120% of her property's full cash value prior to the fire.
>
> Luisa may transfer her base-year property tax value of the old home to the new home, but the workshop will be assessed at full-cash value because it will be rented to a tenant rather than being used as part of her primary residence.

PROPERTY TAX APPEALS

AB 107 (Ch. 20-264) allows county boards of equalization/assessment appeal boards to extend the two-year deadline by which they must issue final determinations in property tax appeal applications to March 31, 2021, for those appeals in which a deadline fell between March 4, 2020, and before March 31, 2021. (R&TC §1604(f))

The bill also authorizes county boards and multijurisdictional appeals boards to conduct their hearings remotely. (R&TC §§1616, 1752.4; Uncodified Sec. 21, AB 107 (Ch. 20-624))

AB 3373 (Ch. 20-57) authorizes county boards of supervisors to create as many assessment appeals boards for the county as it deems necessary for the orderly and timely processing, hearing, and disposition of assessment appeals. (R&TC §1621)

PROPERTY TAX TREATMENT OF NONRESIDENTIAL ACTIVE SOLAR ENERGY SYSTEMS

SB 364 (Ch. 20-58) would change the classification of nonresidential active solar energy systems from real property to personal property, and create a new property tax exemption for systems constructed prior to January 1, 2025, if voters would have approved Proposition 15, an initiative constitutional amendment to require fair market value-based property tax assessments for certain commercial and industrial real property.

Comment

Because Proposition 15 failed, SB 364 (Ch. 20-58) does not go into effect.

2021 DISABLED VETERANS' PROPERTY EXEMPTION

The BOE has announced increases in both the property exemption amounts and the household income limit for the Disabled Veterans' Exemption for 2021. (California SBE Letter to Assessors No. 2020/023 (May 5, 2020))

For the 2021 assessment year, the property exemption amounts are $147,535 for the basic exemption and $221,304 for the low-income exemption, and the household income limit for those claiming the low-income exemption is $66,251.

For the 2020 assessment year, the property exemption amounts are $143,273 for the basic exemption and $214,910 for the low-income exemption, and the household income limit for those claiming the low-income exemption is $64,337.

FTB

"DROP AND SWAP"-TYPE §1031 EXCHANGE UPHELD

In ***Appeal of Mitchell***, the Office of Tax Appeals (OTA) ruled that a taxpayer conducted a valid IRC §1031 like-kind exchange and therefore was not liable for tax on her share of the gain in the year of the sale. (***Appeal of Mitchell***, 2018-OTA-210, petition for rehearing denied, 2020-OTA-001)

The OTA found that the taxpayer-partner timely exchanged her 10% tenant-in-common (TIC) interest in property for a replacement property and therefore complied with the §1031 statutory requirements. (The property was previously owned by a partnership, in which the taxpayer owned a 10% interest.) IRC §1031 requires that the same party sell the relinquished property and purchase the replacement property.

In the decision, the OTA stated that "a taxpayer's 1031 exchange can be preceded by a tax-free acquisition of the relinquished property or followed by a tax-free transfer of the replacement property." In other words, the OTA appears to be open to "drop-and-swap" and "swap-and-drop" type transactions.

Too good to be true?

This decision is a welcome roadmap for tax professionals and attorneys advising partnerships and their partners how to transact a sale of real property when only some of the partners want to undertake a §1031 exchange and the others want to cash out.

However, it's important to remember that this decision is not precedential so the FTB is not bound by its findings, nor is another OTA administrative law judge panel (as we've seen with other issues before the OTA). In fact, last year the OTA denied a taxpayer's petition for rehearing of a decision by the five-member Board of Equalization in which the BOE upheld the FTB's assessment based on similar arguments (discussed in more detail later under "Board's narrower interpretation"), finding that the BOE's decision was supported by the evidence and was not "contrary to the law." (***Appeal of Pau***, petition for rehearing denied, 2019-OTA-119)

The drop-and-swap exchange

In the ***Mitchell*** case, the property was sold to a third party on November 28, 2007, after the managing partner of the partnership had negotiated the sale of the property over the course of 11 months. The day prior to the closing, the partnership redeemed the taxpayer's and her mother's 10% and 8% partnership interests, respectively, in exchange for 10% and 8% tenant-in-common (TIC) interests in the property. The following day, the partnership, the taxpayer, and her mother all signed a grant deed to the purchaser to complete the sale of the property.

Who relinquished the property?

The FTB argued that the §1031 deferral claimed by the taxpayer was invalid because under the "substance over form" doctrine, it was the partnership that sold the relinquished property and not the taxpayer. It was the managing partner of the partnership that negotiated the terms of the sale, and the offer, counter-offer, and purchase agreement were all negotiated in the partnership's name and not the partners' names.

However, the OTA found that all parties to the exchange (the partnership, all the partners, and the purchaser) were aware from the beginning that some of the partners wanted to participate in a §1031 exchange and that the managing partner was negotiating the sale on behalf of all of the partners, some of whom wanted to cash out and some of whom wanted to make a like-kind exchange. In fact, the counter-offer made by the purchaser allowed for an escrow extension for purposes of facilitating a §1031 exchange.

The OTA found that IRC §1031 does not require ownership of the relinquished property for any particular period of time and that the Ninth Circuit Court of Appeals had noted another decision with approval, which stated that "one need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire title solely for the purpose of exchange and accept title and transfer it in exchange for other like property, all as a part of the same transaction with no resulting gain." (***Alderson v. Comm.*** (1963) 317 F.2d 790) Therefore the way the transactions were structured resulted in the sale of the property by the partnership and the taxpayer and her mother, and not just the partnership.

Assignment of income

The FTB also argued unsuccessfully that the transaction as structured was an invalid anticipatory assignment of income. However, the OTA rejected this argument because there cannot be an improper assignment of income when the partnership was a passthrough entity that did not owe taxes on the income to begin with.

Board's narrower interpretation

In one of its last decisions issued prior to transferring its appellate duties to the OTA, the Board of Equalization (Board) reached the opposite conclusion in the ***Pau*** appeal involving a partner in three separate tiered entity partnerships in which the partnership exchanged the partner's partnership interest for TIC interests in the property immediately before the property was sold. (***Appeal of Pau*** (December 17, 2017) Cal. St. Bd. of Equal., Case No. 959931) In ***Pau***, the Board ruled that it was the partnerships, and not the partner, that sold the property or purchased the replacement property. The case illustrates the minefields that taxpayers face when navigating these types of complex transactions involving multiple entities and transactions.

What's all this swapping?

In a typical drop-and-swap scenario, the entity converts the partnership interests to TIC interests, therefore "dropping" the title to the property to the TICs. Each investor receives a tax-free distribution of their share of the investment property's title. With title placed in the name of the individual investors, rather than the partnership, each investor is free to either cash out or make a like-kind exchange using the equity obtained from the original property as payment.

Swap and drop: A partnership may do the reverse: make the exchange, and after waiting "long enough," elect out of the partnership treatment. To avoid the step transaction treatment, the partnership should drop title to the individual partners, or refinance the new property to acquire cash to redeem the partner wanting to leave.

The IRS has indicated that a post-exchange distribution may occur relatively soon after the exchange without destroying the tax shield. (PLR 200521002)

Drop and swap: Although the ***Mitchell*** and ***Pau*** cases appear to involve what's known as a "drop-and-swap" transaction, the drop-and-swap issues were not argued in these cases. In these cases, the issue was who actually negotiated the sale, and therefore it involved a "substance over form" analysis. However, typically these multiple entity/transaction §1031 exchanges involve drop-and-swap or swap-and-drop transactions.

While drop-and-swap transactions are commonly used, the IRS and the FTB will attack the strategy on two fronts:

- Step transaction: The IRS may determine that the arrangement was designed solely to avoid taxation and disallow the exchange; and
- Investment: They will assess whether the property is held long enough to be treated as an investment.

In general terms, it is always better to provide sufficient time between the "drop" and the "swap," or vice versa, so as to avoid an audit.

FTB DELAY LEADS TO PARTIAL INTEREST ABATEMENT FOR TAXPAYER

In a precedential decision, a taxpayer who failed to report pension income on his timely filed 2010 return was allowed partial interest abatement where the FTB took an inordinately long time to assign a hearing officer to the taxpayer's case. (***Appeal of Gorin***, 2019-OTA-018P)

The taxpayer appealed an additional $8,434 in tax plus interest for the unreported income, arguing that the FTB had not timely issued the proposed assessment and that interest should be abated. In looking at the timeline of events, the FTB issued the notice within the four-year timeframe for issuing the proposed assessment so the taxpayer was liable for the additional tax. (R&TC §19060(b))

The taxpayer requested interest abatement for three periods:

1. The date the FTB first received the federal audit information (November 26, 2013) until the date the FTB sent the NPA to the taxpayer (August 15, 2014);
2. The date the FTB received the taxpayer's protest letter (October 17, 2014) until the date the FTB sent a letter explaining their position (June 15, 2015); and
3. The date of the taxpayer's reply to the FTB's position letter (which he faxed to the FTB on November 6, 2015) until the date the FTB sent a letter scheduling a protest hearing (which the FTB mailed on March 23, 2017).

First FTB written contact

For the first period, interest abatement was denied because no interest may be abated for any period accruing before the date the FTB first contacted the taxpayer in writing concerning the deficiency. (R&TC §19104(b)(1)) The NPA was the first contact from the FTB so interest that accrued prior to that contact date cannot be abated.

Reasonable response time

For the second period, the FTB conceded that six months was a reasonable period of time to issue a position letter to the taxpayer and agreed to abate the interest for the remaining time beyond six months — which is April 17, 2015, through June 15, 2015, when the taxpayer actually received the letter. The OTA did not disagree with the FTB's determination regarding reasonable response time.

Ministerial or managerial delay

For the third period, the OTA granted interest abatement due to an unreasonable delay.

The FTB can abate interest (whether paid or unpaid) if the deficiency or proposed deficiency was attributable in whole or in part to any unreasonable error or delay in performing a ministerial or managerial act. Interest can also be abated if the final deficiency was delayed due to the FTB officer or employee being dilatory in performing a ministerial or managerial act.

The definition of "managerial act" includes "the exercise of judgment or discretion relating to management of personnel." (Treas. Regs. §301.6404-2(b)(1)) Because the FTB took 248 days (from February 2, 2016, when the protest hearing file was created, until October 21, 2016) to assign a hearing officer, the OTA found this to be an unreasonable delay in performing a managerial act. The OTA also noted the lack of explanation from the FTB regarding the delay and a lack of evidence that any FTB employee was working on the case during this time period.

Practice Pointer

Requests for interest abatement due to IRS or FTB ministerial error or delay should be submitted using Form FTB 3701, Request for Abatement of Interest, which is available at:

Website
www.ftb.ca.gov/forms/misc/3701.pdf

Interest abatement

To obtain relief from interest, a taxpayer must qualify under one of three statutes: R&TC §§19104, 19112, or 21012.

FTB or IRS error or delay

Under R&TC §19104(a)(1), the FTB may abate interest related to a proposed deficiency to the extent the interest is attributable in whole or in part to:

- An unreasonable error or delay;
- By an officer or employee of FTB;
- In performing a ministerial or managerial act; and
- Which occurred after the FTB contacted the taxpayer in writing regarding the proposed assessment, provided no significant aspect of that error or delay is attributable to the taxpayer.

Under R&TC §19104(a)(3), the FTB can abate California interest payments that are based on an IRS error or delay if the IRS abated interest for the related federal deficiency under IRC §6404(e).

Financial hardship

R&TC §19112 requires a showing of extreme financial hardship caused by significant disability or other catastrophic circumstance. Catastrophic circumstances can include a sudden crippling or terminal illness, or an accident resulting in loss or reduction of income over a long period of time or a natural disaster such as fire, flood, or earthquake.

Along with the written request, the taxpayer or entity must submit a completed Form FTB 3561, Financial Statement. If the taxpayer or entity is claiming significant disability, a detailed physician's statement to support the disability must be included.

Reliance on written advice

R&TC §21012 allows the FTB to waive interest in certain circumstances when a taxpayer, after submitting to the FTB a formal written request for advice and receiving a written response, reasonably relies on that advice and fails to make a timely return or payment.

This section applies only to a taxpayer who made the written request and properly relied on such advice. In support of the request for interest waiver under this section, the taxpayer must provide a copy of the original written request, a statement made under penalty of perjury setting forth the facts on which the claim for waiver is made, and any other information that the FTB may require.

FTB TURNS TO BANK DEPOSITS TO DETERMINE INCOME

A taxpayer unsuccessfully challenged the FTB's use of the bank deposit method for reconstructing income, arguing that it was not a credible way to reconstruct his income for the years at issue because it produced income that did not match his lifestyle. The bank deposit method has been consistently upheld by the OTA. (***Appeal of Paul***, 2020-OTA-050, pet. for rehear. denied, 2020-OTA-049)

The taxpayer owned a concert venue and reported losses for tax years 2003–2005. But following an audit, the FTB reassessed tax on unreported income in the amounts of $176,566; $723,182; and $1,012,390 respectively.

Show me the money

At appeal, the taxpayer requested the amounts to be struck down, arguing that the FTB's method of arriving at these numbers was not credibly supported by evidence. He offered as proof the fact that his lifestyle did not reflect someone earning these amounts: low income in the early 2000s, living in a modest apartment, and driving old cars. He also argued that the FTB did not factor in certain deductions for legal fees and promotional expenses to arrive at the income amounts.

The OTA noted the significant increase in bank deposits for the years at issue, which suggested a significant increase in business activity at the concert venue. The test for determining the reasonableness of the FTB's determination is whether there is credible evidence to support the calculation; in this case, that credible evidence took the form of bank records and credit card records.

Regarding the taxpayer's lifestyle as related to income, the income amounts and living arrangements he cited were from prior to his ownership of the venue.

Lastly, the taxpayer's assertion that the FTB did not factor in deductions for certain business expenses fell flat when he couldn't provide evidence that he had actually paid those expenses. His claim that common sense dictates that a bill for legal services means that bill was paid did not convince the OTA.

CALIFORNIA'S TAXATION OF TRUST INCOME UPHELD

A California court of appeal held that a trust's entire California-source income is subject to California taxation regardless of the residency of its fiduciaries. (***Steuer v. FTB*** (June 29, 2020) Cal. Ct. of App., First App. Dist., Case No. A154691) This decision overturns a lower court decision in favor of the taxpayer, which held that income should be apportioned based on the residency of the beneficiaries. (***Paula Trust et al. v. California Franchise Tax Board*** (March 8, 2018) San Francisco County Superior Court, Case No. CTC-16-55126) The court of appeal decision essentially upheld the taxation scheme that has been followed by the FTB for over 85 years.

The taxpayer argued, and the lower court agreed, that California statutes applied a different taxation scheme to trusts than that applied to individual taxpayers. Under these statutes, according to the taxpayer, all of a trust's income, including California-source income, was subject to apportionment based on the fiduciaries' and noncontingent beneficiaries' residency.

However, the court of appeal ruled that under the plain reading of the governing statutes and governing regulation, all of a trust's California-source income is subject to California taxation, and only the trust's non–California-source income is subject to apportionment if one of the fiduciaries and/or noncontingent beneficiaries is a nonresident. (R&TC §17742 et seq.; 18 Cal. Code Regs. §§17743, 17744)

While the decision is great news for the FTB, it is likely the case will be appealed to the California Supreme Court, which will be given the opportunity to have the ultimate say on this matter.

Example of trust taxation in California

The Golden Trust has two cotrustees, one of whom resides in California, and the other is a Connecticut resident. There is only one beneficiary, who is a Connecticut resident.

The trust has $20,000 in undistributed California-source income and $8,000 in undistributed non–California-source income.

Under current California law, the trust would be subject to tax on $24,000 computed as follows:

100% California-source income	$20,000
50% of the non–California-source income*	4,000
	$24,000

* 50% of the trustees are California residents

The taxpayers in ***Steuer*** argued that if the non–California-source income is apportioned based on residency, then all trust income should be apportioned. Under that calculation, only $14,000 would be subject to California taxation, calculated as follows:

50% California-source income	$10,000
50% of the non–California-source income	4,000
	$14,000

2020/21 COLLECTION AND FILING ENFORCEMENT COST RECOVERY FEES

For the 2020/21 fiscal year, the updated fee amounts are:

- Bank and corporation filing enforcement fee: $83 (down from $85);
- Bank and corporation collection fee: $322 (down from $355);
- Personal income tax filing enforcement fee: $97 (up from $93); and
- Personal income tax collection fee: $316 (down from $317).
  (AB 89 (Ch. 20-7); R&TC §19254)

FTB DISCLOSURES

AB 107 (Ch. 20-264) authorizes the FTB to disclose tax return information necessary to verify a taxpayer's income to the EDD for purposes of determining an individual's eligibility for unemployment benefits, including the Pandemic Unemployment Assistance program, and the federal Disaster Unemployment Assistance program. (R&TC §19551.2)

In addition, the FTB may disclose individual income tax information for the 2018 through 2020 taxable years to the Department of Social Services for purposes of informing state residents of the availability of federal economic stimulus payments. In addition, the Department of Social Security may exchange data with the FTB, including, but not limited to, the names, addresses, and contact information of individuals who may qualify for the Earned Income Tax Credit. (R&TC §19551.2)

CASES

Taxpayer can't blame tax pro for returns they didn't prepare

A taxpayer who filed her 2012 return late and paid her 2012 and 2013 tax late was found to have been responsible for those actions herself, after she tried to blame a tax preparer she had used in the past who had pleaded guilty to filing fraudulent returns. (***Appeal of Marschall***, OTA-2019-370) The taxpayer tried to pin her filing and payment woes on the disreputable preparer, but it turned out she hadn't even used that preparer for the years at issue. The OTA didn't see a connection between the preparer's actions and the taxpayer's late filing and late payments and because she didn't offer any evidence, upheld the tax and penalties due.

Much ado about $216

The OTA found a $216 late-filing penalty did not apply where the taxpayer mailed its 2013 return and 2014 estimate payment in the same envelope, and the FTB cashed the estimate check but claimed they never received the 2013 return. (***Appeal of Non-Stop Carriers, LLC***, 2019-OTA-456; pet. for rehear. denied, 2020-OTA-030) The FTB also claimed the taxpayer had used the wrong EIN, but they had received and processed other returns in the past with the same wrong EIN. Following the 2019 appeal, the FTB's petition for rehearing was denied. The FTB argued the OTA's 2019 opinion was contrary to law and focused on the wrong code section (the IRC §7502 mailbox rule and corresponding R&TC §21027), which the OTA admitted but said their analysis under the correct code section (Gov't. Code §11003) would have led to the same result.

CDTFA

SMALL BUSINESSES GET ADDITIONAL SALES AND USE TAX RELIEF

As part of California's efforts to assist businesses struggling with the economic impacts of COVID-19, businesses with less than $5 million in annual taxable sales for the 2019 calendar year were able to defer payment of up to $50,000 in sales and use tax liability without incurring any penalties or interest. This original relief only applied to sales and use tax due on returns with original due dates between March 1, 2020, and July 31, 2020.

Under the program, participating businesses must make up to 12 monthly payments toward their deferred payment obligation. All payments must be completed within 12 months from the inception of the agreement, meaning under this program the last installment payment must be made in July 2021.

This monthly payment is in addition to any tax due above the $50,000 tax deferred.

A second program has been added, allowing these same businesses to defer payment of an additional $50,000 in sales and use tax liability for the fourth quarter of 2020 and the first quarter of 2021. The deferred tax would be paid in 12 equal monthly installments with the first payment not due until April 2021.

What if you owe less than $50,000?

Taxpayers who initially signed up for the program when they owed less than $50,000 can continue to add taxes to their deferral period until they reach the $50,000 cap. Because all payments must be completed within 12 months from the inception of the agreement, if additional amounts are added at later dates, these additional amounts must be paid back over a shorter period of time.

> ***Example of adding to deferral period***
>
> Resilience, Inc. starts a payment plan on July 31, 2020, for $20,000 for their first quarter tax due. Their first payment in the amount of $1,667 ($20,000 ÷ 12) is made in August. On October 31, 2020, Resilience added an additional $10,000 to the payment plan.
>
> The payment amount will be recalculated to reflect the new monthly payment, but the length of the plan will not change. This means Resilience must add an additional $1,111 ($10,000 ÷ 9) to its monthly payment to bring its total monthly payment to $2,778.

The total amount that may be deferred in aggregate under each program is $50,000, so in the prior example, if Resilience brings its tax liability down below $50,000, it cannot add additional tax to bring its deferred amount up to $50,000.

USED CAR DEALERS

For sales occurring after 2020, licensed used car dealers must remit sales tax to the Department of Motor vehicles with the car's registration fees within 30 days of the date of sale. (AB 85 (Ch. 20-8; R&TC §6295; Veh. Code §4456) Used car dealers are still required to file returns with the CDTFA to report the sales.

VERBAL ADVICE FROM A STATE BOARD OF EQUALIZATION ELECTED OFFICIAL CAN'T BE RELIED ON

Owners of Priscilla's Gourmet Coffee, Tea, & Gifts underpaid their sales tax for the period October 1, 2012, through September 30, 2015. They reported and remitted sales tax based on 3.77% of their total sales. However, the point of sale (POS) transaction reports showed that the business collected sales tax from customers on 15.43% of their total sales. (***Appeal of Priscilla's Gourmet Coffee, Tea, & Gifts, Inc.***, 2020-OTA-086) (**Comment:** Owners Mark and Shannon Hartman operated the business as sole proprietors prior to it being incorporated.)

The taxpayers testified that they had met with Jerome Horton, Chairperson of the State Board of Equalization (Board), and his representatives on several occasions, with the first meeting occurring on February 14, 2011 (at which time the Board was responsible for not only hearing sales tax appeals but was the agency administering the sales and use tax law).

The owners contended that Jerome Horton and his staff orally instructed them to adopt a reporting method allegedly used by Starbucks, whereby they reported an estimated percentage of the coffee shop's total sales as taxable, and that this was the method they used during the liability period.

Note: A footnote in the case states: "CDTFA concedes that, during the liability period, it entered into written agreements with certain (undisclosed) retailers to allow reporting in a manner similar to that which appellant used during the liability period." However, there is no mention of Starbucks.

According to the taxpayer, representatives from Board member Horton's staff helped decide the estimated taxable percentage to use and informed them that 5% would be too high, and 2% would be too low.

Needed written advice

A taxpayer may be relieved of taxes, interest, and penalties where failure to timely pay the tax is due to reasonable reliance on written advice provided by the CDTFA. (R&TC §6596)

The taxpayers in this case conceded that the advice was not in writing and reaffirmed these statements during testimony that they made under penalty of perjury at the oral hearing. Because the advice was not written, the CDTFA is not required to follow the advice.

Interest relief

However, the taxpayers did win some relief from the interest imposed. The OTA allowed interest relief from the due date of the return until October 11, 2016, which was when the taxpayers were made aware that Horton's advice was erroneous and the Notice of Determination was issued. However, further interest abatement was denied because interest relief is not available for a delay in payment of the tax liability because of the inability to pay the liability due to noncollection of the taxes at issue.

Practice Pointer

The sales tax exemption for food products for human consumption does not apply to sales of carbonated beverages, sales of food for consumption at facilities provided by the retailer, and hot prepared food products sold for take-out. (R&TC §6359(b)(3), (c)(2), (c)(7))

CDTFA CALLS THE SHOTS IN A BAR AUDIT

A Northern California-area bar got dinged in a sales and use tax audit when the CDTFA applied the markup method to determine the bar had underreported its sales. (***Appeal of Hyde Park Lounge, LLC***, 2019-OTA-354) The discrepancy was in part because the bar was fairly heavy-handed with the alcohol when it came to making mixed drinks.

Hyde Park Lounge is in a working-class neighborhood in San Jose. Following an audit, the CDTFA assessed an additional $19,800 in tax based on underreported sales, which they determined using the markup method. In performing the markup method, the CDTFA allowed for a 2.5-ounce pour of hard alcohol, when a typical pour is 1.5 ounces. As a note, a typical 750 ml bottle yields about 17 shots; 2.5 ounces per shot yields 10 shots per bottle.

Hyde Park argued their pours were even larger than that, and explained that this was because the bar is in a blue collar neighborhood and 80% to 90% of their patrons are regulars for whom the bartenders poured heavy drinks. Hyde Park further noted that it was unconcerned with how heavy their pours were and how this might affect profits because it was mainly focused on the potential capital gain that could come from selling the real property where the bar was located.

Hyde Park also argued against the use of the markup method because the CDTFA did not look at their register tapes during the audit.

The OTA found that the markup method was allowed (R&TC §6481), and the CDTFA did not have to take the register tapes into consideration as evidence of sales because Hyde Park may not have accurately recorded and reported all of their taxable sales.

The OTA also said it was reasonable that the auditors used a larger 2.5 ounce pour, but there was no evidence to support using an even larger pour than that. Therefore, the OTA upheld the CDTFA's assessment plus a 10% negligence penalty.

EDD

SDI RATE

State Disability Insurance (SDI) Withholding Rate			
Year	**Rate**	**Maximum wage base**	**Maximum payment**
2021	1.2%	$128,298	$1,539.58
2020	1.0%	$122,909	$1,229.09

EMPLOYER'S UI RATES

AB 103 (Ch. 20-22) prohibits the EDD from charging unemployment compensation benefits paid to employees against the employer's reserve account for the duration of all federal unemployment benefit programs specifically created to respond to the COVID-19 pandemic. (UIC §1026.2) This means employers will not see their unemployment insurance (UI) tax rates increase next year as a result of employees receiving UI benefits this year.

However, the relief will not apply if the employer fails to respond timely or adequately, in two separate instances, to the EDD's requests for information relating to an individual's benefits. (UIC §1026.1)

✎ **Practice Pointer**

Remind your clients that it is important to respond to all EDD notices to ensure their UI rates are not raised unnecessarily.

OTA

OTA ADOPTS NEW SMALL CLAIMS PROCEDURE

Effective for original appeals filed on or after January 1, 2021, the OTA will implement last year's legislation (AB 92 (Ch. 19-34)) that allows qualified taxpayers appealing a decision by the FTB or CDTFA to elect to have the appeal heard by one Office of Tax Appeals (OTA) administrative law judge rather than a three-member judge panel. (Gov't. Code §15570 et seq.; 18 Cal. Code Regs. §30000 et seq.)

A decision issued by a single ALJ will not be given precedential effect.

The election is irrevocable once made and must be made within 21 days of the date the OTA mails acknowledgement of the OTA's receipt of the agency's opening brief.

Qualified appeals

The election, which is made by the taxpayer requesting the appeal, is available in cases involving:

- An appeal of a tax, fee, or penalty imposed under the Personal Income Tax Law if the total amount in dispute, including penalties and fees is less than $5,000. Each tax year is treated separately for purposes of applying the limitation, even if the years are consolidated into a single appeal; or
- An appeal of a tax, fee, or penalty administered by the CDTFA, if:
  - The entity filing the appeal has gross receipts of less than $20 million; and
  - The total amount in dispute, including penalties and fees, is less than $50,000.

  (18 Cal. Code Regs. §30209.1(a) and (c))

For the purposes of determining the $5,000 limit on the total amount in dispute, a taxpayer may elect to not request abatement or suspension of interest, in which case the interest amount will not be included in the total. The same applies where the taxpayer elects to separately dispute their penalty amount; that separately disputed amount will reduce the total amount in dispute. Also, if the CDTFA or FTB concedes any amount at issue, that concession amount is not included. (18 Cal. Code Regs. §30209.1(b) and (f)(11))

Corporations are not eligible

Corporations challenging an assessment by the FTB are ineligible to have their appeal heard by only one ALJ. However, because the LLC tax and fee and the limited partnership annual fee are imposed under the Personal Income Tax Law, it would appear that taxpayers challenging these fees and taxes would be able to make this election.

Taxpayers cannot elect to use the small case program if:

- The amount in dispute exceeds the dollar limitations set out above;
- The FTB or CDTFA action being appealed is the denial or deemed denial of a claim for refund of $1 or more;
- The parties can't agree to the amount in dispute, and the OTA is unable to determine of that amount meets the dollar limitations for using the small case program;
- The issue on appeal is one that the OTA determines has significant potential for precedential consideration;
- The appeal involves complex issues of fact or procedure; or
- The issue being appealed is incompatible with the goals of the small case program, as determined by the OTA.

Further appeals

Any petition for rehearing will be assigned to a three-ALJ panel, with the lead ALJ on that panel being the ALJ who issued the original decision. If a petition for rehearing is granted, any new hearing will be assigned to a different single ALJ. (18 Cal. Code Regs. §30209.1(g))

A taxpayer who takes advantage of the small case program will still have the option to appeal the decision in court.

How the process will work

According to the OTA, after the appeal is filed, the OTA will mail letters to qualified taxpayers advising them of their ability to elect to participate in the small claims process.

Within 45 days of a taxpayer electing the small claims process, the OTA will schedule a meeting with the administrative law judge assigned, an OTA subject matter specialist attorney, the taxpayer and his or her representative (if applicable), and the FTB/CDTFA representative to review the issues, explain the applicable law, and determine what additional information may or may not be required.

If all the parties agree to proceed with the appeal, the matter will be submitted once all briefing/additional information is obtained (if needed) for either a written decision or oral hearing.

According to the OTA, all current administrative law judges will be rotated through the program.

Pros and cons of participating in small claims process

The benefit of participating in the program is that the OTA anticipates that the average time for resolution will be shortened from 280 days to approximately six months.

The downside of the program is that the decision will be made by only one judge, so you will be putting all your eggs in one basket.

DISASTER VICTIMS

Responding to the President's major disaster declaration and the Governor's executive order (Governor's Executive Order N-81-20) mandating state tax agencies to provide relief to California wildfire victims, the IRS and FTB have granted relief to taxpayers in the counties listed in the upcoming box. (IRS News Releases CA-2020-07 (October 19, 2020) and CA-2020-06 (August 26 2020); FTB News Releases (October 7, 2020, August 28, 2020, November 5, 2020)) Because there are more counties included in the Governor's state of emergency, more taxpayers will be provided relief from state filing deadlines than federal filing deadlines.

Disaster Filing/Payment Extension Due Dates		
Extended filing/ payment deadline	**Applies for both federal and California returns/payments**	**Applies to California returns/payments only**
December 15, 2020	Butte, Lake, Lassen, Monterey, Napa, San Mateo, Santa Clara, Santa Cruz, Solano, Sonoma, Trinity, Tulare, and Yolo **Covered period:** August 14, 2020–December 15, 2020	Del Norte, Mariposa, Nevada, Shasta, Stanislaus **Covered period:** October 7, 2020–December 15, 2020
January 15, 2021	Fresno, Los Angeles, Madera, Mendocino, Napa, San Bernardino, San Diego, Shasta, Siskiyou, and Sonoma **Covered period:** September 4, 2020–January 15, 2021	N/A

RETURNS/PAYMENTS IMPACTED

The relief specifically applies to:

- 2019 calendar-year tax returns (but not payments) due on extension on September 15, 2020, or October 15, 2020 (as well as any fiscal-year returns due during the applicable covered period);
- Quarterly estimated income tax payments due on September 15, 2020;
- Quarterly payroll and excise tax returns due on October 31, 2020; and
- Tax-exempt organization returns on extension that are due on November 15, 2020.

In addition, penalties on payroll and excise tax deposits will be abated for deposits due after:

- August 14, and before August 31, 2020, if the payments are made by August 31, 2020, for those taxpayers given an extension to file and pay their taxes until December 15, 2020; and
- September 4, 2020, and before September 21, 2020, if the payments are made by September 21, 2020, for those taxpayers given an extension to file and pay their taxes until January 15, 2021.

Taxpayers located in federal disaster areas are given until December 15, 2020, or January 15, 2021, as applicable, to perform other time-sensitive actions described in Treas. Regs. §301.7508A-1(c)(1) and Rev. Proc. 2018-58, for both federal and California purposes. For more details, see IRS CA-2020-07 available at:

Website
www.irs.gov/newsroom/irs-announces-tax-relief-for-september-california-wildfire-victims

AFFECTED TAXPAYERS

Federal extension relief is automatically available to taxpayers with an IRS address of record located in the disaster area, so no extension requests are required for these taxpayers. Taxpayers who are working in the disaster area or whose records needed to complete a return are located in the disaster area may call the IRS to request a disaster-related extension at:

☎ **Telephone**
(866) 562-5227

For California returns, call the FTB Tax Practitioner Hotline at:

☎ **Telephone**
(916) 845-7057

GOVERNOR'S EXECUTIVE ORDER

The Governor has issued an executive order to the FTB, CDTFA, State Board of Equalization, and the Office of Tax Appeals to "use their administrative powers where appropriate" to provide relief to individuals and businesses impacted by the wildfires. These agencies have been directed to grant:

- Extensions for filing, audits, billing notices, and assessments; and
- Relief from subsequent penalties and interest.
  (Executive Order N-81-20 available at: www.gov.ca.gov/wp-content/uploads/2020/09/9.25.20-EO-N-81-20-signed.pdf)

The order also suspends the CDTFA's requirement that taxpayers must provide a sworn statement detailing the facts for a claim for relief as a result of a disaster. Taxpayers will not be required to file the sworn statement until three months after the due date of the return or payment.

In addition, taxpayers in affected counties will be granted an extension until June 1, 2021, to file a claim to have the value of their property reappraised.

The order impacts all taxpayers located in the counties listed in the chart on page 11-17.

NONCONFORMITY TO TAXPAYER CERTAINTY AND DISASTER TAX RELIEF ACT

California, however, does not conform to the TCDTRA provisions for disasters — with the exception of penalty-free disaster distributions and, we believe, recontributions of withdrawals for home purchase where the transaction was not complete.

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.*

10. Which of these statements is true regarding transfers of real property between parents and children and other property issues under Proposition 19?

    a) The child receiving the property must use the property as their primary residence
    b) The provision for the exclusion of $1 million of assessed value upon the parent-child transfer would be eliminated
    c) Taxpayers over age 55 or disabled are able to transfer their base-year value an unlimited number of times
    d) The ability of taxpayers over age 55 or severely disabled to transfer their property tax adjusted base value to a replacement property is eliminated

SOLUTIONS TO REVIEW QUESTIONS

10. Which of these statements is true regarding transfers of real property between parents and children and other property issues under Proposition 19? **(Page 11-1)**

    a) Correct. It is unclear, however, if all children would be required to live in the inherited property together if multiple children receive it.
    b) Incorrect. For a primary residence, only the first $1 million of assessed value would be excluded, but the non-principal residence exclusion would be eliminated.
    c) Incorrect. The base-year value transfer is allowed up to three times.
    d) Incorrect. This provision is expanded in that these taxpayers would be allowed to transfer their base value to any county in the state rather than the limited number of counties now available.

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TAX • ANALYSIS • EDUCATION

Chapter 12

Practitioner Aids

PRACTITIONER AIDS

1040 ENGAGEMENT LETTER

This letter is provided for information purposes, only. Spidell Publishing, Inc.® 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 2020 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 15, 2021. 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 15 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 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.**

By signing this agreement, you authorize [YOUR FIRM NAME] to execute the Online Account View Access Authorization on the Franchise Tax Board's website. You understand [YOUR FIRM

NAME] will have view-only access to all the tax year information available on the FTB's website that is associated with you. This authorization remains in effect until you revoke it in writing.

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
To download a copy of this client letter, go to:
www.caltax.com/files/2020/letter1040.doc

Additional engagement letters for Forms 1120, 1120S, and 1065 are also available online at:

Website
Form 1120: www.caltax.com/files/2020/letter1120.doc
Form 1120S: www.caltax.com/files/2020/letter1120s.doc
Form 1065: www.caltax.com/files/2020/letter1065.doc

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 2020 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 15, 2021, for the 2020 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, 2021, for the 2020 tax year.

Stimulus payments: The CARES Act, which was passed into law to help stimulate the economy during the COVID-19 pandemic, authorized stimulus payments (also referred to as economic impact payments) that were issued to many taxpayers.

People who received the $1,200 economic impact payments should have received IRS Notice 1444, Your Economic Impact Payment, notifying them of the amount of the payment they should have received. The economic impact payments are treated as advance tax credits against your 2020 income taxes. As such, you will need to include a copy of Notice 1444 when you provide us with your other tax documents. We will also need for you to provide us with the amount of your second stimulus check, which was sent out in January.

Unemployment compensation: Expanded unemployment insurance benefits were available to many taxpayers due to the COVID-19 pandemic. California does not tax unemployment compensation, but the federal government does. If you received unemployment compensation, even if you elected to have federal income taxes withheld, it's likely that the withholding was insufficient to cover your tax liability. Be sure to contact us early so we can determine whether you have additional tax liabilities before the April 15 payment deadline.

Retirement changes: In December, 2019, the SECURE Act was passed into law that made many changes to tax provisions for retirement accounts for tax years beginning in 2020. Among many other changes the SECURE Act:

- Increases the age at which required minimum distributions must begin from age 70½ to age 72;
- Removes the age restriction for contributions to traditional IRA accounts, so taxpayers can continue making retirement contributions even after age 70½, providing there is sufficient earned income;
- Makes significant changes to inherited retirement account rules where a taxpayer passes away after December 31, 2019.

California introduced penalties for failure to carry health insurance: The federal government repealed the penalty for failure to maintain health insurance (referred to as the "individual mandate") starting with the 2019 tax year. In response to the federal government's repeal, the state of California will charge an individual who fails to secure coverage an annual penalty of $695 or more when they file their 2020 California tax return. The minimum penalty for families of four or more individuals is $2,085. The penalty can rise as high as 2.5%of household income, which can be many thousands of dollars. Be sure to maintain your health insurance coverage to avoid this costly California tax penalty.

<u>Property transactions:</u> 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.

<u>1099s and K-1s:</u> If you received 1099s or K-1s from investments in 2020, 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.

<u>Foreign accounts:</u> We must report overseas assets owned by businesses as well as individuals. So, 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

P.S. Let's try to file your return as early as possible so you can get your refund quickly!

Website

To download a copy of this client letter, go to:
www.caltax.com/files/2020/organizerletter.doc

SOLAR CLIENT LETTER

Dear [CLIENT NAME]:

Solar energy is growing, and California is leading the way. More and more Californians each year are installing solar panels on their home, businesses, and rental properties, and the energy cost savings can be substantial.

There can also be substantial tax savings as you may get a tax credit of up to 26% of the cost of buying and installing the panels. Under the Consolidated Appropriations Act of 2021, the credit remains at 26% for 2021 and 2022. Home batteries may also qualify for the solar credit, even if you installed solar panels and claimed a solar credit in the past, but certain requirements must be met.

If you are considering putting solar panels on your property or installing a home battery, beware that there are many aggressive salespeople who are misrepresenting the tax savings that you may be entitled to. Note the following:

- Leasing solar panels may be the most economical choice for you; however, tax credits are only available if you purchase the panels;
- Roof replacement and repair costs are typically not available for solar credits;
- If you finance the purchase of the solar panels through any of the programs that allow you to make your finance payments through your property taxes, that portion of your property taxes is not deductible as property tax;
- If you install solar panels on your business or rental property, then you may be required to pay back some or all of the tax credits if you sell the property or convert it to personal use within five years of installing the solar panels; and
- If you are an owner of a partnership, LLC, or S corporation that installs solar panels on its property, then you may be able to claim the tax credits on your personal income tax return, but special rules may limit your credit.

There are other tax and nontax considerations regarding whether you should lease or buy your panels or whether you should go with solar at all. Please contact us to discuss.

Sincerely,

Your tax professional

Website

To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-solar.doc

LENDER LETTER

Many of our subscribers have told us that they are again receiving lender letters asking for verification of tax information contained on borrowers' tax returns. We suggest that when asked for verification, you use the following sample lender letter we have created with the help of CAMICO, a major insurance carrier for CPAs in California.

To Whom It May Concern:

I prepared individual income tax returns that have included Schedules C for [INSERT NAME HERE] for [INSERT WHICH YEARS] tax years based upon information given to me by [INSERT NAME HERE]. My services to [INSERT NAME HERE] were and remain limited to the preparation of individual federal and state income tax returns from information provided to me by my client. I have not reviewed, audited, or otherwise attempted to verify any of the information given to me by [INSERT NAME HERE]. Consequently, I cannot affirm its accuracy or completeness.

Sincerely,

[YOUR NAME]

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/letterlender.doc

AUTHORIZATION TO CONTACT FAMILY OF A CLIENT WITH DEMENTIA

Dear [CLIENT NAME]:

Many of my clients would like me to contact a family member or friend if I cannot reach them, they have not filed a return, or if I have a concern about their financial decisions. If you would like to provide me with permission to release your tax information to a family member or friend, please sign below. You may revoke this permission at any time.

I, CLIENT NAME authorize TAX PROFESSIONAL NAME to contact NAME OF CONTACT at E-MAIL ADDRESS or PHONE NUMBER if TAX PROFESSIONAL NAME is unable to reach me, if I have not filed a tax return, or if TAX PROFESSIONAL NAME has a concern about my financial decisions.

I understand that I may revoke this permission in writing at any time.

Signed,

____________________________ __________________

Name Date

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/contactfamily.doc

IRA/UBI CLIENT LETTER

Dear [CLIENT NAME],

When funds within a taxpayer's IRA are invested in a limited partnership, the partnership reports the IRA's portion of the partnership's income and expense activity on a Form 1065 and Schedule K-1, as well as that of all other partners. (The term IRA in this situation includes traditional IRAs, SEP-IRAs, SIMPLE IRAs, and Roth IRAs.)

We are sending you this letter as we see that you have a retirement account that is invested in one or more such partnerships. This income is not reportable on your Form 1040 because it is inside the IRA. However, the income in these investment vehicles is often considered under the Internal Revenue Code to be "unrelated business income," or UBI, to a qualified retirement plan.

When cumulative UBI in a given tax year exceeds $1,000 for a particular retirement plan, a Form 990-T must be filed, which reports the UBI and calculates the tax. Even if UBI nets to a loss, Form 990-T should be filed, as the loss can be carried back and/or forward, much like a net operating loss.

Tax rates for UBI are the same as those used for trusts (fiduciaries), with the highest bracket being 37%. In addition, any resulting tax must be paid directly from IRA assets to avoid the risk of a prohibited transaction, resulting in a disqualification of the entire IRA, with the worst-case scenario of the entire balance of your IRA being deemed distributed in one lump sum and therefore fully taxable.

IRA trustees must prepare Form 990-T, but in the event they do not fulfill their obligation, it's important that the form be prepared by someone, as the IRA could potentially be disqualified. To avoid complications, we strongly suggest that you contact your IRA trustee immediately to discuss the Form 990-T requirement and coordinate its preparation and filing, if applicable. Because we are not your IRA trustee, we do not prepare Form 990-T, and the IRA Schedule K-1 is not part of your individual income tax return.

If the trustee of your IRA does not prepare the form as required and provide you with a copy, we advise you to seek legal counsel to protect your IRA investment.

If you have any questions, please give us a call.

Sincerely,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-iraubi.doc

IRA-TO-CHARITY CLIENT LETTER

Dear [CLIENT NAME],

If you have reached age 70½ and are evaluating charitable giving options, you may consider making a charitable donation directly from your IRA.

The benefits

Contributions made directly from your IRA to a charity reduce the taxable portion of your IRA distributions and count toward your annual required minimum distribution (RMD). For example, if your RMD is $10,000 and you give $2,000 to a charity directly from your IRA, then you are only required to take an additional distribution for the year of $8,000. In this example, only the $8,000 that you received is taxable to you.

In this way, charitable contributions made directly from your IRA are deductible to you even if you do not itemize your deductions. With the major federal tax reform law that went into effect in 2018, many more seniors are not itemizing their deductions. This means that the only way these seniors can receive a tax benefit for making charitable contributions is if the contribution comes from an IRA.

Additionally, because charitable donations made directly from your IRA reduce your taxable income, they can have a compounding beneficial effect. For example, the taxable amount of your Social Security benefits depends on your other income. By reducing your other income by making charitable contributions directly to a charity, it may also reduce the amount of your taxable Social Security benefits.

The limitations

- You must be over age 70½;
- Contributions cannot come from a SEP IRA or a SIMPLE IRA;
- The annual maximum that can be donated to charity from an IRA is $100,000; and
- Distributions cannot be made to private foundations, donor advised funds, charitable remainder trusts, or charitable annuity trusts.

If you are interested in taking advantage of this provision, please do not hesitate to contact my office so we can discuss the details.

Sincerely,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-iracharity.doc

LETTER FOR CLIENTS CONSIDERING LLCs

Dear [CLIENT NAME]:

RE: You may want to think twice before forming an LLC

Many people feel they need to form an LLC to protect themselves and their assets. But often, these concerns can be more easily addressed with insurance. You should be aware that the liability protection provided by an LLC is limited, and there are annual taxes and fees that must be considered. Also note that the FTB has been aggressively pursuing nonresident LLC members, which may deter out-of-state investors.

Limited liability protection

Generally, members of an LLC are not personally liable for the debts of the LLC. A member's acts may bind the LLC, but they generally do not subject individual members to personal liability. However, like the corporate shareholder, the LLC member is personally responsible for his or her tortious or malpractice acts.

An LLC member's non-LLC assets may be attached if:

- The member caused the event;
- The member was negligent in hiring the person who caused the problem (e.g., the member knew that the employee prepared fictitious Schedules C); or
- The member was responsible for supervising the activity (e.g., a project manager overseeing a job).

What about insurance?

For LLCs that hold property, all lenders will require the owner of the property to carry insurance on the property. Depending on your needs, you may be able to purchase an additional $1 million of insurance for in the neighborhood of $250. Cost of insurance is based on a number of factors, including who the carrier is and what other coverage the carrier provides.

In short, here's the choice: Pay the $800 LLC annual tax plus the cost to prepare the return, or pay $250 for $1 million of additional coverage.

The annual tax and fee

Be aware that, at a minimum, the LLC is liable for an $800 annual tax, and that obligation is indefinite until the LLC formally dissolves. LLCs that have gross receipts attributable to California of $250,000 or more must also pay an LLC fee. The LLC fee starts at $900 and can be has high as $11,790 per year.

While LLCs are an excellent structure for many businesses, they aren't the right choice for everyone. If you are considering forming an LLC, contact me so we can address the issues above and help you decide if an LLC is a good fit for you.

Yours truly,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-consideringllcs.doc

SALES AND USE TAX NEXUS CLIENT LETTER

Dear [CLIENT NAME]:

In July, 2018, the U.S. Supreme Court issued one of the biggest tax cases in decades, which dramatically expands when states can require out-of-state businesses selling to customers in their state to collect and remit sales and use taxes. This change has a huge impact on anyone selling items or services over the internet.

If you are selling items to customers in other states, it's important that we talk soon so we can set up systems to track what sales are being made where, and whether you might be required to register in any other state due to the expanding filing requirements. Being aware of these changes can prevent you from being subjected to numerous fines and penalties.

Prior to the U.S. Supreme Court's decision in ***Wayfair, Inc. v. South Dakota***, a state could only require a business to collect sales or use taxes from customers if the business had some type of physical presence in the state, usually by owning, leasing, or storing property in the state or having an employee or agent in the state.

Now states can require out-of-state sellers to collect and remit sales and use taxes if they make a minimum number of sales to customers in their state (in terms of dollars and/or transactions), even if they have no physical presence in the state.

This is a huge revenue raiser for the states and, not surprisingly, states are changing their requirements for out-of-state sellers on an almost daily basis. To complicate matters even more, each state and each local taxing jurisdiction may have different rules.

Most small retailers making only a few sales into a state will not be impacted because states are providing exceptions for businesses only making a minimum level of sales (e.g., less than $100,000 in annual **gross** revenues and/or less than 200 annual transactions). However, each state can set its own threshold. For example, California's threshold is $500,000 in sales to California customers, with no threshold based on the number of sales.

If there are any states where you have substantial sales, call me so we can make sure you are complying with that state's requirements.

Sincerely,

Your tax professional

Website
To download a copy of this letter, go to:
www.caltax.com/files/2020/cl-wayfair.doc

VIRTUAL CURRENCY CLIENT LETTER

Dear [CLIENT NAME]:

With the rapid fluctuation in value of virtual currencies and the ability to trade Bitcoin futures, the IRS is placing special scrutiny on these transactions.

For example, the IRS began a letter campaign in 2019 aimed at taxpayers with known virtual currency holdings who may not have properly reported the transactions. The letters are: Letter 6174-A, Letter 6174, and Letter 6173. Let us know if you received one of these letters.

In general, here are some things to keep in mind:

- The IRS has determined that virtual currency is treated as property, not currency;
- For taxpayers who have held a virtual currency for more than a year, the gain will qualify for capital gains rates. Conversely, those with capital losses are subject to the $3,000 capital loss limitation;
- Wages paid to employees and payments made to independent contractors using virtual currency are taxable to the employee/worker; and
- Taxpayers who “mine” the virtual currency must include in gross income the fair market value of the currency on the date it is mined. If the taxpayer is in the trade or business of mining currency and is not considered an employee, then the “mining” income is subject to self-employment taxes.

Please advise us whether you have mined, bought, sold, sent, or received any virtual currencies in the last few years. This includes spending virtual currency to make a purchase, because this can trigger a reportable gain or loss. Every time bitcoin is used for a purchase you must compute the gain based on the transaction.

We want to make sure these transactions are correctly tracked and reported. Please do not hesitate to contact us with any questions.

Sincerely,

Your Tax Professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-virtualcurrency.doc

GIG ECONOMY CLIENT LETTER

Dear [CLIENT NAME]:

If you use your own car to earn income through a ride-sharing service like Uber or Lyft or a delivery service such as DoorDash or Grubhub, there are very specific rules for deducting your vehicle-related expenses that we should discuss. For your convenience, I am writing to you to provide a brief summary of the most important rules.

General vehicle expenses can be deducted using one of two methods. The first and easiest is the standard mileage rate (calculated by multiplying $0.575 per mile in 2020 and $0.56 per mile in 2021); using the standard mileage rate is a simple way to deduct an estimated amount of all your vehicle expenses, such as maintenance, tires, gas, and license and registration fees.

Alternatively, you can deduct the actual vehicle expenses, which might potentially yield a larger deduction, but you'll need to keep detailed documentation and receipts relating to these expenses.

Under either method, you'll need to calculate the percentage you used your car for business purposes and the deduction will be based on that percentage and whichever method we use to deduct your vehicle expenses, you must maintain a daily mileage log as proof of your mileage. Most app-based services provide a tax summary of your mileage to help you track your business mileage.

When counting your miles to determine the business percentage of use, you can include any business-related mileage that was driven for the following:

- Mileage driven to pick up a ride request or a package for delivery;
- Any mileage you drove between dropping off a passenger (or delivery) and picking up the next one; and
- Mileage driven before a fare (or delivery request) was cancelled.

Miles between your home and your first fare/delivery and between your last fare/delivery and your home are considered "commuting miles" which are not counted.

Expenses that are deductible for drivers in addition to vehicle expenses include:

- Mobile phones (cost of the phone and billing charges) and accessories (mounts, chargers, cradles, etc.);
- Business taxes and licenses;
- City and airport fees, Freeway, highway, and bridge tolls, and electronic toll transponders;
- Water, snacks, and amenities (such as tissue or hand sanitizer) provided to customers; and
- Floor mats, car tool kits, and tire inflators and pressure gauges.

All out-of-pocket expenses must be substantiated with receipts.

Do not hesitate to contact us if you have any questions or would like further guidance.

Sincerely,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-gigeconomy.doc

PARTNERSHIP AUDIT RULES CLIENT LETTER

Dear [CLIENT NAME]:

You are receiving this letter because there are special rules pertaining to the way the IRS audits all partnerships (and LLCs taxed as partnerships) that went into effect in 2018.

Additional taxes assessed due to an audit will be owed by the partnership or LLC directly and will be assessed in the "adjustment year" based on adjustments found in the "reviewed year." This effectively shifts the economic burden of the additional tax liability from those persons who were partners for the year under audit (the reviewed year) to the current partners in the partnership or LLC. In order to address potential partner inequities resulting from these new partnership audit rules, we recommend discussing amendments to your partnership agreement.

In general, all adjustments resulting from the audit will be netted, and if an "imputed underpayment" for the adjustment year is calculated, then it is assessed using the highest tax bracket for individuals. In 2020, the highest tax rate for individuals is 37% for ordinary income.

The new rules allow partnerships to elect out of the new partnership audit process annually on your partnership's income tax return, but only if certain requirements are met. You can't wait until you are selected for audit to elect out of the partnership-level audit. For partnerships that are eligible to elect out of the new partnership audit process, doing so is often the most appropriate course of action.

Also under the new rules, partnerships will need to elect a partnership representative. This representative does not need to be a partner and is the only party able to act on behalf of the partnership and all of its partners. All agreements made by the partnership representative are binding settlement agreements with the IRS for all partners. The election of a partnership representative should be accomplished by amending your partnership agreement and is made on the partnership's return each year.

California rules

Legislation signed in 2018 allows the FTB to assess California tax resulting from a federal determination assessed against a partnership as a result of a partnership audit. It does not allow the FTB to independently audit and assess at the partnership level; it only allows the FTB to apply the federal adjustments following an IRS audit.

Further information

This is a simplified overview of the new complex partnership audit rules. Please contact our office to discuss how these new rules will affect your partnership and the changes you should consider making to your partnership agreement to address these new audit rules.

Sincerely,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-partnershipaudit.doc

BUSINESS INTEREST CLIENT LETTER

Dear [CLIENT NAME]:

The amount of business interest expense that can be deducted for many taxpayers is limited from year-to-year. Exceptions are made for small taxpayers whose average business gross receipts for the three years are less than $26 million. However, there are many scenarios where "small taxpayers" will still find themselves subject to the new business interest limitation rules. Additionally, certain real estate and farming businesses have the option to elect out of the new rules (at a cost).

In short, the deduction for business interest expense is now limited to the sum of:

- Business interest income;
- 30% of business "adjusted taxable income"; and
- Floor plan financing.

The business interest limitation rules have many complicated nuances, including:

- An expansive definition of business interest expense that encompasses more than the typical bank-type interest expense;
- An expansive definition of "tax shelter" for any flowthrough business (such as a partnership, LLC, or S corporation) if more than 35% of losses during the taxable year are allocated to limited partners or limited entrepreneurs; and
- Special reporting requirements for tracking and carrying over disallowed business interest expense to future tax years.

If you are a business or you are an investor in a partnership, LLC, or S corporation, then we should schedule some time to discuss the business interest limitation rules and how they may affect you. Don't be fooled by the $26 million threshold for small businesses because even small investors can be blindsided by exceptions.

Sincerely,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-businessinterest.doc

CALIFORNIA'S INDIVIDUAL HEALTH CARE MANDATE CLIENT LETTER

Dear [CLIENT NAME],

Beginning January 1, 2020, California imposes penalties generally equal to $750 per adult against California residents who do not have minimum essential health care coverage for the entire year. The penalty for a dependent child is half of what it would be for an adult.

A typical family of four or more persons that goes uninsured for the whole year would face a penalty of at least $2,250. However, for higher income adults/households, the penalty can be as much as 2.5% of household income above certain thresholds, so a household with $500,000 of household income can face a penalty of close to $10,000.

If you do not have adequate health insurance coverage during the 2020 tax year, the penalty will be imposed, although it does not have to be paid until you file your 2020 tax return.

If you do not have health insurance through your employer, you can sign up for health care coverage online at Covered California (www.coveredca.com).

Subsidies available

California is providing subsidies to assist taxpayers who purchase health care coverage through the Covered California website. Subsidies are available to people whose household income is at or below 600% of the federal poverty line (600% of the federal poverty line is equal to $74,940 for a single person, and up to $154,500 for a family of four).

Exemptions

Many taxpayers can avoid the penalty if they qualify for an exemption from the requirement to obtain health care insurance coverage. Common exemption examples include, but are not limited to:

- Coverage is unaffordable (you must meet specific requirements);
- You've experienced a severe hardship (e.g., homelessness, eviction, bankruptcy, domestic violence, illness or death in the family, etc.); or
- You have a short-term coverage gap (three months or less) due to switching jobs.

Most of the exemptions are the same ones that applied under the federal Affordable Care Act.

Call our office if you have any questions as to whether you might qualify for an exemption.

Although this new health care mandate will not impact the filing of your 2019 tax return, make sure to get coverage as soon as possible to avoid the penalty when we file your 2020 return. Open enrollment through Covered California ends January 31, 2020. We look forward to sharing more information with you on this issue as well as other new issues that will impact your taxes for the 2019 tax return when we see you for your annual appointment.

Sincerely,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-healthcareca.doc

IRC §199A CLIENT LETTER (INDIVIDUAL CLIENT)

Dear [CLIENT NAME]:

The major tax reform bill that went into effect in 2018, known as the Tax Cuts and Jobs Act (TCJA), created the qualified business income deduction under IRC §199A. The qualified business income deduction provides taxpayers a deduction of up to 20% of their business or rental income, but only if certain requirements are met.

If you receive income reported from any of the following sources, you may qualify for this new 20% deduction:

- Sole proprietorship business (including statutory employees);
- S corporation;
- Partnership or limited liability company (LLC);
- Real estate investment trust (REIT);
- Publicly traded partnership (PTP);
- Estate or trust;
- Rental property; or
- Farm or fishing boat.

However, income you receive as an employee and reported on Form W-2 is not eligible, nor are guaranteed payments received by a partner or investment income, such as interest, dividends (other than REIT dividends), and capital gains, even if they are received from one of the business entities listed above.

There are many other rules and limitations that accompany the qualified business income deduction, particularly for rental properties, but there are also many planning strategies we can employ to help you maximize this very valuable deduction.

The best tax planning is done as far in advance as possible. Please do not hesitate to contact us as soon as possible with any questions so we can get a jump start on maximizing your qualified business income deduction.

Sincerely,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-199aindividual.doc

IRC §199A CLIENT LETTER (BUSINESS ENTITY CLIENT)

Dear [CLIENT NAME]:

The major tax reform bill that went into effect in 2018, known as the Tax Cuts and Jobs Act (TCJA), created the qualified business income deduction under IRC §199A. The qualified business income deduction provides taxpayers a deduction of up to 20% of their business or rental income, but only if certain requirements are met.

Your business entity is ineligible for the qualified business income deduction, but if your business operates in any of the following entity forms, the income you generate may qualify for this new 20% deduction for your owners and investors:

- S corporation;
- Partnership or limited liability company (LLC);
- Real estate investment trust (REIT);
- Publicly traded partnership (PTP);
- Tenancy-in-common rental properties; or
- Farm or fishing boat.

However, income you pay to employee-owners and report on form W-2 is not eligible, nor are guaranteed payments paid to partners. Additionally, an owner or investor's distributive share of investment income, such as such as interest, dividends (other than REIT dividends), and capital gains, are ineligible for the deduction.

There are many other rules and limitations that accompany the qualified business income deduction, particularly for rental properties, but there are also many planning strategies we can employ to help you maximize this very valuable deduction.

For example, your total income may affect the amount you can deduct and there are things we can do to adjust your income up or down to be able to claim or increase your deduction.

The best tax planning is done as far in advance as possible. Please do not hesitate to contact us as soon as possible with any questions so we can get a jump start on maximizing your qualified business income deduction.

Sincerely,

Your tax professional

Website
To download a copy of this client letter, go to:
www.caltax.com/files/2020/cl-199abusinessentity.doc

TAX EXTENDERS

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA) was signed into law on December 27, 2020. The TCDTRA extended many tax provisions that were scheduled to expire at the end of 2020 for an additional one year, five years, or permanently. The Further Consolidated Appropriations Act of 2020 (FCAA) also had extended several expired tax provisions beyond the 2020 tax year.

Tax Extenders		
Provision	**IRC §**	**TCDTRA/FCAA update**
Individual provisions		
Above-the-line deduction for certain higher education expenses, including qualified tuition and related expenses	§222	Repealed for years after 12/31/2020
Treatment of mortgage insurance premiums as qualified residence interest	§163(h)(3)(E)	Extended through 2021
Exclusion from income of qualified canceled mortgage debt income associated with a primary residence	§108(a)(1)(E)	Extended through 2025 taxable year
The nonbusiness energy property credit	§25C	Extended through 2021
The exclusion of specified income and payments made to volunteer firefighters and emergency medical responders	§139B	Made permanent
Business provisions		
Special expensing rules for film, television, and live theatrical production	§181	Extended through 2025
Three-year depreciation for race horses two years old or younger	§168(e)(3)(A)(i)	Extended through 2021
Seven-year recovery period for motorsports entertainment complexes	§168(i)(15)(D)	Extended through 2025
Accelerated depreciation for business property on Indian reservations	§168(j)(9)	Extended through 2021
The New Markets Credit	§45D	Extended through 12/31/2025
The Credit for Health Insurance Costs of Eligible Individuals	§35	Extended through 2021
The Employer Credit for Paid Family and Medical Leave	§45S	Extended through 2025
The Work Opportunity Credit	§51	Extended through 12/31/2025
Various incentives related to beer, wine, and distilled spirits, including the reduced rate of excise taxes	§§5001, 5041, 5051	Made permanent
The Indian Employment Credit	§45A	Extended through 2021
Designations for empowerment zones	§1391	Extended through 12/31/2025
		(continued)

Tax Extenders (continued)		
Provision	**IRC §**	**TCDTRA/FCAA update**
Business provisions (continued)		
The Railroad Track Maintenance Credit	§45G	Made permanent
The Mine Rescue Team Training Credit	§45N	Extended through 2021
The look-thru rule for related controlled corporations	§954	Extended through 2025
Energy provisions		
The Alternative Fuel Vehicle Refueling Property Credit	§30C(g)	Extended through 2021
The Credit for Qualified Fuel Cell Vehicles	§30B	Extended through 2021
The Credit for Two-Wheeled Plug-In Electric Vehicles	§30D(g)(3)(E)(ii)	Extended through 2021
The Credit for Energy Efficient Homes	§45L	Extended through 2021
The dates at which construction must begin for certain qualified energy producing facilities. The phaseout of the credit for wind facilities is decreased from 60% to 40% for facilities constructed beginning during 2020 or 2021	§45(d)	Extended through 2021
The election to treat certain qualified facilities as energy property	§48	Extended through 2021
Biodiesel fuel credit	§40A	Extended through 2022
Second Generation Biofuel Producer Credit	§40	Extended through 2021
The credit for Indian coal production facilities	§45(e)(10)	Expires at the end of 2020
The special depreciation allowance for second generation biofuel plant property	§168(l)	Expires at the end of 2020
The deduction for energy efficient commercial buildings	§179D	Made permanent
The special rules for sales or dispositions to implement Federal Energy Regulatory Commission or state electric restructuring policy for qualified electric utilities	§451(k)(3)	Expires at the end of 2020
The excise tax credits for alternative fuels	§6426(d)	Extended through 2021
The excise tax credits for biodiesel fuel mixtures	§6427(e)	Extended through 2021
Residential energy property credit (solar) 26% credit extended through 2021, drops to 22% in 2022	§25D	Expires 1/1/2023
Medical expense deduction		
The 7.5% threshold for claiming the medical expense deduction (extended for the 2019 and 2020 tax years)	§213(f)	Made permanent

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. 2020-45)		
	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 $270 for 2020 and 2021.	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 $270 for 2020 and 2021.	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 $270 for 2020 and 2021.	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
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)

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 15, 2021, for 2020 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

SUMMARY OF SECURE ACT PROVISIONS

The following chart summarizes the highlights of the SECURE Act provisions that were passed as part of the Further Consolidated Appropriations Act of 2020 and explains whether or not California conforms to the changes.

SECURE Act Provisions — Further Consolidated Appropriations Act of 2020, Division O		
Description	**Citation**	**CA conformity**
IRA and Individual Provisions		
Allows individuals age 70½ or older to make deductible contributions to a traditional IRA, applicable to contributions made for taxable years beginning after December 31, 2019. Amounts contributed after age 70½ reduce the $100,000 IRA-to-charity limit, applicable to distributions made for taxable years beginning after December 31, 2019	IRC §219(d); SECURE Act §107	No (awaiting confirmation from FTB). Contributions would not be deductible for California purposes
Increases the age for required minimum distributions from age 70½ to age 72. Applies only to taxpayers who turn age 70½ after December 31, 2019	IRC §401(a)(9)(C)(i)(I); SECURE Act §114	Yes
Allows for penalty-free withdrawals of up to $5,000 from retirement plans (other than defined benefit plans) for any qualified birth or adoption distributions, applicable to distributions made after December 31, 2019	IRC §72(t)(2); SECURE Act §113	Yes (awaiting confirmation from FTB)
Treats certain nontuition fellowship and stipend payments paid to graduate and postdoctoral students as earned income for IRA contribution limit purposes, applicable to taxable years beginning after December 31, 2019	IRC §219(f); SECURE Act §106	Yes
Allows In-Home Supportive Services (IHSS) workers to treat excludable difficulty-of-care payments as earned income for purposes of calculating the worker's IRA or defined contribution plan contribution limits, applicable for defined contribution plans to plan years beginning after December 31, 2015, and with respect to IRAs, to contributions after December 20, 2019	IRC §§408(o), 415(c)(3); SECURE Act §116	Yes
		(continued)

SECURE Act Provisions — Further Consolidated Appropriations Act of 2020, Division O (continued)		
Description	**Citation**	**CA conformity**
Expands the definition of qualified higher education expenses for purposes of §529 plans to include costs associated with registered apprenticeships and up to $10,000 of qualified student loan repayments (including those for siblings). Student loan interest payments paid from §529 accounts are ineligible for the above-the-line deduction for student loan interest. Applicable to distributions made after December 31, 2018	IRC §§221(e), 529(c); SECURE Act §302	No. Such distributions would be includable in California taxable income and subject to 2.5% premature distribution penalty
Revises the RMD rules for inherited IRAs to require a 10-year RMD unless beneficiary is the surviving spouse, is disabled or chronically ill, is an individual who is not more than 10 years younger than the employee (or IRA owner), or a minor child of the employee, generally effective for RMDs with respect to employees/IRA owners with a date of death after December 31, 2019 (delayed effective dates for governmental plans and collective bargaining agreements)	IRC §401(a)(9); SECURE Act §401	Yes
Repeals the kiddie tax rate changes enacted by the TCJA, generally applicable to taxable years beginning after December 31, 2019, unless the taxpayer elects to apply it to the 2018 and/or 2019 tax year	IRC §§1(j), 55(d)(4)(A); SECURE Act §501	Yes, California never conformed to the TCJA kiddie tax changes
Employer Provisions		
Increases maximum small employer pension plan startup costs credit limit from $500 to $5,000, applicable to taxable years beginning after December 31, 2019	IRC §45E; SECURE Act §104	N/A
Enacts new small employer automatic enrollment credit equal to $500 per year for first three years, applicable to taxable years beginning after December 31, 2019	IRC §45T; SECURE Act §105	N/A
Requires employers with 401(k) plans (other than collectively bargained plans) to permit an employee to make elective deferrals if the employee has worked at least 500 hours per year with the employer for at least three consecutive years and is age 21 by the end of the three-year period, generally effective for plan years beginning after December 31, 2020	IRC §401(k); SECURE Act §112	Yes
Allows unrelated employers to participate in pooled multiple employer plans (MEPs), applicable to plan years beginning after December 31, 2020	IRC §413; SECURE Act §101	Yes
(continued)		

SECURE Act Provisions — Further Consolidated Appropriations Act of 2020, Division O (continued)		
Description	**Citation**	**CA conformity**
Penalty Provisions		
Increases the penalty for failure to file a return within 60 days of the due date to the lesser of $435 (adjusted for inflation; previously $330) or 100% of the amount of tax due, applicable to returns with filing due dates (including extensions) after December 31, 2019	IRC §6651; SECURE Act §402	No. California's penalty is the lesser of $135 or unpaid tax (R&TC §19131)
Increases the penalties for failure to file retirement plan returns as follows: • Form 5500: $250 for each day up to $150,000 maximum (previously $25 per day, up to $15,000 maximum) • Failure to file an annual registration statement or file notification of changes: $10 for each participant with respect to whom the failure applies per day, up to $50,000 maximum ($5,000 for notifications of change) per plan year (previously $1, with $10,000 maximum ($1,000 for notifications of change) • Failure to provide withholding notice: $100 for each failure, up to $50,000 maximum per calendar year (previously $10 per failure subject to a $5,000 maximum) Applicable to returns, statements, and notifications required to be filed, and notices required to be provided, after December 31, 2019	IRC §6652; SECURE Act §403	N/A
IRC §401(k) Provisions		
Increases the limitation on the default rates under a §401(k) automatic enrollment safe harbor plan from 10% to 15%, applicable to plan years beginning after December 31, 2019	IRC §401(k)(13)(C)(iii); SECURE Act §102	Yes
Plan Administration Provisions		
Allows IRC §403(b) custodial accounts terminated by an employer to be distributed to another custodial account, applicable retroactively to taxable years beginning after December 31, 2008. This provision allows employees to maintain their retirement funds in tax-deferred accounts longer	Uncodified; SECURE Act §110	Yes
Allows plans adopted by filing due date (including extensions) for year to be treated as in effect as of close of year, applicable to plans adopted for taxable years beginning after December 31, 2019	IRC §401(b); SECURE Act §201	Yes

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 the income limitations have been repealed.	☐
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 will have to 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 expect income to be unusually low in 2020 and/or 2021?	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.	☐
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 2021 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?	☐
Have you considered the elimination of recharacterizations under the Tax Cuts and Jobs Act (TCJA)?	Beginning in 2018, Roth conversions cannot be recharacterized under the TCJA. Plan carefully before making a conversion, keeping in mind that it can no longer be reversed.	☐

Website

To download a copy of this checklist, go to:
www.caltax.com/files/2020/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.

- [ ] 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. 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.

- [ ] Depreciation — Basis differences from IRC §179 and bonus.

   California has had different depreciation methods and different §179 expensing amounts in many prior 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.

- [ ] Suspended passive losses — Did they carry over?

   Make sure that suspended passive losses were not accidentally dropped in a prior year.

- [ ] 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 the full amount of the mortgage interest.

- [ ] 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.

- [ ] 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.

- [ ] 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.

Single renters with California AGI of $43,533 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 $87,066 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 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.

❑ **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, partnership, LLC, or S corporation K-1s (or 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 Form 593, Withholding on the Sale of California Real Estate

❑ **California nonconformity to the Tax Cuts and Jobs Act (TCJA).**

The TCJA makes 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, and reduced mortgage interest limitation. See our Schedule CA TCJA checklist to make sure you don't miss any of these differences.

Website
To download a copy of this checklist, go to:
www.caltax.com/files/2020/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 2020 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 2020, 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 2020 and have more than $122,909 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?
☐	☐	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/2020/troublefree.pdf

ITEMS YOUR CLIENT SHOULD BRING TO A TAX INTERVIEW

1. IRS Notice 1444 and information regarding the amount of the second stimulus check.
2. 1099-Ks for merchant charges. Reconcile amounts on 1099s to amounts reported by the client for Schedules C or E (or business entity return).
3. 1099-Bs for sales of stock or securities. Reconcile amounts on 1099s to amounts shown on client reports, if any.
4. 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.
5. Property tax statements: Look for items that are not deductible as property taxes, such as HERO or PACE payments.
6. Review government documents (W-2s, 1099s) for federal/California differences. Also be sure to review government documents for accurate taxpayer identification numbers.
7. Paycheck stubs to review withholding and to provide to the FTB if withholding amount is reduced.
8. Statements and instructions from mutual fund companies breaking down U.S. government and state tax-exempt income information.
9. All tax information broken out separately for both members of a registered domestic partnership.
10. Notices, bills, etc., from the IRS or California.
11. New clients should bring the past four years' returns.
12. 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.
13. California K-1 and accompanying correspondence (check for California differences and possible state tax paid by S corporation, partnership, trust, or LLC).
14. 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.
15. Withholding for residents and nonresidents reported on FTB Form 592-B.
16. 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.
17. Any activity pertaining to a Health Savings Account, including contributions to, earnings or losses from, distributions from, and rollovers to that account.
18. Rollover or distribution amounts from Medical Savings Accounts, FSAs, HRAs, and Roth IRA conversions.
19. 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?
20. Change of ownership of business entity.
21. Title change information for property that changed hands due to gift or death of an owner.

22. 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.
23. For Schedule C and other business returns, alert the taxpayer of the requirement for a city business license.
24. 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.
25. For all documents, please provide a scan, photocopy, or fax. Do not send photos taken with a cell phone.

Website
To download a copy of this list, go to:
www.caltax.com/files/2020/taxinterview.pdf

TIPS TO PREPARE YOURSELF AND YOUR OFFICE FOR TAX SEASON

In addition to worrying about our clients, look at things you can do prior to the end of 2020 to prepare for the upcoming tax season.

Tips to Prepare Yourself and Your Office for Tax Season	
☐	Practice management: Raise prices every year. Jerry Tollefson, former owner of Gear Up, advocated, "Double your rates and you can lose one half of your clients, but still make the same amount of money working half the time!" Don't devalue your worth!
☐	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 2021 application/renewal fee is $21 plus a $14.95 fee payable to the third party contractor.
☐	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, 2021, not January 31, 2021.
☐	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/2020/tipstoprepare.pdf

SAMPLE DATA SECURITY PLAN

Protecting taxpayer data is the law. Federal law gives the Federal Trade Commission (FTC) authority to set data safeguard regulations for various entities, including professional tax return preparers. According to the FTC Safeguards Rules, tax return preparers must create and enact security plans to protect client data. Failure to do so may result in an FTC investigation.

> **Website**
> To download a copy of our sample data security plan, go to:
> www.caltax.com/files/2020/sampledsplan.doc

IDENTITY THEFT VICTIM CHECKLIST

	Identity Theft Victim Checklist
☐	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.
☐	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.
☐	Report the fraud to the police, and save the police report to use when reporting the fraud elsewhere.
☐	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.
☐	Contact the Franchise Tax Board Theft Resolution Coordinator at (916) 845-3669. File Form FTB 3552, Identity Theft Affidavit, and supporting documents.
☐	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.
☐	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
	(continued)

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/2020/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 Question 1 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/2020/determineresidency.pdf

Taxpayer's name ______________________________ Year ____________

T=Taxpayer S=Spouse

	Resident T	Resident S	Nonresident T	Nonresident S
1. a. Are you employed under a contract that requires you to be absent from California for <u>at least</u> 546 days with <u>not more than</u> 45 days per year spent in California for any purpose?	☐ No	☐ No	☐ Yes	☐ Yes
b. If the answer to Question 1 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 T	California S	Elsewhere T	Elsewhere S
2. During the year, how many months did you live	______	______	______	______
3. How much of your income was from sources in:	______	______	______	______
4. Where are you registered to vote?	______	______	______	______
5. Do you own a house in:	______	______	______	______
6. Where do you take your homeowner's	______	______	______	______
7. Where is your driver's license issued?	______	______	______	______
8. Where is your attorney located?	______	______	______	______
9. Where is your stockbroker located?	______	______	______	______
10. Where do you attend regular services?	______	______	______	______
11. Where do you make regular religious contributions?	______	______	______	______

	California		Elsewhere	
	T	**S**	**T**	**S**
12. Where is your tax professional located?	________	________	________	________
13. Where are your closest social contacts?	________	________	________	________
14. Where are your closest business contacts?	________	________	________	________
15. Where are your vehicles registered?	________	________	________	________
16. Where do your children attend school?	________	________	________	________
17. Did you pay nonresident tuition in:	________	________	________	________
18. Where are your social clubs located?	________	________	________	________
19. Where is your union or professional association located?	________	________	________	________
20. Where is your bank located?	________	________	________	________
21. If working outside California:	________	________	________	________
a. Where will you move to when your assignment is completed?	________	________	________	________
b. Where is your personal property stored?	________	________	________	________
c. Where do(es) your spouse (and minor children) live?	________	________	________	________
d. When you take vacation or time off, where do you visit?	________	________	________	________
e. Where is your permanent mailing address?	________	________	________	________
f. Do you own a house in:	________	________	________	________
i. Is it:				
Rented	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No
Leased	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No
ii. Does a related party live there?	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No	☐ Yes ☐ No
22. If working in California or elsewhere on a temporary basis:	________	________	________	________
A. Where did you list your residence on the employment application?	☐ Yes	☐ Yes	☐ No	☐ No
B. Where is your permanent telephone number?	☐ Yes	☐ Yes	☐ No	☐ No
C. Do you cook your meals or eat out?	☐ Cook	☐ Cook	☐ Eat Out	☐ Eat Out
D. Did you deduct a moving expense?	☐ Yes	☐ Yes	☐ No	☐ No
E. Are you on an expense account or being paid per diem?	☐ Yes	☐ Yes	☐ No	☐ No
F. Are you: ☐ Living in a hotel or motel		☐ Renting month-to-month		☐ Leasing
G. Did you file a tax return in another state?	☐ Yes	☐ Yes	☐ No	☐ No
If so, did you file as a resident or	☐ Nonres.	☐ Nonres.	☐ Resident	☐ Resident
23. Where did you have:				
A. Your hair and nails done?	________	________	________	________
B. Your clothes cleaned?	________	________	________	________
C. 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
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	Taxable[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

Website
To download a copy of this chart, go to:
www.caltax.com/files/2020/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/2020/walkingaway.pdf

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.

Website
To download a copy of this checklist, go to:
www.caltax.com/files/2020/disastercasualty.pdf

SAMPLE ACCOUNTABLE PLAN

ACCOUNTABLE REIMBURSEMENT PLAN OF [COMPANY]

It is the policy of [COMPANY] (hereinafter referred to as the “Company”) to reimburse employees, partners, members, and/or independent contractors (hereinafter collectively referred to as “Associates”) for authorized business expenses of the Company pursuant to the following guidelines.

Expenses must have a business connection: Authorized expenses paid by any Associate of the Company must have a business connection and must otherwise be deductible by the Company under federal tax law. (Treas. Regs. §1.62-2(d)) In order to be deductible under federal law, the expenses must be incurred in connection with the performance of services by the Associate on behalf of the Company.

Expenses must be substantiated: Associates must substantiate their business expenses to the Company for reimbursement. (Treas. Regs. §1.62-2(e)) Substantiation includes any relevant documentary evidence that shows the following with respect to every expense for which the Associate seeks reimbursement:

- Amount;
- Date;
- Location;
- Description of the business purposes of the expense; and
- Any other relevant information regarding the expense.

Documentary evidence must be in the form of receipts, invoices, bills of sale, or any similar documentation. Credit card bills and bank statements alone are insufficient documentary evidence.

Mileage reimbursement for personal vehicles: Associates shall be reimbursed for the preapproved business use of their personal automobiles at the standard federal mileage rate for the period of business use. The mileage rate for 2018 is 54.5 cents per mile.

Documentary evidence for mileage reimbursements must include a description of the business purpose, the starting location, ending location, and total miles. Printed driving directions from reputable internet map sources are acceptable to prove mileage.

***Per diem* reimbursement in lieu of strict substantiation:** The Company, at its sole discretion, may reimburse Associates based on *per diem* amounts that do not require strict substantiation or documentary evidence of expenses. If the Company so elects, Associates must demonstrate the time, place, and business purpose of their trip. The *per diem* reimbursement shall cover the costs of lodging, meals, and incidentals but cannot exceed federal *per diem* rates.

Expenses that are not reimbursed: The following expenses are specifically not reimbursed under this plan:

- [List any expenses the Company specifically wishes to exclude from reimbursement, such as personal entertainment while traveling for work, meals in excess of a specified dollar limit, alcohol, home office, etc.]

Excess reimbursements must be returned: Associates must return to the Company, within sixty (60) days, any amounts provided as a reimbursement under this plan in excess of the Associate’s substantiated expenses. (Treas. Regs. §1.62-2(f))

Time for submitted reimbursement requests: Requests for reimbursement of business expenses under this plan must be submitted to the Company's designated department in the manner required by such department (i.e., submitting documentary evidence together with a summary or tracking sheet) within sixty (60) days of the date of the expense).

Payment of reimbursed expenses: Reimbursements shall be paid to Associates in the same manner as the Associate receives his or her regular payment for services (i.e., employees shall receive reimbursement through a regular payroll check or a separate payroll check, independent contractors, partners, and members shall receive a nonpayroll check).

Plan year: This plan shall be maintained on a calendar-year basis.

Plan amendments and alterations: This plan shall not be amended or altered in any way by the Associate or the Company during the plan year. Once the method of reimbursement is established during the plan year, it must be used throughout the remainder of the plan year.

Associate's failure to comply with plan: At the discretion of the Company, an Associate's failure to comply with the requirements of this plan will render his or her expenses related to such failure nonreimbursable.

This accountable plan is hereby adopted by [COMPANY].

By: [NAME]
Its: [TITLE]

Website

To download a copy of this sample accountable plan, go to:
www.caltax.com/files/2020/sampleap.doc

SCHEDULE CA NONCONFORMITY CHECKLIST

Use this checklist to ensure that you have properly reported all of the TCJA, SECURE Act, FFCRA, CARES Act, and AB 5 nonconformity items on Schedule CA.

Schedule CA Nonconformity Checklist	
Part I — Income Adjustment Schedule	
Section A: Income	
☐	**California employee/federal independent contractor:** Some taxpayers may be classified as independent contractors for federal purposes and as employees for California purposes. If the taxpayer is classified as an employee for California purposes, enter the amount reported as gross income of the business from federal Schedule C (Form 1040), line 7, as wages on line 1, column C.
☐	**Sinai Peninsula:** California does not conform to the extension of combat zone tax benefit to the Sinai Peninsula of Egypt. Enter the amount of combat pay excluded from federal income on line 1, column C.
	(continued)

Schedule CA Nonconformity Checklist (continued)

Section B: Additional Income

- ☐ **Alimony received:** California does not conform to the TCJA change that excludes alimony received from income if made under post-2018 divorce/separation agreement. Enter the alimony received on line 2a, column C.
- ☐ **FFCRA paid sick and family leave credits:** California does not conform to the FFCRA provision requiring employers who claim paid sick and family leave credits to include the credit amount in gross income. Enter the credit amounts in line 3, column B.
- ☐ **Entertainment expenses and transportation fringe benefits:** California does not conform to the repeal of transportation fringe benefits, or 50% of entertainment expenses. Enter the additional California deductions on line 12, column B.
- ☐ **California employee/federal independent contractor:** Some taxpayers may be classified as independent contractors for federal purposes and as employees for California purposes. If the taxpayer is classified as an employee for California purposes, enter the amount of federal business income on line 3, column B.
- ☐ **Professional gamblers:** For professional gamblers, California does not conform to the provision limiting gambling deductions to gambling winnings. Enter the additional California deductions on line 3, column B.
- ☐ **Limitation on business interest:** California does not conform to the limitation on the net interest expense deduction for businesses. Figure the difference between the amounts using federal and California law. Enter the difference on line 3, column B.
- ☐ **Qualified equity grants:** California does not conform to the new IRC §83(i) election to defer the recognition of income attributable to qualified stock. If you elected to defer income for federal purposes, make an adjustment on line 8f, column C.
- ☐ **IRC §529 accounts:** California does not conform to the provisions expanding qualified education expenses to include K–12 tuition costs, registered apprenticeship costs, and qualified education loan repayments. If these amounts were excluded for federal purposes, make an adjustment on line 8f, column C.
- ☐ **Sexual harassment settlement:** California does not conform to the provision prohibiting a deduction for any settlement, payout, or attorney fees related to sexual harassment or abuse if the payments are subject to a nondisclosure agreement. Enter the amount received and included in federal income on line 3, column B.
- ☐ **Excess business loss limitation:** California does not conform to the retroactive repeal of the excess business loss limitation for the 2018–2020 tax years. Enter the amount of California's excess business loss limitation on line 8f, column C.
- ☐ **Employer payments of student loans:** California does not conform to the educational assistance program exclusion of student loan payments on behalf of an employee by an employer. Enter the amount of the loan payment on line 8f, column C.

(continued)

Schedule CA Nonconformity Checklist (continued)	
Section B: Additional Income (continued)	
☐	**Repatriation and GILTI income:** California does not conform to the federal repatriation or GILTI provisions. If you included IRC §965 repatriation income on your federal Schedule 1 (Form 1040), enter the amount on line 8f, column B, and write "IRC §965" on line 8f and at the top of Form 540. If you included GILTI on your federal Schedule 1 (Form 1040), enter the amount on line 8f, column B, and write "IRC §951A" on line 8f.
☐	**Employer payments of student loans:** California does not conform to the educational assistance program exclusion of student loan payments on behalf of an employee by an employer. Enter the amount of the loan payment on line 8f, column C.
☐	**California employee/federal independent contractor:** Some taxpayers may be classified as independent contractors for federal purposes and as employees for California purposes. If the taxpayer is classified as an employee for California purposes, enter the amount of self-employment tax claimed on the federal return on line 14, column B, and the amount of any self-employed health insurance deduction related to the independent contractor business on line 16, column B.
Section C: Adjustments to Income	
☐	**Alimony paid:** California does not conform to the provision disallowing deductions for alimony paid if made under any post-2108 divorce or settlement agreement. Enter the alimony paid on line 18a, column C.
☐	**Excess deduction on termination of an estate or trust:** California allows taxpayers to claim these deductions as miscellaneous itemized deductions. Enter these amounts on line 22, column B.
☐	**Living expenses for Congressional members:** Members of Congress will still be permitted to deduct $3,000 per year of living expenses incurred while on official business in Washington, D.C. Enter the amount of living expenses on line 11, column C.
☐	**Moving expenses:** California does not conform to federal law regarding the suspension of the deduction for moving expenses, except for members of the Armed Forces on active duty. Nonmilitary taxpayers enter either the excess moving expense reimbursements or moving expenses in excess of reimbursements reported on federal Form 3903, Moving Expenses, on line 13, column C.
Part II — Adjustments to Federal Itemized Deductions	
☐	**Taxpayers who did not itemize on their federal return:** Taxpayers who did not itemize deductions on their federal return but will itemize on their California tax return must complete federal Schedule A (Form 1040). Then check the box at the top of Schedule CA (540), Part II, and complete lines 1 through 30. Attach a copy of federal Schedule A (Form 1040) to the Form 540.
	(continued)

Schedule CA Nonconformity Checklist (continued)	
Medical and Dental Expenses	
☐	**California employee/federal independent contractor:** Some taxpayers may be classified as independent contractors for federal purposes and as employees for California purposes. If the taxpayer is classified as an employee for California purposes, they may treat the amounts deducted as self-employed health insurance as a medical and dental expense by entering the amount of federal self-employed health insurance deduction that exceeds 7.5% of federal AGI on line 4, column C.
Taxes Paid	
☐	**Deduction for state and local taxes**: California allows deductions for foreign property taxes, and does not conform to the $10,000 SALT limitation. Enter taxes in excess of the $10,000 limitation on line 53, column C and foreign property taxes paid on line 6, column C.
Interest Paid	
☐	**Mortgage interest:** California will continue to allow a deduction for acquisition debt of $1 million and equity debt of $100,000 (not allowed for AMT) for a maximum of $1.1 million. Enter an adjustment on line 8, column C for the amount over the federal limit.
Gifts to Charity	
☐	**Qualified charitable contributions:** For California purposes, charitable contributions will continue to be limited to a percentage of federal AGI. Figure the difference between the amount allowed using federal law and the amount allowed using California law. Enter the difference on line 11, column B. California does not allow an above-the-line deduction for cash charitable contributions made in 2020 and only allows charitable deductions to be claimed as an itemized deduction. Enter any difference in itemized deduction amounts on line 11, column B.
☐	**College athletic seating rights:** California does not conform to the elimination of the charitable contribution deduction for contributions made to institutions of higher education for which the taxpayer receives the right to purchase tickets for seating at an athletic event. Enter the amount on line 11, column C.
Casualty and Theft Losses	
☐	**Casualty or theft losses (other than qualified disaster losses):** Taxpayers are still permitted to deduct casualty losses on their California returns. Complete another federal Form 4684 using California amounts, and enter the difference between the federal and California amount on line 15, column B or C.
	(continued)

Schedule CA Nonconformity Checklist (continued)

Job Expenses and Certain Miscellaneous Deductions

☐ **Unreimbursed employee expenses:** California allows deductions for unreimbursed employee business expenses. Enter these deductions on line 19. Attach a copy of federal Form 2106 if required.

☐ **California employee/federal independent contractor:** Some taxpayers may be classified as independent contractors for federal purposes and as employees for California purposes. These employees may claim unreimbursed employee expenses on line 19.

☐ **Tax preparation fees:** California allows deductions for tax preparation fees. Enter these deductions on line 20.

☐ **Excess deduction on termination of an estate or trust:** California allows excess deductions on termination of an estate or trusts. Enter these deductions on line 21.

☐ **Other miscellaneous itemized deductions:** California will continue to allow miscellaneous itemized deductions subject to 2% of federal AGI. This includes:

- Home office for employees;
- Union dues, uniforms, and safety equipment;
- Investment advisor fees and/or asset management fees;
- Hobby expenses;
- Expenses related to nonbusiness income; and
- Attorney fees.

Enter these amounts on line 21.

☐ **Itemized deduction limitation:** The TCJA suspended the limitation on itemized deductions. California phases out the amount of itemized deductions that may be claimed for taxpayers with federal AGI above certain thresholds. Compute this limitation on line 29.

Website

To download a copy of this checklist, go to:
www.caltax.com/files/2020/schedulecanonconformity.pdf

TCJA ITEMIZED DEDUCTIONS 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

- 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 $ ____________

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/2020/tcjaitemized.pdf

OTHER PRACTITIONER AIDS

The following is a list of other practitioner aids that can be found throughout this book.

2020 California Tax Rates, Exemptions, and Credits

The rate of inflation in California, for the period from July 1, 2019, through June 30, 2020, was 1.4%. The 2020 personal income tax brackets are indexed by this amount.

Exemption credits

- Married/RDP filing joint, and surviving spouse $248
- Single, married/RDP filing separate, and HOH $124
- Dependent $383
- Blind $248
- Age 65 or older.. $248

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	$203,341
Married/RDP filing separate	$6	$1,250	$203,341
Head of household	$6	$2,500	$305,016
Married filing joint	$12	$2,500	$406,687
Surviving spouse	$12	$2,500	$406,687

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 $219,000. He must phase out each of his exemptions by $42. That is, ($219,000 – $203,341) ÷ $2,500 = 7 (always round up); 7 × $6 = $42. His exemption credit for 2020 is $423, calculated as follows:

Joe's personal exemption credit is	$ 124
Less phaseout amount	($ 42)
Personal exemption credit allowed is .	$ 82
Joe's dependent credit exemption is ...	$ 383
Less phaseout amount	($ 42)
Total dependent credit allowed is	$ 341
Total exemption credits allowed is......	$ 423

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 $203,341
- Head of household $305,016
- Married/RDP filing joint and surviving spouse....$406,687

Standard deductions

- Single and married/RDP filing separate $4,601
- Married/RDP filing joint, head of household, and surviving spouse.........................$9,202
- Minimum standard deduction for dependents $1,100

Miscellaneous credits

- Qualified Senior Head of Household Credit is 2% of California taxable income, with a maximum California AGI of $79,539, and a maximum credit of $1,499
- Joint Custody Head of Household Credit and Dependent Parent Credit are each 30% of net tax, with a maximum credit of $491

Nonrefundable Renter's Credit

This nonrefundable, noncarryover credit for renters is available for:

- Single and married/RDP filing separate with a California AGI of $43,533 or less .... $60 credit
- Married/RDP filing joint, head of household, and surviving spouse with a California AGI of $87,066 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.....$99,707
- Single and head of household $74,780
- Married/RDP filing separate, estates, and trusts.....$49,851

AMT exemption phaseout

- Married/RDP filing joint, and surviving spouse...$373,899
- Single and head of household $280,424
- Married/RDP filing separate, estates, and trusts..... $186,946

FTB cost recovery fees

- Bank and corporation filing enforcement fee..............$83
- Bank and corporation collection fee $322
- Personal income tax filing enforcement fee.................$97
- Personal income tax collection fee $316

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%

2020 California Tax Rate Schedules

Schedule 1 — Single or Married/RDP Filing Separate

If the taxable income is…

Over	But not over	Tax is...			Of amount over...
$0	$8,932	$0	plus	1.00%	$0
$8,932	$21,175	$89.32	plus	2.00%	$8,932
$21,175	$33,421	$334.18	plus	4.00%	$21,175
$33,421	$46,394	$824.02	plus	6.00%	$33,421
$46,394	$58,634	$1,602.40	plus	8.00%	$46,394
$58,634	$299,508	$2,581.60	plus	9.30%	$58,634
$299,508	$359,407	$24,982.88	plus	10.30%	$299,508
$359,407	$599,012	$31,152.48	plus	11.30%	$359,407
$599,012	and over	$58,227.85	plus	12.30%	$599,012

Schedule 2 — 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	$17,864	$0	plus	1.00%	$0
$17,864	$42,350	$178.64	plus	2.00%	$17,864
$42,350	$66,842	$668.36	plus	4.00%	$42,350
$66,842	$92,788	$1,648.04	plus	6.00%	$66,842
$92,788	$117,268	$3,204.80	plus	8.00%	$92,788
$117,268	$599,016	$5,163.20	plus	9.30%	$117,268
$599,016	$718,814	$49,965.76	plus	10.30%	$599,016
$718,814	$1,198,024	$62,304.95	plus	11.30%	$718,814
$1,198,024	and over	$116,455.68	plus	12.30%	$1,198,024

Schedule 3 — Head of Household

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$17,876	$0	plus	1.00%	$0
$17,876	$42,353	$178.76	plus	2.00%	$17,876
$42,353	$54,597	$668.30	plus	4.00%	$42,353
$54,597	$67,569	$1,158.06	plus	6.00%	$54,597
$67,569	$79,812	$1,936.38	plus	8.00%	$67,569
$79,812	$407,329	$2,915.82	plus	9.30%	$79,812
$407,329	$488,796	$33,374.90	plus	10.30%	$407,329
$488,796	$814,658	$41,766.00	plus	11.30%	$488,796
$814,658	and over	$78,588.41	plus	12.30%	$814,658

Individual Filing Requirements

Filing Status	Age as of December 31, 2020*	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	$18,496 $24,696	$31,263 $34,271	$40,838 $41,931	$14,797 $20,997	$27,564 $30,572	$37,139 $38,232
Married filing joint, RDP, or separate	Under 65 (both spouses/RDPs) 65 or older (one spouse) 65 or older (both spouses/RDPs)	$36,996 $43,196 $49,396	$49,763 $52,771 $58,971	$59,338 $60,431 $66,631	$29,599 $35,799 $41,999	$42,366 $45,374 $51,574	$51,941 $53,034 $59,234
Surviving spouse	Under 65 65 or older		$31,263 $34,271	$40,838 $41,931		$27,564 $30,572	$37,139 $38,232
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, 2021, you are considered to be age 65 at the end of 2020.

2020 Federal Tax Rate Schedules

Schedule 1 — Single

If the taxable income is…

Over	But not over	Tax is...			Of amount over...
$0	$9,875	$0.00	plus	10%	$0
$9,875	$40,125	$987.50	plus	12%	$9,875
$40,125	$85,525	$4,617.50	plus	22%	$40,125
$85,525	$163,300	$14,605.50	plus	24%	$85,525
$163,300	$207,350	$33,271.50	plus	32%	$163,300
$207,350	$518,400	$47,367.50	plus	35%	$207,350
$518,400	and over	$156,235	plus	37%	$518,400

Schedule 2 — Married Filing Separate

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$9,875	$0.00	plus	10%	$0
$9,875	$40,125	$987.50	plus	12%	$9,875
$40,125	$85,525	$4,617.50	plus	22%	$40,125
$85,525	$163,300	$14,605.50	plus	24%	$85,525
$163,300	$207,350	$33,271.50	plus	32%	$163,300
$207,350	$311,025	$47,367.50	plus	35%	$207,350
$311,025	and over	$83,653.75	plus	37%	$311,025

Schedule 3 — Married Filing Joint and Surviving Spouse

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$19,750	$0.00	plus	10%	$0
$19,750	$80,250	$1,975.00	plus	12%	$19,750
$80,250	$171,050	$9,235.00	plus	22%	$80,250
$171,050	$326,600	$29,211.00	plus	24%	$171,050
$326,600	$414,700	$66,543.00	plus	32%	$326,600
$414,700	$622,050	$94,735.00	plus	35%	$414,700
$622,050	and over	$167,307.50	plus	37%	$622,050

Schedule 4 — Head of Household

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$14,100	$0.00	plus	10%	$0
$14,100	$53,700	$1,410.00	plus	12%	$14,100
$53,700	$85,500	$6,162.00	plus	22%	$53,700
$85,500	$163,300	$13,158.00	plus	24%	$85,500
$163,300	$207,350	$31,830.00	plus	32%	$163,300
$207,350	$518,400	$45,926.00	plus	35%	$207,350
$518,400	and over	$154,793.50	plus	37%	$518,400

2021 Federal Tax Rate Schedules

Note: These tax rates are for the 2021 tax year (for filing in 2022), 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	$9,950	$0.00	plus	10%	$0
$9,950	$40,525	$995.00	plus	12%	$9,950
$40,525	$86,375	$4,664.00	plus	22%	$40,525
$86,375	$164,925	$14,751.00	plus	24%	$86,375
$164,925	$209,425	$33,603.00	plus	32%	$164,925
$209,425	$523,600	$47,843.00	plus	35%	$209,425
$523,600	and over	$157,804.25	plus	37%	$523,600

Schedule 2 — Married Filing Separate

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$9,950	$0.00	plus	10%	$0
$9,950	$40,525	$995.00	plus	12%	$9,950
$40,525	$86,375	$4,664.00	plus	22%	$40,525
$86,375	$164,925	$14,751.00	plus	24%	$86,375
$164,925	$209,425	$33,603.00	plus	32%	$164,925
$209,425	$314,150	$47,843.00	plus	35%	$209,425
$314,150	and over	$84,496.75	plus	37%	$314,150

Schedule 3 — Married Filing Joint and Surviving Spouse

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$19,900	$0.00	plus	10%	$0
$19,900	$81,050	$1,990.00	plus	12%	$19,990
$81,050	$172,750	$9,328.00	plus	22%	$81,050
$172,750	$329,850	$29,502.00	plus	24%	$172,750
$329,850	$418,850	$67,206.00	plus	32%	$329,850
$418,850	$628,300	$95,686.00	plus	35%	$418,850
$628,300	and over	$168,993.50	plus	37%	$628,300

Schedule 4 — Head of Household

If the taxable income is…

Over	But not over	Tax is…			Of amount over…
$0	$14,200	$0.00	plus	10%	$0
$14,200	$54,200	$1,420.00	plus	12%	$14,200
$54,200	$86,350	$6,220.00	plus	22%	$54,200
$86,350	$164,900	$13,293.00	plus	24%	$86,350
$164,900	$209,400	$32,145.00	plus	32%	$164,900
$209,400	$523,600	$46,385.00	plus	35%	$209,400
$523,600	and over	$156,355.00	plus	37%	$523,600

TAX PLANNING IN 2020

In 2018, the TCJA fundamentally changed some tried-and-true tax planning techniques, such as bunching itemized deductions. Let's talk about other effective strategies that can have a big tax impact.

AFFORDABLE CARE ACT

The ACA contained some stiff marriage penalties. You need to run the numbers, but being married seems like a distinct disadvantage, particularly in the area of premium tax credits. For example, taxpayers must repay 100% of their advanced premium tax credit if their household income is 400% or more of the relative poverty line. If a lower-income earner marries a moderate or high-income earner during the year, then the newly married couple may be forced to repay a significant amount of advanced premium tax credits received by the lower-income earner during the year. This is true even if the blissful couple marries on December 31.

In addition to taking on liabilities for the other spouse's overpaid premium tax credit (PTC), increased shared responsibility payment, and more exposure to the 3.8% net investment income tax (NIIT), also consider these planning issues:

- Electing to include a kiddie's income on the parent(s)' return will subject the kiddie's unearned income to the parents' NIIT. Filing the child's return will give the child their own NIIT exemption of $200,000;
- If possible, determine which parent should claim the children based on the tax effects relating to health insurance. The PTC could be greater if the low-income parent claims the children;
- Remember to include the 3.8% NIIT on capital gains when estimating cost of sales of assets. Seldom do our high-income clients pay 20% on capital gains; and
- Make trust distributions because the 3.8% NIIT will begin at the highest bracket for trusts on undistributed income ($12,950 for 2020). Beneficiaries may be less likely to pay the 3.8% surtax because thresholds for individuals are much higher.

CAPITAL GAINS

Speaking of capital gains, we know to take losses at the end of the year. For clients with publicly traded partnerships (PTPs), you may sell one PTP at a loss, free up any suspended losses, and replace it with another PTP that is similar. There will be some capital gain and ordinary income on the disposition, but all the suspended losses from the PTP will be freed up. If you don't repurchase the same PTP, you will not run afoul of the wash sale rules.

CHARITABLE CONTRIBUTIONS

If you have a client with a large spike in income, discuss the benefit of setting up a donor advised fund. It's easy to do through major brokerages. In short, your client makes a contribution to the fund and over the ensuing years makes contributions from the fund directly to the charity. This gives your client a large charitable contribution in the high-income year. After that, the fund uses the contributed amount to make contributions over the next years in the amounts the taxpayer normally would have made.

Example of using a donor advised fund

In late 2020, Ben received a large severance from his employer. A month later, he received a $500,000 distribution from a previous employer's nonqualified deferred compensation plan when the company was sold. Ben was looking at an AGI of close to $1 million. Ben usually contributes around $15,000 per year to various charities. In December of 2020, he established a donor advised fund and put $75,000 into it. This gives him a $75,000 charitable contribution deduction for 2020 when he's in a high tax bracket.

He will make his annual contributions from the fund rather than from his checking account. This is especially beneficial now that he is not working and considering full retirement. He is able to continue making charitable gifts, even though his income has dropped significantly and he wouldn't get much tax benefit from personally making charitable contributions.

Add a bonus to this plan: If Ben contributes appreciated stock to the donor advised fund, he will have a deduction equal to the fair market value of the stock and avoid capital gains. (Remember, these transactions don't qualify for the 50%/100% of AGI maximum.)

IRA-TO-CHARITY

The IRA-to-charity provision is particularly beneficial because it helps both high- and low-income taxpayers. Consider that this type of contribution:

- Reduces AGI with these potential benefits:
  - Less taxable Social Security;
  - Reduces potential for hospital insurance (HI) and NIIT; and
- Reduces phaseouts; and
- Provides a tax benefit for a taxpayer who is not itemizing.

GIFTING

More often than not, gifting is a personal decision not a tax planning one. Regarding the transfer of wealth, while most think of this as only applicable to high net worth individuals, this is not the case. There are many reasons, no matter a person's financial status, to gift assets now.

With new considerations for clients with larger estates, this is the year to combine traditional tax planning with some new planning for future savings.

How much is too much?

The TCJA increased the maximum exemption amount for gifts and estates for tax years 2018 through 2025. The 2020 exclusion amount is $11.58 million per individual, meaning a married couple will be able to shield $23.16 million from gift and estate tax. The old saying goes, all good things must come to an end. In 2026, the exemption amount is scheduled to be reduced to $5 million per individual.

The 2020 annual gift exclusion amount remains at $15,000 per taxpayer per person. (Rev. Proc. 2019-44) That means a taxpayer can gift $15,000 each year to as many individuals as they choose and not have a gift tax return filing requirement.

Consider making large gifts now

Transferring wealth through gifting now will not harm estates if the exclusion amount is reduced in the future. Final regulations issued November 26, 2019, clarified there will be no claw back of gifts made prior to the December 31, 2025, sunset date of the current increased estate and gift tax exclusion amounts. (IRC §1015(a)) As a matter of fact, this is something high net worth families should consider now because the reduction may happen before 2025, as both presidential candidates have it on their radar.

Making large gifts to maximize the exclusion amount today can save millions for these clients if the exclusion amount is reduced later.

Gifting business stock or interest

Gifting appreciated business interests can be beneficial for all taxpayers. Though the basis of gifted stock or a business interest is the same as it was in the hand of the donor (increased by any gift tax that was paid), the fair market value of the asset is removed from the taxable estate. (IRC §529(c)(3)) Additionally, the annual income derived from the business is reported and taxed by the recipient so there is an immediate income tax benefit to the donor.

Example of gifting stock

Five years prior to retiring, Harry gifted his son Billy 10% of his S corporation's stock each year. Harry's basis in the stock was $150,000. The company had done well over the years as Harry had been able to receive large cash distributions while reporting a healthy taxable profit. The fair market value from an appraisal Harry had obtained prior to Billy's receipt of the shares was $5 million. Over the five-year gifting period, Harry removed a sizable portion of his taxable estate as well as shifted current income to Billy, who was in a lower tax bracket.

Appreciated assets

Gifting appreciated assets or those expecting to increase rapidly in the future, such as stock to an adult child not subject to "kiddie tax," will not only reduce a taxable estate at death but will reduce potential future income from those assets. While the gifted asset produces income, the tax burden is on the recipient. When the family member sells the asset, the capital gain will presumably be at a lesser tax rate than the original owner.

Example of gifting an appreciated asset

Mom and Dad have stock worth $100,000 and a basis of $25,000. They want to help Junior and his new bride purchase a home. They gift the appreciated stock to Junior, who sells it for a $75,000 capital gain. Junior is in the lowest tax bracket, while Mom and Dad are in the highest. Their gift saved thousands of dollars in tax while achieving their goal to help Junior buy his house.

IRC §529 plans

Contributing to a child's or grandchild's education savings plan is a great way to transfer assets. There is a special rule allowing a $75,000 front-end-loaded contribution with no gift tax consequences. (IRC §213(d)) The contribution is per person per beneficiary. The annual gift exclusion is used up for the next five years with respect to that beneficiary. If the client dies before the full five years, their estate will be treated as though the decedent still owned a portion of the gift at the time they died.

> ***Example of gifting to a §529 plan***
>
> A grandparent couple have 10 grandchildren. Without using any of their lifetime exclusion, they can each contribute $75,000 per grandchild to each grandchild's §529 plan for a total wealth transfer of $1.5 million. They cannot make any additional excludable gifts for five years. A bonus advantage is the taxable income that would have been earned on the principal is now out of the grandparents' estate, too.

Pay the bill

A taxpayer may make direct payments for qualified medical expenses to medical providers or qualified educational institutions without affecting the $15,000 gift exclusion or incurring a taxable gift. (IRC §2503(e); Treas. Regs. §20.2010-1(c)) This method is a good way to ease the financial burden of a family member while preserving the taxpayer's lifetime exclusion.

> ***Example of gifting education expenses***
>
> Molly is attending Harvard for her medical degree. Her grandparents can make a $100,000 tuition payment directly to the school and still give her $30,000 each year tax-free without affecting their lifetime exclusion.

As we are coming into the last quarter of 2020, there is still time to plan for a client's transfer of wealth through gifting. Any gift must be a complete and irrevocable transfer with no strings attached. Congress at any time can change the laws related to estate and gift taxes so 2020 is a great time to take advantage of the current generous limitations.

ROTH CONVERSIONS

If the client's income is low, consider a Roth conversion. The amount converted from the traditional IRA to a Roth IRA is taxable in the current year but is not subject to the 10% penalty. Once the amount is in the Roth, future earnings inside the account will be tax-free, and Roths are not subject to RMDs.

The Roth conversion must be done during the taxable year (on or before December 31, 2020). Remember, the TCJA eliminated the ability to recharacterize Roth conversions, so be sure a Roth conversion is right for your client before engaging in the rollover.

If the client moved into a retirement community and signed a lifetime care contract, the client may have a very large medical expense deduction during the year. A Roth IRA conversion for the same year can help keep the tax burden of the Roth conversion very low.

ESTABLISH A PENSION PLAN

A taxpayer may establish an IRA or a Roth on or before April 15, 2021, and contribute for 2020 on or before April 15, 2021.

Under the SECURE Act (P.L. 116-94), an employer may adopt a plan up to the extended due date of a plan sponsor's income tax return, starting with the 2020 tax year. The change allows plans adopted by the filing due date (including extensions) for the year to be treated as in effect as of the close of year. This is applicable to plans adopted for taxable years beginning after December 31, 2019. This means that the SEP IRA plan is not the only way to establish a plan and be able to deduct contributions after a valid estimate of the net income is established.

SIMPLE PLAN

A SIMPLE plan must be established between January 1 and October 1 for the applicable year. In other words, the plan must have been established by October 1, 2020, to have eligible 2020 contributions. (**Exception:** An employer that comes into existence after October 1 must establish the plan as soon as administratively feasible.)

BUSINESS

Consider these options:

- Plan wage payments to children who work in the business to keep them under the filing requirement;
- Pay a spouse wages to include the spouse on the company retirement plan or to build Social Security quarters for the spouse;
- Adjust bonuses and final paychecks to reduce or minimize tax, including the 0.9% additional Medicare tax if the client is near the threshold;
- Plan C corporation dividend distributions to minimize the 3.8% NIIT. Distribute dividends rather than wages if a C corporation has large, retained earnings and the individual's income is low;
- Give your clients an accounting policy that is updated to reflect the $2,500 *de minimis* election amount (the election must be in place at the beginning of the applicable tax year, and the policy must actually be followed for financial statement purposes); and
- Maximize repair expenses by taking advantage of the safe harbor for small taxpayers with buildings. A landlord or a business can elect to expense certain costs that would otherwise (and traditionally) need to be capitalized, up to $10,000. Split multiple projects at the same property over two years to avoid capitalizing the expenditures.

Example of repair expenses

Rory owns a rental property. The tenant moved out in November. Before he re-rents the property, Rory needs to replace the carpeting (estimated cost $3,500) and remodel the bathroom (cost $7,500).

If Rory replaces the carpet and does the bathroom remodel in the same year, he will be over the $10,000 annual limit. If he does one project in December and one in January, he may expense them both, if other requirements are met.

BUNCHING

Time-tested bunching strategies can still work, even under the TCJA. Accelerate or defer deductions so that you alternate years of itemizing with years of taking the standard deduction. For married couples filing a joint return, it is especially critical to keep an eye on changing tax law. Consider accelerating or deferring:

- Medical expenses;
- Charitable contributions;
- Property tax payments; and
- State estimated tax payments.

The TCJA's $10,000 limitation on state and local income tax deductions can limit the effectiveness of the last two items on this list.

In bunching, it's important to consider alternative minimum tax, particularly with regard to taxes paid. If a client is paying AMT, push property tax payments and state estimated tax payments into the following year.

MEDICARE PREMIUM

The Medicare premium increases based on AGI. Plan income and deductions to limit the surcharge on the Medicare premium. Taxpayers who are charged a Medicare premium surcharge can appeal the surcharge by filing Form SSA-44, Medicare Income-Related Monthly Adjustment Amount – Life-Changing Event, with the Social Security Administration if the taxpayer experiences:

- 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.

AB 5 CLIENT LETTER

Dear [CLIENT NAME]:

In 2019, the Governor signed AB 5. Under AB 5, most workers are presumed to be employees for both labor and payroll tax purposes unless the business (hiring entity) satisfies a three-factor test, referred to as the ABC test. This means that many workers previously classified as independent contractors are now employees under California law and you must withhold California income and payroll taxes, and meet California's minimum wage and overtime requirements.

However, as discussed below, AB 5 provides numerous exemptions from the ABC test, and AB 2257, enacted in 2020, significantly expands on the number of available exemptions. AB 2257 also applies the ABC test for purposes of determining an employee for personal income tax purposes. In addition, Proposition 22, which was passed by the voters in the November 2020 election, makes an independent contractor carve-out for certain app-based drivers (for example, Uber, Lyft, and Doordash), but requires the companies that contract with these drivers to provide additional benefits to the workers.

The ABC test

Under the ABC test, all three of these conditions must be met in order to treat the worker as an independent contractor:

A. The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact, commonly known as the ***Borello*** "control test" (***S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.*** (1989) 48 Cal.3rd 342);
B. The worker performs work that is outside the usual course of the hiring entity's business; and
C. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

The ABC test means, for example, that a hospital who hires nurses to work in specialized areas, such as an anesthesia nurse or neonatal nurse, may not treat the nurse as an independent contractor if those nurses are filling in for or working alongside employee-nurses. While physicians have their own specific exemption from AB 5, the same treatment would apply to other medical services, as well as consulting services, some portions of the entertainment industry, and many personal service workers.

A previous court case, ***Borello***, will continue to apply. Many workers have been treated as independent contractors rather than employees, even using the ***Borello*** test. The difference now, is that AB 5 is putting the issue in the forefront and many businesses have not been properly classifying workers. We will see an increase in audits by the state in this area.

Exemptions

While applying the ABC test to workers will result in many more workers being classified as employees, the legislation provides for numerous exemptions to the application of the ABC test. The exemptions are complicated, and very specific. However, the exemptions do not mean workers are automatically independent contractors.

If an exemption applies, you are still required to apply the traditional tests to determine if a worker is an employee or an independent contractor. Under these traditional tests, the "B" part of the ABC test will still be considered, but it is not a make-or-break factor.

Penalties could apply

Be aware that California law includes severe financial penalties for willfully treating an employee as an independent contractor.

The penalties, which are in addition to other assessments, penalties, or fines, are:

- $5,000 to $15,000 for each violation (a single misclassified individual); and
- $10,000 to $25,000 for each violation if the Labor Commissioner, or a court, determines there is a "pattern and practice" of these violations.
- (Labor Code §226.8)

With the exception of an attorney or other employee of the business, these penalties also apply to your tax professional or any paid person who advises you to incorrectly treat a worker as an independent contractor. This means that you may be required to obtain a legal opinion if there is a question as to the classification of employees and as a non-attorney, I cannot provide this advice.

Important points

There are three important points to understand:

1. Forming or operating as a corporation or an LLC is not a work-around. The corporation or LLC will be ignored if the worker does not meet the ABC test, and the worker who owns the entity will still be an employee of the payor;
2. In many cases the worker may still be an independent contractor for federal purposes if the "A" and "C" test apply. This is an area that we must discuss in detail; and
3. The effective date of the law is January 1, 2020, but could be applied retroactively, so time is of the essence.

The law is extremely complex with many unanswered questions. We continue to research and educate ourselves and are available to consult with you regarding this new issue as well as any other tax-related matters.

Sincerely,

Your tax professional

> **Website**
> To download a copy of this client letter, go to:
> www.caltax.com/files/2020/cl-ab5.doc

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Glossary

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GLOSSARY — Part I

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

Alternative minimum tax (AMT): an income tax that ensures that individuals and corporations that benefit from various exclusions, credits, and deductions will pay at least some tax. The AMT is assessed on an adjusted amount of taxable income above a specified threshold

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

Back door Roth: allows high-income individuals to make a nondeductible contribution to a traditional IRA and then convert the traditional IRA to a Roth IRA

Basis: the amount of an individual's capital investment in property for tax purposes, which includes sales tax and other expenses. If property is acquired in other ways, e.g., by gift or inheritance, other rules apply when determining basis. Specifically, basis for property acquired from a decedent is the fair market value at date of death (unless it is income in respect of a decedent)

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

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

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

Coronavirus Aid, Relief, and Economic Security (CARES) Act: signed into law on March 27,2020, provides economic impact payments to qualified individuals, low-interest Payroll Protection loans for business with fewer than 500 employees per location, Employer Retention Credits, delays payroll tax payments, provides retirement plan benefits, expands unemployment insurance coverage for those impacted by COVID-19, and more tax relief for individuals and businesses

Cost segregation study: segregates the components of real property into its shorter depreciable-life components

Defined benefit plan: an employer-sponsored retirement plan whereby benefits are based on a formula using such factors as salary history, employment duration, etc.

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. Not available for married individuals filing separate returns

Economic impact payments: payments to eligible individuals under the CARES Act. Also known as "2020 recovery rebates," the advance payments of a 2020 taxable year credit are equal to $1,200 per qualifying individual ($2,400 MFJ) and $500 per qualifying child

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, but the grant is taxable for state purposes

Employee Retention Credit: a refundable credit against quarterly employment taxes equal to 50% of the qualified wages and compensation paid to each employee by a qualified employer. Wages paid after March 12, 2020, and before January 1, 2021, qualify for the credit

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. The CARES Act retroactively delays implementation of the excess business loss limitations until 2021

Families First Coronavirus Response Act (FFCRA): provides immediate relief for individuals and employers affected by the coronavirus pandemic. Provisions include mandatory paid sick leave; mandatory paid family leave; employer payroll tax credits; and expanded unemployment benefits. Effective date is expected to be not later than April 2, 2020

Family and Medical Leave Act (FMLA): administered by the Wage and Hour division of the Department of Labor. Requires that covered employers provide employees with job-protected and unpaid leave for qualified medical and family reasons. Under the FFCRA, the FMLA has been expanded in that it requires employers to provide paid leave benefits to qualified employees and applies to all employers with fewer than 500 employees unless the DOL grants a waiver. The FMLA previously only applied to employers with between 50 and 499 employees

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

FinCEN: the Financial Crimes Enforcement Network of the U.S. Department of the Treasury established to "safeguard the financial system from illicit use and combat money laundering and promote security through collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities"

Five-year rule: in the event a retirement account owner dies prior to the RBD for receiving distributions, the inherited assets must be distributed over the life expectancy of the beneficiary or distributed by December 31 of the fifth year from the retirement account owner's death

Floor plan financing interest: interest on debt used to finance the acquisition of assets held for sale or lease where the debt is secured by the acquired inventory; most common with motor vehicle sales and leasing

Foreign-derived intangible income exclusion: a 37.5% deduction that may be claimed by U.S. corporations on certain export income

Full-time equivalent employees (FTEEs): a combination of employees, each of whom individually is not a full-time employee because they are not employed on average at least 30 hours per week, but who, in combination, are counted as the equivalent of a full-time employee

Global intangible low-taxed income (GILTI) tax: a minimum tax on 10% U.S. shareholders of a controlled foreign corporation that is basically a minimum tax on their foreign investments

Hybrid dividend: a dividend that can qualify for tax benefits from both the U.S. and a foreign jurisdiction

Kiddie tax: a special tax on a person under age 17 who has earned income above an annually determined threshold. For California purposes, income above the threshold is taxed at the parent's or guardian's rate. However, under the Tax Cuts and Jobs Act, a child's income will is taxed at trust rates. The tax deters shifting income to children in hopes of paying tax at the child's lower tax rate. Under the SECURE Act, changes to the kiddie tax under the TCJA are repealed, and parents can elect to apply pre-TCJA rules for the 2018 and 2019 tax years

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

IRA: individual retirement account that allows a person to save for retirement on a tax-deferred basis. With a traditional IRA, contributions may be able to 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 §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

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

Modified outside basis method: one of two safe harbors for reporting tax capital; take the partner's adjusted basis in its partnership interest and subtracting from that basis the partner's share of partnership liabilities

Modified previously taxed capital method: one of two safe harbors for reporting tax capital; a more complex method than computing modified outside basis; based on what the amount the partner would receive in a hypothetical liquidation of the partnership

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. Prior to the TCJA, the loss could be carried back against income in prior years or carried forward as a deduction against future income. Under the TCJA, however, NOL carrybacks are largely repealed with limited exceptions. For losses arising in tax years beginning after December 31, 2017, the NOL deductions are limited to 80% of the taxpayer's taxable income for the year of the claimed deduction, but carryovers are allowed indefinitely. **New under the CARES Act:** NOLs are allowed to be carried back five years if they arose in the 2018, 2019, and 2020 taxable years for all taxpayers. The two-year carrybacks for farming losses and insurance company losses do not apply during this period. Also for taxable years beginning before January 1, 2021, the 80% taxable income limit for NOLs is repealed

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

Pandemic unemployment assistance: expanded unemployment benefits under the CARES Act to include individuals who historically are ineligible for benefits, such as long-term unemployed or self-employed individuals and independent contractors who are unemployed, partially unemployed, or unable to work due to COVID-19. Benefits begin on or after January 27, 2020, and end on December 31, 2020

Paycheck Protection Program: under the CARES Act, whereby the Small Business Administration will guarantee 100% of loans made under the program between February 15, 2020, and June 30, 2020 (known as the "covered period"). Benefits include: loans may be forgiven for amounts used to cover basic operating expenses, loan payment deferral for six months (interest will run), no personal guarantees required, and waiver of SBA administration fees

People First Initiative: an IRS initiative that provides notification to taxpayers and tax professionals about the IRS's intended course of action pertaining to enforcement of various provisions starting April 1, 2020, through July 15, 2020 – the suspension period

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

Professional employer organization (PEO): also referred to as employee leasing companies, which enter into contracts with businesses to provide payroll support

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 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 retirement plan: a type of retirement plan established by an employer for a company's employees. The employers get a tax break for contributions made for their employees, and employees get to defer a portion of their income and reduce current taxable income

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 energy efficient property (REEP) credit: a tax credit under IRC §25D for residential solar energy property

Regulated investment company (RIC): an investment entity like a mutual fund, exchange-traded fund, or REIT that is considered eligible by the IRS to pass through the taxes on capital gains, dividends, or interest to individual shareholders

Rollover: a transfer of funds from a retirement account into a traditional or Roth IRA by a direct transfer or by a check written by the custodian of the retirement account to the account holder who must deposit the funds into another IRA account. The purpose of the rollover is to maintain the tax-deferred status of the funds

Roth IRA: a special retirement account where taxes are paid on money going into the account, but all future withdrawals are tax-free

SARSEP: Salary Reduction Simplified Employee Pension Plan, repealed as of December 31, 1996, with the establishment of SIMPLE IRAs. Contributions may still be made for existing SARSEPs, up to a maximum of $19,000 for 2019

SECURE Act: Setting Every Community Up for Retirement Enhancement Act of 2019 enacted to impact almost all types of employer and retirement plans

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

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. An eligible employer must have employed 100 or fewer employees who earned a minimum of $5,000 during the previous year. An eligible employee is one who received at least $5,000 as compensation during any two years prior to the current calendar year and who is reasonably expected to receive at least $5,000 in the current calendar year. Employers cannot maintain any other qualified plan

SIMPLE 401(k): differs from a SIMPLE IRA in that the employer is not permitted to match contributions of more than 3% of the employee's compensation. No other amount of employer contribution is allowed, and there is no flexibility of contributions. Also, withdrawals in the first two years are subject to a 10% penalty (rather than 25% for a SIMPLE IRA), and the employer is required to file IRS Form 5500 each year

Subpart F: that part of the Tax Code that deals with foreign corporations controlled by U.S. shareholders

Syndicate: any partnership or other entity (other than a corporation that is not an S corporation) if more than 35% of the losses of the entity during the taxable year are allocable to limited partners or limited entrepreneurs

Top-heavy plan: a defined benefit plan where the present value of the benefits for key employees exceeds 60% of the present value of cumulative benefits under the plan for all employees, or a defined contribution plan where the aggregate of the accounts for key employees is more than 60% of the accounts of all employees

Traditional IRA: also known as a "regular IRA," contributions are generally tax-deductible, and income is tax-deferred. Withdrawals are taxable

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: tax-advantaged vehicle for education savings held in an account for a designated beneficiary

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

Borello **right-to-control test:** determines independent contractor status. The test analyzes whether the business to which services are provided has the right to control the manner in which the work is performed

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

Coronavirus Aid, Relief, and Economic Security (CARES) Act: signed into law on March 27, 2020, provides economic impact payments to qualified individuals, low-interest Payroll Protection loans for business with fewer than 500 employees per location, Employer Retention Credits, delays payroll tax payments, provides retirement plan benefits, expands unemployment insurance coverage for those impacted by COVID-19, and more tax relief for individuals and businesses

Covered California: California's health insurance exchange

Domicile: a legal term that does not have the same meaning as "residence" in California. For tax purposes, domicile is the place where an individual voluntarily establishes his/her true permanent home and principal establishment, and to which place that individual has the intention of returning whenever absent. Per 18 Cal. Code Regs. §17014(c), an individual can only have one domicile at any one time

Drop and swap: a like-kind exchange transaction where a partnership distributes property to partners as tenants-in-common (the drop), which allows some partners to exchange their tenants-in-common interest in the property, while others may cash out (the swap)

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. Not available for married individuals filing separate returns

Economic impact payments: payments to eligible individuals under the CARES Act. Also known as "2020 recovery rebates," the advance payments of a 2020 taxable year credit are equal to $1,200 per qualifying individual ($2,400 MFJ) and $500 per qualifying child

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. California does not conform to the retroactive suspension of the excess business loss limitation for noncorporate taxpayers

Families First Coronavirus Response Act (FFCRA): provides immediate relief for individuals and employers affected by the coronavirus pandemic. Provisions include mandatory paid sick leave; mandatory paid family leave; employer payroll tax credits; and expanded unemployment benefits. Effective date is expected to be not later than April 2, 2020

Individual shared responsibility provision: like the federal provision, California's health care mandate requires all family members to either have qualifying health coverage, qualify for an exemption, or make a shared responsibility payment for the months that the individual and family members did not have coverage or an exemption

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

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

Modified adjusted gross income (MAGI): like adjusted gross income but with certain adjustments that were previously subtracted from income added back in. For example, IRA contributions, and tuition-related costs that may have been deducted when calculating AGI must be added back to compute MAGI

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. Prior to the TCJA, the loss could be carried back against income in prior years or carried forward as a deduction against future income. Under the TCJA, however, NOL carrybacks are largely repealed with limited exceptions. For losses arising in tax years beginning after December 31, 2017, the NOL deductions are limited to 80% of the taxpayer's taxable income for the year of the claimed deduction, but carryovers are allowed indefinitely. **New under the CARES Act:** NOLs are allowed to be carried back five years if they arose in the 2018, 2019, and 2020 taxable years for all taxpayers. The two-year carrybacks for farming losses and insurance company losses do not apply during this period. Also for taxable years beginning before January 1, 2021, the 80% taxable income limit for NOLs is repealed. California does not conform to the five-year carrybacks for 2018-2020 NOLs and the temporary suspension of the 80% taxable income NOL carryover limitation.

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

Paid family leave: a family temporary disability insurance program in California that provides up to six weeks of wage replacement benefits in a 12-month period for individuals to care for a seriously ill family member or bond with a child

Paycheck Protection Program (PPP): under the CARES Act, whereby the Small Business Administration will guarantee 100% of loans made under the program between February 15, 2020, and June 30, 2020 (known as the "covered period"). Benefits include: loans may be forgiven for amounts used to cover basic operating expenses, loan payment deferral for six months (interest will run), no personal guarantees required, and waiver of SBA administration fees. Under the PPP Flexibility Act, the loan forgiveness period has been extended from eight weeks to 24 weeks for the loan origination date, as long as the covered period does not extend beyond December 31, 2020. Changes have also been made with regard to loan forgiveness and the payroll cost threshold, maturity date, deferring payments, and eliminating the full-time equivalent employee reduction provision under certain circumstances

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. California does not conform to treating qualified improvement property as 15-year recovery period property eligible for bonus depreciation (California has never allowed shortened recovery periods for real property and does not allow bonus depreciation)

Resident: for California purposes, a person who is in the state for other than a temporary or transitory purpose or who is domiciled in California, but who is outside California for a temporary or transitory purpose

SECURE Act: Setting Every Community Up for Retirement Enhancement Act of 2019 enacted to impact almost all types of employer and retirement plans

Short coverage gap: for purposes of the individual health care mandate, a period of three consecutive calendar months or less

Swap and drop: the reverse of drop and swap whereby the partnership in a like-kind exchange makes the exchange, and after waiting “long enough,” elects out of partnership treatment

Transfer on death (TOD) deed: in California, a deed that is executed and recorded designating beneficiaries who will take title to real property upon the owner’s death. The designation can be modified or revoked but must be notarized and recorded within 60 days of execution. There are no income tax considerations

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December 2020

Dear Customer:

Thank you for purchasing Spidell's 2020/2021 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 1-6) qualifies for six hours of Federal Tax Update credit and Part II (Chapters 7-11) qualifies for two hours of California tax credit.

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2020/2021 FEDERAL AND CALIFORNIA TAX UPDATE
PART I — CHAPTERS 1-6
Course description and study guide

Course objectives: This update provides a thorough review and analysis of essential issues in federal tax law and practice that have developed during the past year and prepares tax professionals for the upcoming 2020-2021 filing season. Topics addressed include: economic impact payments; charitable contributions; unemployment compensation; kiddie tax rules; business vs. nonbusiness bad debts; virtual currency transactions; alimony; student loan interest; individual tax credits; maximizing qualified business income on the 1040; Families First Coronavirus Response Act (FFCRA); employment benefits related to COVID-19; mandatory paid sick leave and paid family leave; Employee Retention Credit; payroll tax credits and deferral; net operating losses; CARES Act; excess business losses; IRC §179 and depreciation; IRC §199A; partner capital accounts; business interest limitation; SECURE Act; qualifying coronavirus-related distributions from retirement accounts; IRA-to-charity rules; required minimum distributions; estate, trust, and gift taxes; like-kind exchanges; Qualified Opportunity Funds; foreign tax issues; forms and filing updates; 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 Tax Update
CRTPs — 6 Federal Tax 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, Inc. (Registry ID: 104931)

Expiration Date: December 2021*

*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
- Paycheck Protection Program

Learning Objectives:

After completing this course, you will be able to:

- Recall who is ineligible for an economic impact payment
- Identify the order in which debt is considered repaid under the rules for home mortgages
- Choose expenses that are eligible for §529 distributions
- Recall the employer's responsibility when an employee requests a Social Security tax deferral
- Determine how employer payroll credits work under the FFCRA
- Recall what is included in wages for purposes of the Employee Retention Credit
- Identify the two safe harbors for determining tax basis capital accounts for partnerships
- Choose the retirement accounts from which a penalty-free coronavirus-related distribution may be made
- Recall how the CARES Act affects inherited retirement accounts
- Determine whether a long-time, part-time employee is eligible to participate in an employer-sponsored 401(k) plan
- Identify deductible administrative costs for estates and trusts
- Recall IRS-provided relief for Qualified Opportunity Funds and their investors

After studying the materials, please answer exam questions 1-30.

2020/2021 FEDERAL AND CALIFORNIA TAX UPDATE
PART II — CHAPTERS 7-11
Course description and study guide

Course objectives: This course provides a comprehensive review and analysis of key issues in California tax law and regulations that developed during the past year and will prepare tax professionals for the upcoming California 2020-2021 filing season. Topics include: individual health care mandate; residency issues, including changing California residency/domicile; Earned Income Tax Credit; electric vehicle rebates; calculating S corporation shareholder basis; dissolving with the SOS; administrative dissolutions; CalSavers; excess business loss limitation; multistate business issues; "doing business" in California; cannabis businesses; net operating losses; AB 5; revocable transfer on death deeds; COVID-19 conformity; SECURE Act; Quick Guide to California Nonconformity for Taxable Year 2020; property taxes; disaster victims; 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 — 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, Inc. (Registry ID: 104931)

Expiration Date: December 2021*

*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

Learning Objectives:

After completing this course, you will be able to:

- Determine the individual share responsibility penalty for a family of four that remains uninsured for the entire year
- Recall who is exempt from the requirement to have health care coverage
- Identify whether a California domiciliary is out of the state for a temporary or transitory purpose
- Recall how to deal with passthrough losses in excess of a shareholder's basis
- Identify the three conditions under which the FTB will not assess the $800 minimum franchise tax
- Identify the entities that are eligible for administrative dissolution
- Recall how the FTB treats workers telecommuting due to COVID-19
- Determine how to file tax returns for taxpayers who are independent contractors for federal purposes and employees for California purposes

After studying the materials, please answer exam questions 1-10.

Course Evaluation for Spidell Publishing, Inc.

Program title: **2020/2021 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? _______________

IRS Course Number (if applicable): CRA7E-U-00490-20-S

TTP (CTEC) Course Number (if applicable): 1019-CE-1036

Date course completed: _______________

Number of hours it took to complete the course: _______________

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Course Evaluation for Spidell Publishing, Inc.

Program title: **2020/2021 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? ______________

IRS Course Number (if applicable): N/A

TTP (CTEC) Course Number (if applicable): 1019-CE-1037

Date course completed: ______________

Number of hours it took to complete the course: ______________

Examination for Spidell's 2020/2021 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.

<u>Final Exam Questions</u>

1. Which statement is true based on this example?

   Jackie is single and claims her 75-year-old mother, who lives in a nursing home, as a dependent on her 2019 and 2020 tax returns. Jackie's AGI is $65,000, and her mother received $10,500 in Social Security benefit income in 2019. Jackie's mother receives an economic impact payment of $1,200.

   a) Jackie receives an EIP for claiming her mother as a dependent
   b) Jackie receives an EIP of $1,700
   c) Because she is claimed as Jackie's dependent, her mother received an erroneous payment
   d) Because Jackie's mother did not have a filing requirement, she was ineligible for an EIP

2. Which of the following is eligible for an economic impact payment?

   a) U.S. citizen working abroad
   b) Nonresident alien
   c) Business entity
   d) Estate or trust

3. In order for a child's unearned income to be taxed at their parents' highest marginal income tax rate, certain conditions must be met including all of the following except:

   a) The child's unearned income for the 2019 and 2020 tax years must be more than $2,200
   b) The child must be under age 18
   c) The child didn't file a joint return for the tax year
   d) The child is required to file a tax return for the year

4. What is true regarding student loan payments made by an employer under IRC §127?

   a) Any payments made by an employer on an employee's student loan in 2020 may be excluded from the employee's gross income
   b) Employer student loan payments may not exceed $5,250 per calendar year
   c) The employer is not required to pay payroll and workers' compensation on employer student loan payments
   d) Payments must be made directly to the lender of the qualified education loan

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5. Under the rules for home mortgages, if at any time any portion of a debt is repaid and the debt is allocated to both acquisition debt and equity debt, then the debt is considered as repaid in a specific order, with which of the following coming first?
   a) Acquisition debt
   b) Amounts allocated to passive activity expenditures
   c) Amounts allocated to business expenditures
   d) Amounts allocated to personal expenditures

6. Which choice best describes some of the details of the IRC §199A deduction?
   a) For taxpayers below the phaseout threshold, the deduction is 20% of qualified business income or taxable income before the deduction and after reduction for net capital gains, whichever is less
   b) Net capital gains are included in taxable income for purposes of the §199A taxable income limitation
   c) When determining the phaseout range, taxable income refers to income before the §199A deduction and after the reduction for any net capital gains
   d) Net capital gains are not included in taxable income for purposes of the §199A phaseout

7. Which choice is accurate regarding IRC §529 distributions?
   a) They are limited to $10,000 annually for K-12 and college
   b) Tuition is covered, but books and supplies are ineligible expenses
   c) Expenses for special needs services of a K-12 beneficiary in connection with enrollment and attendance are ineligible
   d) Expenses for the purchase of computer equipment is always eligible

8. Which choice correctly describes form and filing updates?
   a) For the 2020 tax year, nonemployee compensation is reported on Form 1099-MISC
   b) All Forms 1099-MISC are due to the IRS by January 31
   c) The IRS will not forward Form 1099-NEC to states as part of the combined federal/state filing program
   d) Form 1099-NEC, Nonemployee Compensation, must be filed and mailed to the recipient by February 28

9. What is the current backup withholding rate?
   a) 28%
   b) 26%
   c) 24%
   d) 23%

10. What are among the most current e-filing updates?
    a) Form 1040-X, Amended U.S. Individual Income Tax Return, can now be e-filed
    b) Amended returns may be e-filed even if the original return was paper-filed
    c) Amended returns may not be paper-filed
    d) Only tax year 2019 Forms 1040 and 1041 may be amended electronically

11. If ABC Partnership files an administrative adjustment request for the 2018 taxable year in 2020 and makes a push-out election at that time, what is the result?
    a) The partnership will provide each partner a Form 8978, Partner's Additional Reporting Year Tax
    b) The partners will report the adjustments on their 2020 returns
    c) The partners will amend their 2018 returns
    d) The partners will calculate any additional tax liability using 2020 tax rates

12. Which of these factors correctly pertains to a PPP borrower that sells their business or assets?

    a) For purposes of PPP loans, a change of ownership means that at least 25% of common stock or other ownership interest is sold or transferred
    b) Even with a change of ownership, the original PPP borrower remains responsible for all loan obligations
    c) The bank must have SBA approval if the sale consists of the sale of stock or other ownership interest
    d) If the sale is structured as an asset sale, no SBA approval is required

13. Which of these statements is true regarding the deferral of Social Security taxes?

    a) For cash basis taxpayers, the deferral amount is deducted in the year of deferral
    b) The deferral does not apply to household employers
    c) Self-employed individuals may defer 50% of their employer-share of Social Security and Medicare taxes
    d) The above-the-line deduction for 50% of self-employment tax pertains to what would otherwise be the employer's portion of Social Security tax

14. Which is true about paid family leave?

    a) Under the FFCRA, all employees who work for an employer that employs fewer than 500 employees may take up to 12 weeks of employer-paid family leave
    b) There is a 14-day waiting period before family leave kicks in
    c) For employers, paid family leave benefits are not subject to the employer's portion of Social Security tax
    d) Small employers must apply to the Department of Labor for an exemption from paying family leave benefits

15. When counting wages for purposes of the Employee Retention Credit, all of the following are included except:

    a) Employer contributions to a health savings account
    b) Cash tips
    c) Employee salary reductions allocated to a health reimbursement arrangement
    d) Vacation pay

16. Which is incorrect regarding the Employee Retention Credit?

    a) Wages paid to relatives are not considered qualified wages
    b) Household employers are eligible to claim the credit
    c) Payments made to an independent contractor are not "qualified wages" for purposes of the credit
    d) An employer is required to prove that they have experienced a significant decline in gross receipts because of COVID-19

17. Based on the year an NOL is generated, which of the following applies?

    a) For post-2020 tax years, there are no carrybacks, and carryforwards are indefinite
    b) For pre-2018 taxable years, carrybacks were for two years and carryforwards were indefinite
    c) For 2018-2020 taxable years under the CARES Act, carrybacks are for five years and carryforwards are for 20 years
    d) For pre-2018 tax years, there was an 80% taxable income limitation

18. What is true about automobile expenses?

    a) Personal vehicles converted to business use qualify for bonus depreciation
    b) To qualify for bonus depreciation, business use must be at a minimum of 50%
    c) For 2019 and 2020, the lease inclusion threshold has been increased to $55,000
    d) The standard business mileage rate for 2020 is 58 cents

19. Under the provisions of Rev. Proc. 2020-22 regarding the business interest expense limitation, which statement is correct?

   a) Taxpayers may elect out of the 30% adjusted taxable income limitation beginning in 2019 or 2020
   b) Taxpayers may elect out of deducting 50% of excess business interest expense by filing an election statement
   c) Taxpayers may withdraw the irrevocable election to be treated as an electing real property business for the 2018-2020 tax years for purposes of the business interest expense limitation
   d) Taxpayers must use their 2020 adjusted taxable income for purposes of calculating the 2020 business interest expense limitation

20. For various types of business interest expense limitation elections, which statement is true?

   a) A late IRC §163(j)(7) election for 2018-2020 tax years must be made by filing an administrative adjustment request
   b) An IRC §163(j)(7) election withdrawal must be titled "Revenue Procedure 2020-22 Section 163(j)(7) Election"
   c) An election to use the taxpayer's 2019 ATI must be made on a timely filed income tax return using the statement, "Revenue Procedure 2020-22 Section 163(j)(10)(B) Election to Use Taxpayer's 2019 ATI"
   d) The election out of using the increased 50% ATI limitation for 2019 and 2020 must be made separately each year

21. Under the SECURE Act, taxpayers must begin to take required minimum distributions at age _______ and may make qualified charitable distributions at age _______.

   a) 70½; 70½
   b) 70½; 72
   c) 72; 70½
   d) 72; 72

22. A penalty-free coronavirus-related distribution may be made from all of these accounts except:

   a) Defined benefit plan
   b) 401(k)
   c) Annuity plan
   d) Individual retirement account

23. Under the CARES Act, loans may be taken from which of these plans?

   a) SEP
   b) SIMPLE IRA
   c) Government
   d) SARSEP

24. Based on this scenario, and under the TCJA, which of the following statements is correct?

   On July 1, 2020, XYZ Corporation closed due to COVID-19, and Jackie, age 58, lost her job. At that time, she had an outstanding loan from her retirement plan of $15,000.

   a) She is required to recontribute the $15,000 to her IRA within 60 days of her separation from service or she'll be assessed an early withdrawal penalty
   b) She will not be taxed on the loan amount, but she will be subject to the penalty for early withdrawal
   c) If she files an extension, she'll have until October 15, 2021, to avoid recognizing the income and being assessed any penalties
   d) If she does not recontribute the entire amount to an IRA, she must recognize the distribution in the year following the year of separation from employment

25. When a taxpayer inherits a retirement account, which of the following applies?

    a) If an eligible retirement plan allows a beneficiary to elect whether RMDs are determined using either the five-year rule or the life expectancy rule, there is a CARES Act 2020 RMD suspension that extends the time to make this election until December 31, 2021
    b) When a taxpayer inherits a retirement account from someone who died on or before December 31, 2019, the entire account must be distributed immediately
    c) The five-year rule no longer matters for 2020
    d) Any beneficiary may roll the IRA over into their own account

26. For plan year beginning in 2020, IRC §403(b) plan holders with retirement plans that no longer offer a lifetime income investment option may make a trustee-to-trustee transfer to another lifetime investment option in another employer-sponsored retirement plan or IRA. The distribution must be made within the _______ period ending on the date when the lifetime income investment is no longer authorized to be held as an investment option under the plan.

    a) 30-day
    b) 45-day
    c) 60-day
    d) 90-day

27. Which of the following is an allowable rollover?

    a) SEP-IRA to designated Roth account
    b) Roth IRA to qualified plan
    c) 403(b) plan to traditional IRA
    d) Designated Roth account to qualified plan

28. Deductible administrative costs for estates and trusts include all of the following except:

    a) Executor fees
    b) Appraisal fees
    c) Investment expenses
    d) Attorney fees

29. What is considered qualified improvement property under the CARES Act?

    a) Improvements made by the taxpayer to the interior of a nonresidential building placed in service after the building itself is first placed in service
    b) Enlargement of a building
    c) Expenses that can be attributed to the internal structural framework of a building
    d) Improvements to residential rental property

30. For purposes of timing for the investment of gains in a QOZ fund, when does the 180-day investment period begin for specific eligible capital gains?

    a) For §1231 gains, the 180-day period starts at the time of the transaction that generates the §1231 gain
    b) For passthrough entity owners, the 180-day period must begin at the end of the entity’s taxable year
    c) For installment sales, the 180-day period must begin on the last day of the taxable year
    d) For a regulated investment company, the 180-day period begins at the time the shareholder receives a RIC dividend

Examination for Spidell's 2020/2021 Federal and California Tax Update — Part II

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Final Exam Questions

1. What are among the facts regarding the new FTB Form 593, Real Estate Withholding Statement?

   a) A Social Security number is required to complete the form
   b) The buyer's signature is only required when the transaction is an installment sale
   c) The remitter is the person who sends the tax withheld on any disposition from the sale or exchange of property, which is usually the buyer/transferee
   d) The seller's signature's signature is not required on any Form 593

2. California conforms to:

   a) Five-year NOL carrybacks for 2018-2020 NOLs
   b) Retroactive suspension of the excess business loss limitation for noncorporate taxpayers
   c) Increase in the age for required minimum distributions from age 70½ to age 72 for taxpayers who turn age 70½ after December 31, 2019
   d) Retroactive modifications to the business interest expense limitations

3. Unless an individual qualifies for an exemption, if their income is above California's state income tax filing threshold, they will be subject to a penalty if they go without insurance for more than:

   a) 30 days
   b) 45 days
   c) Two consecutive months
   d) Three consecutive months

4. For purposes of California's monthly minimum essential health care coverage, all of the following qualify as minimum essential coverage except:

   a) Medicaid
   b) Workers' compensation
   c) Refugee Medical Assistance under the Administration for Children and Families
   d) COBRA

5. A California domiciliary absent from the state for an uninterrupted period of at least _______ under an employment-related contract is considered outside the state for other than a temporary or transitory purpose and is thus not a resident of California.

   a) 180 consecutive days
   b) 273 consecutive days
   c) 365 consecutive days
   d) 546 consecutive days

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6. Under California law, what is true about paid family leave?
   - **a)** It covers up to six weeks of wage replacement benefits in a 12-month period
   - **b)** It is included in gross income for California purposes
   - **c)** Family leave benefits received from an employer-administered plan rather than the EDD do not qualify for an exclusion from income
   - **d)** It is not taxable on the federal or the California return

7. Under the voluntary administrative dissolution process for corporations, LLCs, or limited partnerships, which of these penalties will not be abated?
   - **a)** Estimated tax penalty
   - **b)** Late-payment penalty
   - **c)** Withholding-at-source penalty
   - **d)** Demand penalty

8. A domestic corporation may be administratively dissolved involuntarily if, as of January 1, 2020, and thereafter, the entity has been suspended by the FTB for at least ________ and has no outstanding liabilities.
   - **a)** 60 consecutive months
   - **b)** 48 consecutive months
   - **c)** 36 consecutive months
   - **d)** 24 consecutive months

9. Which of these statements regarding "drop and swap" or "swap and drop" transactions is correct?
   - **a)** With a drop-and-swap transaction, the entity converts the partnership interests to tenant-in-common interests, with title dropping to the TICs
   - **b)** With a swap-and-drop transaction, the partnership retains title to the property
   - **c)** The IRS has stated that property must be held for a minimum of 18 months to be considered an investment
   - **d)** Drop-and-swap transactions are not commonly used because the FTB and IRS typically rule that the arrangement was designed to avoid taxation, and they disallow it

10. The Cool Trust has two cotrustees, one who lives in California and the other who lives in Georgia. There is one beneficiary, a Georgia resident. The trust has $60,000 in undistributed California-source income and $10,000 in undistributed non-California-source income. On what amount is the trust subject to tax in California under current state law?
    - **a)** $70,000
    - **b)** $65,000
    - **c)** $60,000
    - **d)** $50,000

Name ____

Answer Sheet for Spidell's 2020/2021 Federal and California Tax Update — Part I

Name: ________________________ Signature: ________________________

Company: ________________________ No. of Hours to Complete (Max. 6): __________

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 2020/2021 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 credit.

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Name ______________________________

Final Exam Questions

1. ☐ **a)** Jackie receives an EIP for claiming her mother as a dependent
   ☐ **b)** Jackie receives an EIP of $1,700
   ☐ **c)** Because she is claimed as Jackie's dependent, her mother received an erroneous payment
   ☐ **d)** Because Jackie's mother did not have a filing requirement, she was ineligible for an EIP

2. ☐ **a)** U.S. citizen working abroad
   ☐ **b)** Nonresident alien
   ☐ **c)** Business entity
   ☐ **d)** Estate or trust

3. ☐ **a)** The child's unearned income for the 2019 and 2020 tax years must be more than $2,200
   ☐ **b)** The child must be under age 18
   ☐ **c)** The child didn't file a joint return for the tax year
   ☐ **d)** The child is required to file a tax return for the year

4. ☐ **a)** Any payments made by an employer on an employee's student loan in 2020 may be excluded from the employee's gross income
   ☐ **b)** Employer student loan payments may not exceed $5,250 per calendar year
   ☐ **c)** The employer is not required to pay payroll and workers' compensation on employer student loan payments
   ☐ **d)** Payments must be made directly to the lender of the qualified education loan

5. ☐ **a)** Acquisition debt
   ☐ **b)** Amounts allocated to passive activity expenditures
   ☐ **c)** Amounts allocated to business expenditures
   ☐ **d)** Amounts allocated to personal expenditures

6. ☐ **a)** For taxpayers below the phaseout threshold, the deduction is 20% of qualified business income or taxable income before the deduction and after reduction for net capital gains, whichever is less
   ☐ **b)** Net capital gains are included in taxable income for purposes of the §199A taxable income limitation
   ☐ **c)** When determining the phaseout range, taxable income refers to income before the §199A deduction and after the reduction for any net capital gains
   ☐ **d)** Net capital gains are not included in taxable income for purposes of the §199A phaseout

7. ☐ **a)** They are limited to $10,000 annually for K-12 and college
   ☐ **b)** Tuition is covered, but books and supplies are ineligible expenses
   ☐ **c)** Expenses for special needs services of a K-12 beneficiary in connection with enrollment and attendance are ineligible
   ☐ **d)** Expenses for the purchase of computer equipment is always eligible

8. ☐ **a)** For the 2020 tax year, nonemployee compensation is reported on Form 1099-MISC
   ☐ **b)** All Forms 1099-MISC are due to the IRS by January 31
   ☐ **c)** The IRS will not forward Form 1099-NEC to states as part of the combined federal/state filing program
   ☐ **d)** Form 1099-NEC, Nonemployee Compensation, must be filed and mailed to the recipient by February 28

9. ☐ **a)** 28%
   ☐ **b)** 26%
   ☐ **c)** 24%
   ☐ **d)** 23%

10. ☐ **a)** Form 1040-X, Amended U.S. Individual Income Tax Return, can now be e-filed
   ☐ **b)** Amended returns may be e-filed even if the original return was paper-filed
   ☐ **c)** Amended returns may not be paper-filed
   ☐ **d)** Only tax year 2019 Forms 1040 and 1041 may be amended electronically

Name ____

11. ☐ **a)** The partnership will provide each partner a Form 8978, Partner's Additional Reporting Year Tax
☐ **b)** The partners will report the adjustments on their 2020 returns
☐ **c)** The partners will amend their 2018 returns
☐ **d)** The partners will calculate any additional tax liability using 2020 tax rates

12. ☐ **a)** For purposes of PPP loans, a change of ownership means that at least 25% of common stock or other ownership interest is sold or transferred
☐ **b)** Even with a change of ownership, the original PPP borrower remains responsible for all loan obligations
☐ **c)** The bank must have SBA approval if the sale consists of the sale of stock or other ownership interest
☐ **d)** If the sale is structured as an asset sale, no SBA approval is required

13. ☐ **a)** For cash basis taxpayers, the deferral amount is deducted in the year of deferral
☐ **b)** The deferral does not apply to household employers
☐ **c)** Self-employed individuals may defer 50% of their employer-share of Social Security and Medicare taxes
☐ **d)** The above-the-line deduction for 50% of self-employment tax pertains to what would otherwise be the employer's portion of Social Security tax

14. ☐ **a)** Under the FFCRA, all employees who work for an employer that employs fewer than 500 employees may take up to 12 weeks of employer-paid family leave
☐ **b)** There is a 14-day waiting period before family leave kicks in
☐ **c)** For employers, paid family leave benefits are not subject to the employer's portion of Social Security tax
☐ **d)** Small employers must apply to the Department of Labor for an exemption from paying family leave benefits

15. ☐ **a)** Employer contributions to a health savings account
☐ **b)** Cash tips
☐ **c)** Employee salary reductions allocated to a health reimbursement arrangement
☐ **d)** Vacation pay

16. ☐ **a)** Wages paid to relatives are not considered qualified wages
☐ **b)** Household employers are eligible to claim the credit
☐ **c)** Payments made to an independent contractor are not "qualified wages" for purposes of the credit
☐ **d)** An employer is required to prove that they have experienced a significant decline in gross receipts because of COVID-19

17. ☐ **a)** For post-2020 tax years, there are no carrybacks, and carryforwards are indefinite
☐ **b)** For pre-2018 taxable years, carrybacks were for two years and carryforwards were indefinite
☐ **c)** For 2018-2020 taxable years under the CARES Act, carrybacks are for five years and carryforwards are for 20 years
☐ **d)** For pre-2018 tax years, there was an 80% taxable income limitation

18. ☐ **a)** Personal vehicles converted to business use qualify for bonus depreciation
☐ **b)** To qualify for bonus depreciation, business use must be at a minimum of 50%
☐ **c)** For 2019 and 2020, the lease inclusion threshold has been increased to $55,000
☐ **d)** The standard business mileage rate for 2020 is 58 cents

Name ____

19. ☐ **a)** Taxpayers may elect out of the 30% adjusted taxable income limitation beginning in 2019 or 2020
☐ **b)** Taxpayers may elect out of deducting 50% of excess business interest expense by filing an election statement
☐ **c)** Taxpayers may withdraw the irrevocable election to be treated as an electing real property business for the 2018-2020 tax years for purposes of the business interest expense limitation
☐ **d)** Taxpayers must use their 2020 adjusted taxable income for purposes of calculating the 2020 business interest expense limitation

20. ☐ **a)** A late IRC §163(j)(7) election for 2018-2020 tax years must be made by filing an administrative adjustment request
☐ **b)** An IRC §163(j)(7) election withdrawal must be titled "Revenue Procedure 2020-22 Section 163(j)(7) Election"
☐ **c)** An election to use the taxpayer's 2019 ATI must be made on a timely filed income tax return using the statement, "Revenue Procedure 2020-22 Section 163(j)(10)(B) Election to Use Taxpayer's 2019 ATI"
☐ **d)** The election out of using the increased 50% ATI limitation for 2019 and 2020 must be made separately each year

21. ☐ **a)** 70½; 70½
☐ **b)** 70½; 72
☐ **c)** 72; 70½
☐ **d)** 72; 72

22. ☐ **a)** Defined benefit plan
☐ **b)** 401(k)
☐ **c)** Annuity plan
☐ **d)** Individual retirement account

23. ☐ **a)** SEP
☐ **b)** SIMPLE IRA
☐ **c)** Government
☐ **d)** SARSEP

24. ☐ **a)** She is required to recontribute the $15,000 to her IRA within 60 days of her separation from service or she'll be assessed an early withdrawal penalty
☐ **b)** She will not be taxed on the loan amount, but she will be subject to the penalty for early withdrawal
☐ **c)** If she files an extension, she'll have until October 15, 2021, to avoid recognizing the income and being assessed any penalties
☐ **d)** If she does not recontribute the entire amount to an IRA, she must recognize the distribution in the year following the year of separation from employment

25. ☐ **a)** If an eligible retirement plan allows a beneficiary to elect whether RMDs are determined using either the five-year rule or the life expectancy rule, there is a CARES Act 2020 RMD suspension that extends the time to make this election until December 31, 2021
☐ **b)** When a taxpayer inherits a retirement account from someone who died on or before December 31, 2019, the entire account must be distributed immediately
☐ **c)** The five-year rule no longer matters for 2020
☐ **d)** Any beneficiary may roll the IRA over into their own account

26. ☐ **a)** 30-day
☐ **b)** 45-day
☐ **c)** 60-day
☐ **d)** 90-day

27. ☐ **a)** SEP-IRA to designated Roth account
☐ **b)** Roth IRA to qualified plan
☐ **c)** 403(b) plan to traditional IRA
☐ **d)** Designated Roth account to qualified plan

28. ☐ **a)** Executor fees
☐ **b)** Appraisal fees
☐ **c)** Investment expenses
☐ **d)** Attorney fees

Name ____________________

29.☐ **a)** Improvements made by the taxpayer to the interior of a nonresidential building placed in service after the building itself is first placed in service
☐ **b)** Enlargement of a building
☐ **c)** Expenses that can be attributed to the internal structural framework of a building
☐ **d)** Improvements to residential rental property

30.☐ **a)** For §1231 gains, the 180-day period starts at the time of the transaction that generates the §1231 gain
☐ **b)** For passthrough entity owners, the 180-day period must begin at the end of the entity's taxable year
☐ **c)** For installment sales, the 180-day period must begin on the last day of the taxable year
☐ **d)** For a regulated investment company, the 180-day period begins at the time the shareholder receives a RIC dividend

Name ____

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Final Exam Questions

1. ☐ **a)** A Social Security number is required to complete the form
   ☐ **b)** The buyer's signature is only required when the transaction is an installment sale
   ☐ **c)** The remitter is the person who sends the tax withheld on any disposition from the sale or exchange of property, which is usually the buyer/transferee
   ☐ **d)** The seller's signature's signature is not required on any Form 593

2. ☐ **a)** Five-year NOL carrybacks for 2018-2020 NOLs
   ☐ **b)** Retroactive suspension of the excess business loss limitation for noncorporate taxpayers
   ☐ **c)** Increase in the age for required minimum distributions from age 70½ to age 72 for taxpayers who turn age 70½ after December 31, 2019
   ☐ **d)** Retroactive modifications to the business interest expense limitations

3. ☐ **a)** 30 days
   ☐ **b)** 45 days
   ☐ **c)** Two consecutive months
   ☐ **d)** Three consecutive months

4. ☐ **a)** Medicaid
   ☐ **b)** Workers' compensation
   ☐ **c)** Refugee Medical Assistance under the Administration for Children and Families
   ☐ **d)** COBRA

5. ☐ **a)** 180 consecutive days
   ☐ **b)** 273 consecutive days
   ☐ **c)** 365 consecutive days
   ☐ **d)** 546 consecutive days

6. ☐ **a)** It covers up to six weeks of wage replacement benefits in a 12-month period
   ☐ **b)** It is included in gross income for California purposes
   ☐ **c)** Family leave benefits received from an employer-administered plan rather than the EDD do not qualify for an exclusion from income
   ☐ **d)** It is not taxable on the federal or the California return

7. ☐ **a)** Estimated tax penalty
   ☐ **b)** Late-payment penalty
   ☐ **c)** Withholding-at-source penalty
   ☐ **d)** Demand penalty

8. ☐ **a)** 60 consecutive months
   ☐ **b)** 48 consecutive months
   ☐ **c)** 36 consecutive months
   ☐ **d)** 24 consecutive months

9. ☐ **a)** With a drop-and-swap transaction, the entity converts the partnership interests to tenant-in-common interests, with title dropping to the TICs
   ☐ **b)** With a swap-and-drop transaction, the partnership retains title to the property
   ☐ **c)** The IRS has stated that property must be held for a minimum of 18 months to be considered an investment
   ☐ **d)** Drop-and-swap transactions are not commonly used because the FTB and IRS typically rule that the arrangement was designed to avoid taxation, and they disallow it

10. ☐ **a)** $70,000
   ☐ **b)** $65,000
   ☐ **c)** $60,000
   ☐ **d)** $50,000