CAST IN CONCRETE 2022

Federal Bus and Misc.

Alan Pinck, EA
Alan@APinckTax.com

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Cast in Concrete: Business and Practice Update 2022

Introduction

With another year behind us, we now move into tax season with few changes from last year. In 2022, we saw a few pieces of tax legislation, notably the Inflation Reduction Act of 2022 (IRA '22) and the SECURE 2.0 Act. Interestingly, the IRA '22 did not have much to do with inflation reduction although it did give a few tax credits primarily for "green energy". The SECURE 2.0 Act includes many retirement-related provisions affecting both individual and business clients. A nice budget was given to the IRS which was long overdue, although most likely the $80 billion over 10 years will not be enough to do everything the IRS needs to be done.

PPP Loans

This year we should be pretty much past PPP loans and forgiveness with our clients. We do need to go back and review that we handled everything correctly on the tax returns. One thing in particular comes to mind: did your client really qualify for the forgiveness? The purpose for the question is that like many of the government programs aimed at helping taxpayers, there was a tremendous amount of abuse. Our clients may have received loan forgiveness but that does not mean they were eligible for the loan or the forgiveness. The IRS issued a Chief Counsel Advice Memorandum stating improperly forgiven loans are taxable income (CCA 202237010). If you suspect your client did not meet the requirements, you cannot deduct the expenses paid for with the loan proceeds unless you include the forgiven loan in income. If your client did not receive forgiveness and is not applying for forgiveness, then any loan proceeds used for expenses are allowable as they would be with any traditional loan.

The below information is included as a refresher to help you decide if you need to amend a previously prepared return (but these topics will not be covered in today's session):

- There was another round of funding made available in 2021, so second-round PPP loans were given to those who were eligible. The same forgiveness rules applied, and many businesses did apply and receive the funds.
- SBA announced on July 28, 2021, a simplified forgiveness program for loans of $150,000 or less. They did so by creating a new direct forgiveness portal directly through the SBA and the borrower could avoid going through the lender.
- Forgiveness is not taxable income; it is considered tax exempt income and will increase the basis for the S corporation shareholder and partner including LLC members if taxed as a partnership or S corporation.

Timing

When does the income get recognized? Last year we had to decide with no guidance how we were going to deal with moving the liability to income. For example, this became a real issue when the expenses taken created a passthrough loss to a partner or shareholder that did not have the basis to take the loss. Remember most of our clients did not apply for nor receive forgiveness in 2020. On November 18, 2021, the IRS issued Rev. Procs. 2021-48, 2021-49, and 2021-50 which gave us the guidance we had been waiting for.

Rev. Proc. 2021-48 gives the taxpayers the option on when to treat the loan forgiveness as tax-exempt income for taxable years ending after March 27, 2020. We can treat the tax-exempt income from the forgiven loan as received when:

- The money was spent or accrued;
- The taxpayer filed for forgiveness; or
- Forgiveness was granted.

This allows a taxpayer to go back and amend their 2020 returns to report the tax-exempt income in that year to step up the basis if needed. Under Rev. Proc. 2021-50, a BBA partnership could have amended the return if it was filed and the K-1s were sent to the partners by December 31, 2021. For partnerships they may need to prepare an administrative adjustment request (AAR) if they did not elect out of the centralized audit regime (BBA partnerships) and in either case issue new K-1s to the partners. S corporations will amend the returns and issue new K-1s to the shareholders. If a partner or shareholder receives the amended K-1, they need to amend their 2020 return accordingly.

Amending a partnership or S corporation return should be considered in the event the partner or shareholder:

- Had a nondeductible loss due to lack of basis; or
- Had to recognize income due to distributions in excess of basis.

In the event that the taxpayer expects or expected to receive full PPP loan forgiveness and does not receive it, amended returns are needed if the original return included the entire amount of tax- exempt income.

What is included in the tax-exempt income

Grants

- EIDL grants;
- Targeted EIDL grants;
- Supplemental targeted EIDL grants;
- Shuttered Venue Operator grants; and
- Restaurant Revitalization grants.

PPP loans

- First draw loans;
- Second draw loans; and
- As well as principal and interest payments by the SBA on behalf of borrower for SBA 7(a) loans and SBA microloans.

Rev. Proc. 2021-49 tells us that in regard to an S corporation shareholder or consolidated group that the PPP loan forgiveness gives rise to a basis adjustment. For partnerships, it goes into much more detail in order to comply with the partnership distributive share rules under IRC §104(b). I encourage you to review this Rev. Proc. for more details if it applies to your clients.

Employee Retention Credit

Like PPP loans, we may have an issue with some of our clients taking the Employee Retention Credit and need to let them know that if they did not qualify, they are not entitled to take the credit and should repay it. Every day, businesses were inundated with emails and phone calls letting them know that they qualify for the ERC and to be sure to get their big fat refund. Unfortunately, many of these fly-by-night outfits are not tax professionals and do not vet the business correctly; even worse they charged a percentage of the refund as their fee, which could be anywhere from 15%–25% or more. If one of your clients used one of these disreputable services you can report the service using Form 3949-A. The Treasury Inspector General Administration (TIGIA) on August 31, 2022, reported that the IRS has identified 11,096 suspicious payroll tax returns claiming more than $2 trillion in COVID-19–related payroll tax credits.

When the credit is refunded, we must reduce the payroll taken on the tax return. This is done in the year of the credit not the year of the refund. We will be amending returns accordingly and when we are looking at a passthrough entity such as a partnership or S corporation, that will also mean the partner or shareholder will need to amend their returns. By amending the returns, they will show more net profit and will require a tax payment. Fortunately, we can use "reasonable cause" per IRS Notice 2021-49 and IR-2022-89 to get the penalties waived. As a reminder, when requesting penalty abatement for a failure-to-pay penalty the IRS will generally allow it under the First-Time Abatement (FTA) program. Regardless of the situation, if reasonable cause is available, push for it since FTA is only allowed once every four years and you may need to save FTA for another issue.

Practice pointer: Although FTA is not in the code but is instead a policy, it is only available for the following penalties:

- Failure to file;
- Failure to deposit; and
- Failure to pay.

It will be offered first if your client has had no issues with timely filing or paying. We can use it once every four years and can generally get it with a call to Practitioner Priority Services (PPS). If you do not have a POA when calling, they will talk to you but they will send any notification to the taxpayer.

We will not be discussing the basics of the ERC, but it is in the material for your reference.

Employee Retention Credit Basics

Under §2301 of the CARES Act, eligible employers can take a credit against employer payroll taxes for each quarter. The allowable amount is 50% of the qualified wages for each employee employed by the employer for that quarter. Wages taken into consideration are those paid after March 12, 2020, and before January 1, 2021.

The amount of qualified wages an employer can take into consideration in calculating the credit can be no more than $10,000 per employee for all calendar quarters. So, the employer may be eligible to take a credit of $5,000 per employee that the employer retains. The credit allowed for any quarter cannot exceed the applicable employment taxes under IRC §3111(a) and §3221(a).

If the eligible amount of the credit exceeds the payroll taxes, the difference is refundable. In essence, this allows the employer to apply the difference as an overpayment.

Example of calculation

Jayco is an eligible employer with applicable payroll taxes of $12,000 and credits of $4,000 for paid sick leave under the Emergency Paid Sick Leave Act, $5,000 credit for paid Family Leave under the Emergency Family and Medical Leave Expansion Act, and a $5,000 Employee Retention Credit. Jayco would reduce their payroll tax obligation to $0 and have a $2,000 overpayment.

Payroll taxes	$12,000
ESPLA credit	<$4,000>
EFMLEA credit	<$5,000>
Retention credit	<$5,000>
Refundable amount	$2,000

Eligible employer

To define who is an eligible employer for the purposes of the ERC, the employer must meet one of these two tests:

1. **Governmental order.** Under this test, the employer is eligible due to the business operations being completely or partially shutdown/suspended during the calendar quarter from orders of a governmental authority, e.g., state, county, or citywide; or
2. **Period of significant decline in gross receipts.** Under this test, a significant decline in gross receipts means a period starting with the first calendar quarter after December 31, 2019, with gross receipts (as defined in IRC §448(c)) of 50% less than those of the same calendar quarter of the previous year. NOTE: The period ends the first quarter in which gross receipts are greater than 80% of the same calendar quarter of the previous year.

Examples of governmental order from IRS FAQ #28

Example 1: Governor of State Y issues an order that all non-essential businesses must close from March 20, 2020, until April 30, 2020. The order provides a list of non-essential businesses, including gyms, spas, nightclubs, barber shops, hair salons, tattoo parlors, physical therapy offices, waxing salons, fitness centers, bowling alleys, arcades, racetracks, indoor children's play areas, theaters, chiropractors, planetariums, museums, and performing arts centers. The governor's order limits the operations of non-essential businesses and entitles those employers to claim the Employee Retention Credit for qualified wages.

Example 2: Mayor of City Y holds a press conference in which she encourages residents to practice social distancing to prevent the spread of COVID-19. The statement during the press conference is not an order limiting commerce, travel, or group meetings. Accordingly, the mayor's statement would not be a governmental order for purposes of the Employee Retention Credit.

Example 3: A restaurant is ordered by a local health department to close due to a health code violation. The order is unrelated to COVID-19, so not considered a governmental order for purposes of the Employee Retention Credit.

Example of governmental order from IRS FAQ #33

Software development company Employer C maintains an office in a city whose mayor has ordered that only essential businesses may operate. Employer C's business is not essential under the mayor's order and must close its office.

Prior to the order, all company employees teleworked once or twice per week, and business meetings were held at various locations. Following the order, the company ordered mandatory telework for all employees and limited client meetings to telephone or video conferences.

Employer C's business operations are not considered to be fully or partially suspended by the governmental order because its employees may continue to conduct its business operations by teleworking.

Note that Employer C could still be eligible for the Employee Retention Credit if its business experienced a significant decline in gross receipts (Test 2).

Example of decline in gross receipts

John's Garage had gross receipts in 2019 of $10,000 per quarter. In 2020, Q1 = $10,000; Q2 = $4,000, Q3 = $5,000, and Q4 = $8,500. John's Garage would be eligible for the ERC for Q2 and Q3, but not Q4.

FAQs are more than guidance than legal authority, but they do indicate the position the government is currently taking. At this point, the IRS pretty much requires that the business be shut down to qualify under the government order test.

Definition of "qualified wages"

As we have learned over the years, when it comes to tax questions the answer is often: "It depends."

For businesses with 100 or more full-time employees in 2019, qualifying wages are wages paid to the employee who is not providing any services due to either of the tests above. The wages cannot be in excess of what the employee was paid in the 30 days immediately prior to such period.

Example #1 of qualified wages

Jane's restaurant is limited to take-out orders only, due to the COVID-19 stay-at-home orders. Because of the shutdown, she meets Test 1 above.

In 2019, Jane had an average of 125 employees. She retains the kitchen staff who are all full-time, 40-hour-week employees and has them work 15 hours per week each. Provided she pays them for the 40 hours, 25 hours would be considered qualified wages. On the other hand, if Jane only pays them for the 15 hours they work, none of the wages qualify.

Example #2 of qualified wages

The Best (a marketing firm) had an average of 500 full-time employees in 2019. They were forced to close their offices due to Test 1 above.

They do not require the mail room or custodial employees to work yet they continue to pay the regular salaries. These payments are qualified wages. The administration staff is only required to work two days per week, but they still get their full salaries. Their qualified wages would be three-fifths of the salaries paid.

Example #3 of qualified wages

Joe the plumber, an eligible employer, had more than 100 employees in 2019 and paid them all $25 per hour. Now he pays them $20 per hour when they work and $30 per hour when they do not. In this case Joe is only allowed $25 per hour (not $30/hour) for the qualified wages.

If Joe were to pay his employees $30 per hour whether they were working or not, he would still be limited to $25 per hour because that was what he was paying in the 30-day period prior to meeting the tests.

For employers with fewer than 100 full-time employees in 2019, qualified wages are wages paid to employees during the period which the employer meets either of the two tests. Qualified wages do not include wages taken into account for purposes of the payroll tax credits provided under the Family First Act (for all employers).

Example of reduced work hours

Jack's Garage, an eligible employer, had 15 full-time employees in 2019. He meets the gross receipts test for Q2 and Q3. He is paying his employees

$25 per hour for 40 hours. All the wages paid during the two quarters are qualified wages. If Jack reduces the employees to 20 hours per week, he still qualifies for the wages paid on the 20 hours.

Qualified wages also include the eligible employer's health plan costs that are properly allocated to the employees' wages. As we have seen with the other employer wage credits, this is the amount paid or accrued to maintain the employer's group health plan and not included in the employees' table wages. An allocation is allowed provided that it is done on a pro rata basis among employees and covers periods relative to the wages of that period.

Practice tip: If employer did not realize that they had a significant decline until after January 1, 2021, they may still claim the credit by filing a Form 941X.

When calculating the ERC, an employee is not included for any period that the employer is allowed a Work Opportunity Tax Credit under IRC §51 for that employee. Also, the employer does not count the wages or credit paid for Family Medical Leave under IRC §45S. Unlike the other credits mentioned where we would add the credit as income to ensure no double dipping took place, the wage deduction is reduced by the amount of the credit taken.

If the employer receives a small business interruption loan under the CARES Act, then the employer is not eligible for the ERC.

Note: Recognizing that the rules for the ERC are less than straightforward, §2302 of the CARES Act allows the IRS (under IRC §6656) to waive a penalty if it is determined that underpayment of taxes was due to reasonable anticipation of the ERC.

Practice tip: If the above Note applies to your client, challenge the penalty — even if your client has already paid it.

Employer Retention Credit under the Consolidated Appropriations Act of 2021 (CAA)

The 2021 year-end bill modified the CARES Act as follows:

- Allows the credit even if a PPP loan was taken out:
  - No payroll is allowed to be used for both;
- No double dipping. The credit cannot be used for wages used for the following credits:
  - §41 credit for increasing research activity;
  - §45A Indian Employment Credit;
  - §45P Employer Wage credit for employees who are active duty military;
  - §45S Employer Credit for Paid Family Leave and Medical Leave;
  - §51 Work Opportunity Tax Credit; or
  - §1396 Empowerment Zone Employee Credit.

For calendar quarters after December 31, 2020, the CAA amends the CARES Act by:

- Extending the credit to qualified wages paid through July 1, 2021;
- Increasing the credit from 50% to 70% of qualified wages; and
- Increasing the $10,000 of wages per employee, per quarter instead of per year.

Eligible employers were also expanded to include any employer with a decline in gross receipts as follows:

- 20% or more decline from the same quarter in 2019;
- At the election of the employer, for the immediately prior calendar quarter gross receipts are less than 80% for the corresponding quarter in 2019; and
- At the election of the employer, if the business was not operating in 2019 (in part or full), may use the corresponding quarter of 2020.

The definition of small employer was expanded to include employers with 500 or fewer full-time employees versus the 100 or fewer full-time employees under the CARES Act. This is big since all wages will count for these larger employers not just the wages for those who are being paid not to work.

There is also a qualified disaster ERC that is only available for employers in presidentially declared disaster areas and is different than the CARES Act. If you have a client in a disaster area it is worth looking into but this credit is not covered further in these materials. (TCDTRA §303)

ERC changes for 2021

For Q1 and Q2 wages:

- The employer must be in business for the calendar quarter in which they claim the ERC;
- The employer must either be subject to a full or partial suspension of business or experience a significant decline in gross receipts:
    - A reduction is considered to be at least 20% of gross receipts over the same quarter in 2019;
    - If not in business in 2019, then use 2020;
- The maximum ERC is 70% of qualified wages paid up to a maximum of $10,000 per employee per quarter; and
- The definition of a small employer was expanded so that now employers with 500 or fewer employees can claim the ERC for payments to employees that were not actually working.

For Q3 and Q4 (modified in the Infrastructure Investment and Jobs Act (IIJA)):

- Credit is against Medicare tax rather than Social Security tax;
- For Q4 only, recovery startup business are allowed to take the credit;
- Statute for these returns is extended to five years as it relates to this credit.

If the credit was taken before the IIJA, the IRS issued Notice 2021-65 that explains how to avoid late-payment penalties:

- Must repay the credit by the due date of the applicable employment tax return;
- Deposit the amounts initially retained by December 31, 2021;
- Report the tax liability resulting from the termination of the ERC on the appropriate employment tax return for Q4; and
- The penalty will apply if employer reduced deposits after December 20, 2021.

For full text of notice, go to:

www.irs.gov/pub/irs-drop/n-21-65.pdf

Wages paid to relatives are not allowed to be used for the ERC. The IRS will look at IRC §51(i)(1) to define who a relative is:

- A child or a descendant of a child;
- A brother, sister, stepbrother, or stepsister;
- The father or mother;
- Stepfather or stepmother;
- A niece or nephew;
- An aunt or uncle; or
- An in-law.

A spouse is not a related individual.

If the employer is a corporation then we look to see if any of the above relations own 50% or more of the stock to be disqualified. If the business is a partnership or LLC being taxed as a partnership, we apply the same rules to partners with a 50% or more capital and profits interest.

The IRS confirmed that the ERC may not be claimed for majority shareholders or their spouses (see Notice 2021-49). There is one rare exception and that is a majority owner who has no living sibling, parent, or child (basically no living relative).

The following are examples from the IRS guidance.

Example of shareholder with son

XYZ Corp. is owned 100% by Greg. Greg has one son, Harry, who is not employed by the corporation and has no ownership interest in the corporation. XYZ pays wages to Greg. Under the attribution rules of IRC §267(c), Harry is attributed 100% ownership of XYZ, and both Greg and Harry are treated as 100% owners. As a result, wages paid to Greg are not qualified wages for purposes of the ERC because he is one of the disqualifying relatives of a majority owner (his son, Harry). If Harry worked for the company, his wages would also not be considered qualified wages.

Example of married shareholder with no relatives

ABC Corp. is owned 100% by Jack. Jack is married to Karen. Jack and Karen are both employees of ABC. Jack has a brother, Bruce. Jack's ownership is attributed to Bruce so Bruce is deemed to be a 100% shareholder. Wages paid to Jack and Karen are not qualifying because they both have a disqualifying relationship to a majority owner (brother in Jack's case and brother-in-law in Karen's case).

Example of sibling shareholders

MNO Corp. is owned equally by three siblings (33.33% each), who are all employed by MNO. Under the IRC §267 attribution rules, all three siblings are treated as owning 100%of MNO. Because the siblings are "related individuals" to each other, all wages paid to the siblings are nonqualified wages.

Delayed Employer Share of Social Security Tax

For those employers that did not pay in their share of the Social Security taxes in 2020, the first half was due December 31, 2021, and the second half came due December 31, 2022. Be sure to follow up with your clients that did hold back on these payments.

Payments were to be made using EFTPS; most payroll services did not handle this for the employer. If an employer paid through EFTPS, the employer should have applied the payment to Form 941 for the quarter in which they did not pay in 2020.

The IRS sent Notice CO256V to employers who chose to defer Social Security tax payments as a reminder of the December 31 due date. Failure to repay any portion will result in the entire amount being subject to the 10% failure to deposit penalty under IRC §6656. This means even if the employer paid the first half on time but failed to pay the second half on time, the 10% penalty applies to the full amount of deferred tax.

Depreciation

The inflation adjustment for 2022 for the IRC §179 expensing limit is $1,080,000 and the phaseout threshold is $2,700,000. (Rev. Proc. 2021-45) The inflation-adjusted amounts for 2023 are $1,160,000 and $2,890,000. (Rev. Proc. 2022-38) Remember this is per return, not per business.

Bonus depreciation is still 100% of the cost of qualified property (general) acquired and placed in service through December 31, 2022. Do not forget that used property is included as well as qualified improvement property. Bonus depreciation will start phasing out for most property starting in 2023. There are exceptions for longer production period property and certain aircraft (special) so you may need to do more research if this pertains to a client.

	General	Special
2018–2022	100%	100%
2023	80%	100%
2024	60%	80%
2025	40%	60%
2026	20%	40%
2027	None	20%
2028 and after	None	None

Note: Bonus depreciation is mandatory and you need to elect out if you do not take it. When electing out, the election is for the property class, not for individual property. You are allowed to use §179 for as much as you like once you elect out.

Automobile expenses

The standard mileage rates for 2022 are:

	January 1, 2022– June 30, 2022 (Notice 2022-03)	**July 1, 2022– December 31, 2022 (IRS Ann. 2022-13)**	**2023 (Notice 2023-03)**
Business	$0.585	$0.625	$0.655
Charitable*	$0.14	$0.14	$0.14
Medical	$0.18	$0.22	$0.22
Moving**	$0.18	$0.22	$0.22
* Statutory, only Congress can change this ** Moving expense deduction is only allowed for active duty military under the TCJA			

The 2022 maximum depreciation allowed amounts (based on 100% business use) are:

	Auto without bonus	**Auto with bonus**	**Light Truck without bonus**	**Light Truck with bonus**
1st Year	$11,200	$19,200	$11,200	$19,200
2nd Year	$18,000	$18,000	$18,000	$18,000
3rd Year	$10,800	$10,800	$10,800	$10,800
4th Year and Following	$6,460	$6,460	$6,460	$6,460

Lease inclusion amounts kick in with autos trucks and vans with FMV of vehicles exceeding $56,000 for 2022. (Rev. Proc. 2022-17) For the inclusion amounts to use, see Rev. Proc. 2022-17 at:

www.irs.gov/pub/irs-drop/rp-22-17.pdf

Meals and Entertainment

For 2021 and 2022, there is a 100% deduction for meals that are provided by a restaurant. The IRS issued Notice 2021-25 to let us know what is considered a "restaurant" for the 100% deduction. According to the Notice:

For this purpose, the term "restaurant" means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises.

This Notice also clarifies what is not a restaurant for the 100% deduction:

However, a restaurant does not include a business that primarily sells pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk.

A few things to remember are:

- The meal does not need to be consumed on the premises of the establishment selling it;
- If the establishment is not a considered a restaurant under this notice, there is still a deduction but it is limited to 50%; and
- We still need the proper logs to satisfy IRC §274 (the 4 W's: Who, What, Where, and When).

Meals provided by the employer in the employer eating facilities are still subject to 50%. When using per diem rates, meals are eligible for the 100% deduction. See IRS Notice 2021-63, which gives us this clarification.

Entertainment is still not deductible under TCJA. If meals were associated with entertainment, to be deductible the meals must be purchased separately from the entertainment.

Travel

There has been no change in this area; there needs to be a business purpose and remember to be careful of the taxpayer's tax home. The tax home issue has been coming up in many Tax Court cases recently so be advised the IRS is looking at this.

What is your tax home? It may not be where you live. A person's tax home for the purpose of IRC §162(a)(2) means the vicinity of the taxpayer's principle place of business or employment and not the location of his personal residence. (***Mitchell v. Comm.*** (1980) 74 TC 578, 481)

Research and Development

The TCJA affects the deductibility of R&D for tax years beginning after December 31, 2021. Starting in 2022, R&D expenses need to be capitalized and amortized over five years (15 years if conducted outside the U.S.). (IRC §174(a)(2)(B); TCJA §13206)

Although many of us were hoping to see Congress address this issue, it did not happen. This is an unfortunate change for many businesses that have been deducting their R&D expenditures each year. When amortizing the expenditure, it will start mid-year and continue for the five- or 15-year life accordingly. In the event the R&D was deemed unsuccessful, the taxpayer must continue to amortize for the balance of the time period.

Practice pointer: Be sure to ask your client where the R&D took place; we see many businesses using offshore companies to do engineering work as it can be much less expensive than in the U.S. This will be an easy audit target for the IRS and with their focus turning more towards corporations, do not be surprised to see this issue come up.

Example of amortizing R&D expenses

PPS, Inc. is a cellphone booster manufacturer and incurs $750,000 of research expenditures in 2022. During your interview, you learn that $500,000 of the expenses were paid to an engineering firm in India. PPS's amortization expense will be calculated as follows for 2022:

Research expenditures during the year	$750,000
Domestic expenses	$250,000
Amortization period	÷ 60
Monthly deduction	4,167
Deductible months	× 6
Amortization for 2022 (Domestic)	$ 25,002
Foreign expenses	$500,000
Amortization period	÷ 180
Monthly deduction	2,778
Deductible months	× 6
Amortization for 2022 (Foreign)	$ 16,668
Total amortization for 2022	**$ 41,670**

When expensing R&D expenses, it was not as important to know what constituted R&D under IRC §174 versus ordinary and necessary expenses under §162. Now that we are amortizing these expenses, it is more important to be sure to capture them correctly. We need to look at Treas. Regs. §1.174-2 to define what is considered a R&D expense.

(a)(1) Research or experimental expenditures defined. The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense.

These costs include:

- Legal and patent fees;
- Drawings;
- Salaries and wages related to;
- Utilities and overhead related to;
- Depreciation ;
- Laboratory materials; and
- Models.

There are expenses specifically excluded, such as:

- Quality control inspections;
- Efficiency surveys;
- Advertising or promotion;
- Acquisition of a patent, model, production, or process from a third party; and
- Research in connection with literary, historical, or similar projects.

Schedule K-2 and K-3

This year we may need to prepare more of the Schedules K-2 and K-3. For clarification, the K-2 is the reconciliation of the K-3's which are issued to the partner or shareholder when required. The K-3 information may be needed by the partner or the shareholder when they must file a Form 1116 to claim a Foreign Tax Credit. The purpose of these Forms is to provide more continuity in the reporting of Foreign Tax Credits.

In 2021, the IRS provided some relief in the required filing although only in respect to the 2021 filing season. As we are getting the draft instructions for Forms 1065 and 1120-S and there is some relief this year as well.

Partnerships and S corporations that must file include, but are not limited to:

- Those holding assets in a foreign country;
- Employing remote workers who reside in a foreign country;
- Investing in a foreign business either directly or indirectly;
- Investing in any mutual funds that have foreign holdings (unless creditable tax is less than $300 and reported on 1099-DIV);
- Contracting for any research activities offshore;
- Partnerships or S corporations that have partners or shareholders required to file Form 1116; and
- Partnerships that have any partners with spouses that are nonresident aliens.

For 2022, there are exemptions for filing in limited cases. For a partnership or S corporation to be exempt, they need to have no or limited foreign activity. "Limited foreign activity" is defined as having less than $300 of foreign creditable taxes that are reported on a Form 1099-DIV. Also, to meet the exemption, all partners or shareholders must be U.S. citizens or resident aliens, single shareholder S corporations, SMLLCs, domestic decedent trusts, or grantor trusts. Written notice of the entity's plan on including the K-2/K-3 is provided with a timely provided K-1 unless a recipient requests it within one month of this notification. When requested, only the information pertaining to that individual is reported on the K-2 and K-3.

Who is exempt from filing a Form 1116?

A taxpayer may elect to take the Foreign Tax Credit without filing Form 1116 if they have $300 ($600 for joint returns) or less in foreign creditable tax paid and reported on a Form 1099-DIV. There is the caveat that any unused credit will not be carried over to the subsequent year.

Practice pointer: If you have clients that need to file Form 1116 and also have partnership or S corporation interests, contact them early and have them request the K-3 from the partnership or S corporation. This can help expedite the processing. If you are preparing partnership or S corporation returns, you may want to have your clients send out the notification sooner than with the K-1 so you know if there will be a need for the K-2/K-3 preparation.

Penalties for failure to file

Failure to file or show information on a partnership or S corporation return is $195 per month for up to 12 months. Also, there is potentially no statute of limitations if the return filed is not a complete return. The penalty for failure to file correct informational returns is $280 per return up to a maximum of $3,426,000. (IRC §§6698, 6699, 6721, 6722)

Form 7203

For another year we will use Form 7203 for S corporation shareholders, only there is still no required form for partners to show basis. This three-part form is designed to show the shareholders basis and will replace the statements that we have been attaching to Schedule E in the event of a passthrough loss. I encourage everyone to at least prepare for your file so you have an accurate calculation moving forward. You need to file Form 7203 if the shareholder has:

- A deduction for a passthrough loss including a suspended passthrough loss;
- Received a non-dividend distribution;
- Disposed of any of the S corporation stock; or
- Received a loan repayment.

Forms 1099-NEC and 1099-K

The 1099-NEC is required to be sent by any business to any business that performs services and receives payment in excess of $600. The exception is if the service provider is a corporation (except a law firm). The requirement applies with the exception of payments made with a credit card, PayPal, or Venmo since these payments require a 1099-K. If the total paid is over $600 for the year and paid partially by credit card and partially by other means such as cash, check, trade, or virtual currency, that portion still requires a 1099-NEC.

Example of reporting on 1099-NEC versus 1099-K

Randy has a webmaster Kathy who charges him $100 a month. For January through March he pays her by check. In April, she lets Randy know he can pay by credit card if he would like and he pays her the rest of the year by credit card. Randy will need to send Kathy a 1099-NEC for $300, since the balance is reported on her 1099-K.

Total payments made to Kathy for the year	$1,200
Paid by check	$300
Paid by credit card	$900

The instructions for 1099-NEC specifically state:

"Payments made with a credit card or payment card and certain other types of payments, including third party network transactions, must be reported on Form 1099-K by the payment settlement entity under section 6050W and ***are not subject to reporting on Form 1099-NEC*** *[emphasis added]."*

The IRS delayed the lowered threshold for reporting 1099-K for tax year 2022 at the last minute. As an early Christmas present for many on December 23, the IRS sent out Notice 2023-10 letting us know that they are delaying the reporting at the lowered $600 threshold regardless of the number of transactions. Instead, the $20,000 or 200 transactions under ARPA continue to apply. Your client may still receive a 1099-K reporting less than $20,000 and the IRS is expected to release more guidance soon on what to do for these taxpayers. If this is income, it will still need to be reported accordingly, so do not ignore it if you see it.

Corporate Transparency Act (CTA)

We are starting to get guidance on what reporting will be needed. The CTA requires just about all entities that are registered with a Secretary of State's office (SOS) to file an annual return with the information of the beneficial owners of the entity. The purpose of this reporting is to help prevent bad foreign actors from money laundering or helping terrorists. There are exemptions to this filing for highly regulated entities which are already required to provide this information to the government. Unfortunately, that is most likely not our clients. The good news is that this will go into effect starting in 2024 and the first filing will be January 1, 2025.

The bad news is the reporting will be cumbersome, with a required updated filing within 30 days of any changes from the original filing and the ugly news is that there will be substantial penalties for failure to comply, like the FBAR penalties. We will be receiving more guidance over the next couple of years.

Inflation Reduction Act (IRA '22)

There are many "green" related credits and incentives in the IRA '22 but the one item that is bringing the most attention is the $80 billion budget increase given to the IRS. These funds are

going to be spent over a 10-year period and are designated for a number of things. The funds will be used for more than hiring. The IRS has many needs, from improving technology to increasing customer service and compliance personnel. There has been a lot of negative publicity over this; frankly, this is most likely not enough to bring the IRS up to what is needed in today's environment. Assuming the IRS can find the personal, we will see increased audits, what we are hearing through the grapevine is that the focus will be on high income individuals and business entities.

It is important that we stay away from any of the negativity we may encounter with our clients this year and help them understand this is actually a positive. We have all experienced issues with communicating with the IRS and some of these funds are designed to help with improving this. Let's try to paint this a positive with our clients in hopes to avoid any more animosity against the IRS.

SECURE 2.0 Act

This 358-page bill makes a number of retirement-related changes that roll out over many years. Just a few of the changes that took effect as of the date of signing on December 29, 2022, include:

- A reduction in the excise tax from 50% to 25% or 10% for failure to take RMDs;
- Extension of the waiver of the early distribution penalty to various taxpayers;
- The elimination of the 25%retirement account limit on the amount one can convert to a Qualified Longevity Annuity Contract (QLAC);
- Waiver on the 10% early distribution penalty expanded; and
- The RMD excise tax (six year) statute of limitations begins on the filing date of the 1040.

For 2023 planning purposes, the following go into effect starting with the 2023 tax year for individuals:

- RMD is required for those age 73 who turned 72 after 2022;
- A one-time distribution from an IRA of up to $50,000 can be contributed to charitable gift annuities, charitable remainder unitrusts, and charitable remainder annuity trusts;
- Establishes the availability of SEP and SIMPLE IRA Roth contributions;
- Sole proprietors and SMLLC with no employees can adopt and fund a solo 401(k) up to the due date of the return including extensions and deduct contributions;
- Employers can offer *de minimis* incentives to employees to enroll in their plan; and
- The pension plan startup cost credit increased from 50% to 100% for employers with 50 or fewer employees.

A full discussion of the SECURE 2.0 Act provisions is beyond the scope of these materials, as the effective dates for the majority of the provisions are in tax years 2023 and beyond (as late as 2033).

Representation Updates

Per the IRS data book released in 2022 (TY 2019), the likelihood of examination based on AGI is:

- No positive income: 0.8%
- Under $25,000: 0.4%
- $25,000–$50,000: 0.2%
- $50,000–$75,000: 0.1%
- $75,000–$100,000: 0.1%
- $100,000–$200,000: 0.1%
- $200,000–$500,000: 0.1%
- $500,000–$1 million: 0.3%
- $1 million–$5 million: 0.6%
- $5 million–$10 million: 1%
- $10 million and above: 2%

Although the IRS offices opened up in June 2022, many exams are still be conducted remotely. This is creating issues such as:

- Audits are taking much longer to close;
- Auditors are not getting mail timely;
- RO's are starting to go back to the field and are showing up at taxpayers homes or businesses;
- This is adding the frustration of our clients as well;
- We are seeing some auditors using Zoom.gov for interviews but only a few;
- New hires are being trained remotely, causing a lot of issues; and
- New hires are not lasting, creating more complications as we are faced with starting over in some cases.

Currently, the IRS is cross-training their Large Business International (LB&I) examiners and Small Business Self Employed (SBSE); we may see a merging of the two groups in coming years. During this period, we will see that the LB&I auditors are taking on small issues primarily to understand how the process works.

Appeals are taking up to six months to respond and then they are telling us they cannot hear our case for another two to three months. Currently, appeals will not accept a case that has less than 12 months left on statute. With that said, in tight statute cases, appeals is forced to prioritize them (so at least they understand). Be prepared to extend the statute in these situations in the event there simply is not time.

Collections

Revenue officers are knocking on doors again and it is pretty much back to business as usual. The new addition is QR Codes on most of the letters from collections. With a smartphone you can now:

- Log in to the IRS website and get an explanation of the notice;
- Create an online account;
- Set up a payment plan; and
- Contact Taxpayer Advocate Services (TAS).

This is all to improve customer service.

CAF

Instead of the seven to 10 days we learned to love and expect, we are lucky to get the POAs and TIAs CAF'ed in four to six weeks. When working with an auditor or revenue officer, always fax to them as well as sending to CAF so you can work with them. If you need transcripts faster than the CAF process, you will have to use PPS and have your knitting needles ready, as you will be on hold for a while before you get through. We can now also upload a hand-signed POA to CAF via our Tax Pro Account.

Offer in Compromise (OIC)

Thank you to the TAS for getting the IRS to change a couple of things:

- The IRS will no longer apply refunds to offers accepted after November 1, 2021;
- There are caveats, so be sure to review the IRM section 5.19 for more information; and
- For hardship situations, the Offset Bypass Remedy (OPR) is available. The taxpayer needs to request this upon filing the tax return; see same IRM section as above for more on this.

Record keeping

This tax season is a good time to remind our clients of their obligation to retain adequate records if they do get audited. A good rule of thumb is four years from the date of filing with the exception of anything on a tax return that is a carryover. For example:

- Purchase records of any item being depreciated;
- All items that created an NOL carryover; or
- All items that created a capital loss carryover.

In ***Betty Amos v. Commissioner*** (TCM 2022-109) we have a successful tax practitioner who did not retain the information that created a $4 million NOL carryover and was audited. When she could not support the 15-year-old loss, the IRS disallowed the carryover. She petitioned the Tax Court who of course agreed with the IRS, causing Judge Urda to write, "It beggars belief that she would be unaware...[of] her responsibility to demonstrate her entitlement to the deductions she claimed." The judge may have been harder on her since she was a tax professional, but the rules are the rules.

Conclusion

This coming season has fewer changes to deal with, fortunately, and we do not expect anything popping up during tax season that will affect the 2022 filings. Unfortunately, many of the anticipated tax extenders did not happen at year-end and with a new Congress coming in January there seems less likely to be much happening until later this year. Be sure to keep aware of what is going on throughout the tax season so you can feel comfortable that you are helping your clients. As a few suggestions on getting the latest information I encourage you to read the weekly news releases from CSEA and NAEA as well as subscribe to the IRS emails:

https://service.govdelivery.com/accounts/USIRS/subscriber/new

E-news for tax pros is a weekly e-mail and there are others you can also register to receive once you set up an account.

For California, go to:

www.ftb.ca.gov/about-ftb/newsroom/subscriptions.asp

This will get you a monthly newsletter from the FTB that has tax news updates. You can also check the FTB Newsroom periodically to see if there is anything new you need to know:

www.ftb.ca.gov/about-ftb/newsroom/index.html

Have a great tax season, keep a positive attitude, and do not forget to leave it at the office at the end of the day.