


SCORE Bucks County

SCORE 
For the Life of your Business

Small Business Tax Talk

This webinar will provide education and tax tips to help small business owners take advantage of benefits the tax system offers and minimize tax liability.

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SCORE's Mission & Values

 **Our Mission**
SCORE's mission is to foster vibrant small business communities through mentoring and education.

 **Our Vision**
We aim to give every person the support they need to thrive as a small business owner.

 **Our Values**
Our core values provide the most ethical, certified approach to achieving our goals in a way that contributes to our greater cause.

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Organizer: Charlie Morris
Certified Mentor, Technology and Marketing Committee Chair at SCORE Bucks County

(215) 520-2909
charles.morris@scorevolunteer.org
<http://buckscounty.score.org>

▶ Workshop: Small Business

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Presentors:

- ▶ **Shana Holcomb**
- ▶ *I am currently a Senior Tax Analyst and have been with H & R Block for 20 years. I am certified as an Annual Filing Season Preparer by the IRS. And I am Small Business Certified through H & R Block, specializing in Sole Proprietorship and LLCs. I also specialize in military, retirement, and multi-state returns. I enjoy solving puzzles, and we all know there is nothing more puzzling than the tax code! I do my best to translate the tax code for my clients in a way that makes sense; so that even if we don't like an outcome, we can understand it. And then we can make adjustments going forward to get to an outcome that we DO like.*
- ▶ **Edward Marden**
- ▶ *I am Small Business Certified, a Senior Tax Analyst, and have been with H & R Block for 30 years. I have worn many hats; in the past I was a manager and instructor with the company. I am a small business owner also - own and operate a very busy campground in the summer months and help my H&R Block clients during tax season. I enjoy helping my business clients understand what they need to focus on year-round to make their tax filing smooth and seamless. Building trust and relationships with my clients is how I measure success.*

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Agenda

- ▶ **Small Business Tax Talk**
- ▶ This webinar will provide education and tax tips to help small business owners take advantage of benefits the tax system offers and minimize tax liability.
- ▶ **Topics covered:**
- ▶ Key changes in tax law impacting small business owners in 2022
- ▶ Most important things to do as a small business owner to take advantage of benefits the tax system offers
- ▶ Most important pitfalls to avoid; minimizing tax liability issues
- ▶ Entity Options and Tax Implications
 - ▶ Sole Proprietor
 - ▶ Limited Liability Company (LLC)
 - ▶ Partnerships and Corporations
- ▶ Answer burning tax questions

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Business Entity Pros and Cons	
<p>Sole Proprietorship</p> <p>Pros</p> <ul style="list-style-type: none"> • No formal creation process. • Easy to separate and dissolve. • No separate tax return. • Easy to integrate business use of home deductions. • No double taxation of profits. <p>Cons</p> <ul style="list-style-type: none"> • No liability protection, except through insurance. • Self-employment tax is assessed on entire profit of the business. • Transfer of ownership can be complex. • Limited access to fringe benefits for owners. <p>Good Fit</p> <ul style="list-style-type: none"> • Seasonal or part-time businesses. • Businesses with little liability. • Home-based businesses. • Businesses intended to operate for the owner's life only. 	
<p>Multi-member LLC</p> <p>Pros</p> <ul style="list-style-type: none"> • Limited liability for all members, except for malpractice or debt guarantees. • Unlimited number of members. • Separate entity from members, allowing for greater flexibility in operations. • Ownership is in the form of membership interest and can be transferred more easily than ownership in a single-member LLC. • No double taxation of profits. <p>Cons</p> <ul style="list-style-type: none"> • Requires a separate tax return. • Laws regarding LLCs vary widely among states. <p>Good Fit</p> <ul style="list-style-type: none"> • Businesses requiring equity capital. • Businesses with potential liability in operations. • Businesses intended to exist beyond the lives of the members. • Businesses expecting changes in ownership over time. 	
<p>Single-Member LLC</p> <p>Pros</p> <ul style="list-style-type: none"> • Simple creation process. • Easy to separate and dissolve. • No separate tax return. • Easy to integrate business use of home deductions. • Liability protection for members, except for malpractice. • No double taxation of profits. <p>Cons</p> <ul style="list-style-type: none"> • Self-employment tax is assessed on entire profit of the business. • Transfer of ownership can be complex. • Limited access to fringe benefits for owners. • Laws regarding LLCs vary widely among states. <p>Good Fit</p> <ul style="list-style-type: none"> • Businesses with potential liability in operations. • Businesses intended to operate for the owner's life only. 	
<p>General Partnership</p> <p>Pros</p> <ul style="list-style-type: none"> • Easy to create. • No limit on partner number or type. • Can be used to hold investments in other businesses and consolidate multiple lines of business. • Flexible allocation of profits, loss, and distributions. • Favorable tax treatment when liquidated. • No double taxation of profits. <p>Cons</p> <ul style="list-style-type: none"> • Requires a separate tax return. • Unlimited liability for all partners. • Difficult to dissolve or change ownership without substantial planning. • Requires tracking of basis for partners, both inside and outside the partnership. • Individual partner's share of income is subject to self-employment taxes. <p>Good Fit</p> <ul style="list-style-type: none"> • Two established businesses who wish to work as one. • Partners wishing to consolidate multiple entities into one entity. 	

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Electric Vehicle Charger Credit

The Inflation Reduction Act extends through 2032 the tax credit for installing an electric vehicle charging station in a commercial or rental building garage or parking lot.²³

Prevailing Wage Rules Apply Here Too

Starting in 2023, the credit remains 30 percent of the cost of installing such chargers, but only if the project complies with prevailing wage and apprenticeship requirements (these are the same requirements discussed above).

If the project does not comply with these requirements, the law reduces the credit from 30 percent to 6 percent. The maximum annual credit is now capped at \$100,000, and the cap applies per charger unit.²⁴ Under prior law, there was a \$30,000 annual cap for an entire location regardless of the number of chargers.

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The Electric Vehicle Credit for 2023 and Later

A new clean vehicle credit goes into effect in 2023 and continues through 2032. Although the credit maximum remains \$7,500, the credit is massively changed. Due to the changes, many taxpayers will no longer be able to claim the credit. And there may be fewer electric vehicles available that qualify for the credit.

Key point. Business taxpayers have a decision to make when buying an electric vehicle in 2023 or later. They can choose either the new clean vehicle credit or the new qualified commercial clean vehicle credit.¹

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Section 1031: Don't Miss This Depreciation Election

As you likely remember, the Section 1031 exchange allows you to sell a piece of appreciated real estate and defer all the taxes as long as you invest the entire proceeds in like-kind property.

And then consider this: a cost segregation study allows you to separate qualifying real estate into separate components with shorter depreciable lives that speed up deductions and in many cases create immediate write-offs.

Can you (a) defer a large gain via Section 1031 and (b) immediately create a large write-off on the new asset with a cost segregation study?

You can, but you have to make sure you don't miss this one important step.

1031 Exchange Overview

The Section 1031 exchange allows you to sell appreciated real estate and defer all taxable gains when you fully reinvest the sales proceeds into new qualifying real estate.¹

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Getting ready for tax season 2023: Schedules K-2 and K-3 with an important action item for S corporations and partnerships

Background on Schedules K-2 and K-3

The IRS introduced Schedules K-2 and K-3 in 2022 for passthrough entities to report "items of international relevance" to shareholders and partners. International relevance generally refers to international business activities, international investments, or foreign partners (partnerships only). Similar to Schedules K and K-1 reporting for passthrough entities, Schedule K-2 shows S corporation shareholders' pro-rata shares or partners' distributive shares of international items as a whole and Schedule K-3 shows each shareholder's or partner's share of these items.

For the 2021 tax year the IRS provided transition relief for passthrough entities that had no foreign activities including foreign taxes paid on income from foreign investments, had no foreign partners (partnerships only), and did not provide information to shareholders or partners regarding foreign transactions or activities on Schedules K and K-1 for the 2020 tax year. See the February 23, 2022 TAX in the News for details on transition relief for 2021.

Why a shareholder or partner might need Schedule K-2 / K-3 information

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Action item for S corporations and partnerships: If a passthrough entity checks the "international transactions" box on Schedule K-1 it means the entity *is* providing Schedule K-3 to shareholders or partners. If the box is *not* checked, the entity must notify shareholders or partners that the schedule will not be provided.

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The Inflation Reduction Act

Public Law 117-169, the Inflation Reduction Act of 2022:

- Extended the limitation on ordinary business losses by individuals through 2028.
- Extended the health insurance premium credit through 2025 with modifications.
- Effective 2023, created an annual rather than a lifetime limitation on the residential energy credit with a yearly cap of \$1,200.
- Effective 2023, increased the tax credit for purchasing new all-electric vehicles to \$7,500 and created a credit for the first purchaser of a used all-electric vehicle up to \$4,000 (can be claimed only by low and middle income taxpayers on dealer purchases of up to \$25,000 on vehicles at least two model years old claimable only once every three years).
- Effective 2023, created a 15% minimum tax on the adjusted financial statement income of C corporations with financials showing over \$1 billion in average profit over a three-year period (estimated to be 150 companies).
- Created a 1% tax on the fair market value of stock in a public company that is redeemed if the total redemption value is at least \$1 million.
- Increased the Research & Development Credit that can be claimed by small businesses against payroll taxes by \$250,000 to \$500,000.
- Increased the IRS budget by \$80 billion over 10 years to hire more personnel and to upgrade technology.



Andrew Hesse/Bloomberg

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Resources & Documents

All material used in completing this PowerPoint are available to be emailed by Charlie Morris

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Questions & Answer

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Business Entity Comparison Chart

Edward J Marden
Small Business Certified
Warminster PA Office
215-674-0899



Entity	Accounting and Recordkeeping	Fringe Benefits	Liability
<p>Sole proprietor, single-member LLC, and spouses-owned business</p> <ul style="list-style-type: none"> Schedule C (Form 1040), <i>Profit or Loss From Business</i> Schedule F (Form 1040), <i>Profit or Loss From Farming</i> Schedule SE (Form 1040), <i>Self-Employment Tax</i> IRS Pub. 334, <i>Tax Guide for Small Business</i> 	<ul style="list-style-type: none"> Accounting is less involved than partnerships and corporations. Double-entry bookkeeping is not required as no balance sheet is needed when filing Schedule C or F. A business owned solely by two spouses may elect not to be taxed as a partnership and may file as two sole proprietorships to minimize bookkeeping requirements. Cannot file as a fiscal year business unless owner files Form 1040 under the fiscal year rules. 	<p>Excludable fringe benefits are generally not allowed for the owner.</p> <p>Exceptions: Health insurance is deductible if the spouse is an employee of the sole proprietorship, and the owner is covered as a family member of the employee-spouse. The spouse is also eligible for dependent care assistance fringe benefits, de minimis fringe benefits, and working condition fringe benefits.</p>	<p>Owner is personally liable for all debts and lawsuits against the business. Exception: If organized as an LLC, liability is usually limited to owner's investment and his or her own malpractice or debt guarantees.</p>
<p>Partnership</p> <ul style="list-style-type: none"> Form 1065, <i>U.S. Return of Partnership Income</i> IRS Pub. 541, <i>Partnerships</i> IRC Subchapter K, §701 through §761 	<ul style="list-style-type: none"> Small partnerships are not required to provide a balance sheet and can use the same bookkeeping system as a sole proprietor. Larger partnerships must provide a balance sheet with the return, which requires double-entry bookkeeping. A partnership must generally use the same tax year as its partners, but can use a fiscal year if there is a business purpose or an IRC section 444 election was made. Complex books and records are needed when a partner exchanges property, other than cash, for a partnership interest or for special allocations and basis elections. 	<p>Partners are eligible for some excludable fringe benefits. Taxable benefits are reported as guaranteed payments or an adjustment to a partner's distributable share of profits.</p>	<p>A general partner is personally liable for all debts and lawsuits brought against the partnership. Exception: If the partner is a limited partner, or the business is organized as an LLC, liability is generally limited to the partner's investment, plus his or her own malpractice or debt guarantees.</p>
<p>S corporation</p> <ul style="list-style-type: none"> Form 1120-S, <i>U.S. Income Tax Return for an S Corporation</i> IRC Subchapter S, §1361 through §1379 	<ul style="list-style-type: none"> Double-entry bookkeeping may be required depending on income and other factors affecting the need for a balance sheet on the return. Must use a calendar year unless it establishes a business purpose for using a fiscal year, or it makes an IRC section 444 election. 	<p>Shareholder/employees are eligible for some excludable fringe benefits. Benefits added to taxable wages on W-2 of more than 2% shareholders include accident and health plans, up to \$50,000 of group health insurance, and meals and lodging furnished for the employer's convenience.</p>	<p>A shareholder's liability is limited to the amount invested, plus his or her own malpractice or debt guarantees.</p>
<p>C corporation</p> <ul style="list-style-type: none"> Form 1120, <i>U.S. Corporation Income Tax Return</i> IRS Pub. 542, <i>Corporations</i> IRC Subchapter C, §301 through §385 	<ul style="list-style-type: none"> Double-entry bookkeeping may be required if the tax return requires a balance sheet. No restriction on use of a fiscal year. Exception: A personal service corporation (PSC) must use a calendar year unless it establishes a business purpose for using a fiscal year or makes an IRC section 444 election. Required to use accrual method of accounting if average annual gross receipts exceed \$26 million. 	<p>Shareholder/employees eligible for excludable fringe benefits, generally to the same extent as any other employee, with exceptions under the nondiscrimination rules. Benefits can include health insurance and reimbursement, education, life insurance, etc.</p>	<p>A shareholder's liability is limited to the amount invested, plus his or her own malpractice or debt guarantees.</p>

Business Entity Comparison Chart

Entity	Organization and Ownership	Taxation of Profits and Losses
<p>Sole proprietor, single-member LLC, and spouses-owned business</p> <ul style="list-style-type: none"> Schedule C (Form 1040), <i>Profit or Loss From Business</i> Schedule F (Form 1040), <i>Profit or Loss From Farming</i> Schedule SE (Form 1040), <i>Self-Employment Tax</i> IRS Pub. 334, <i>Tax Guide for Small Business</i> 	<ul style="list-style-type: none"> One individual carrying on an unincorporated trade or business. A qualified joint venture whose only members are spouses may elect not to be taxed as a partnership and file as two sole proprietorships. An LLC may not make this election. Easiest business to organize with minimal legal restrictions. The entity does not exist apart from the owner. Business starts and ends based on engaging in and ending engagement in business. The owner has complete freedom over business decisions and is entitled to 100% of the profits. The owner is limited by his or her own ability to raise capital and obtain financing. Outside investors cannot be part owners. Transfer of ownership consists of selling the business assets. A single-member LLC is taxed as a sole proprietorship unless the election is made to be taxed as a corporation. 	<ul style="list-style-type: none"> The owner is self-employed and pays self-employment (SE) tax on net profits. Net profits are subject to income tax in the year earned and cannot be deferred by retaining profits. Losses offset other income in year incurred, such as W-2 wages, interest, dividends, and capital gains. Exceptions: Losses cannot be used to offset income from activities subject to passive loss, at-risk loss, and hobby loss rules. Owner may qualify for the 20% qualified business income deduction (QBID).
<p>Partnership</p> <ul style="list-style-type: none"> Form 1065, <i>U.S. Return of Partnership Income</i> IRS Pub. 541, <i>Partnerships</i> IRC Subchapter K, §701 through §761 	<ul style="list-style-type: none"> Two or more owners conducting an unincorporated trade or business. Easy to organize with minimal legal restrictions. Multi-member LLCs are taxed as partnerships, unless the election to be taxed as a corporation is made. No limitations on the number of partners or partner entities. More flexibility than a corporation in dividing up profits, losses, ownership of capital, and making special allocations to partners. Contributing property in exchange for a partnership interest is a tax-free event (except for the receipt of cash). Liquidating a partnership interest in exchange for property is generally tax-free, unless the liquidation is in cash only. Getting out of a partnership may be more complicated than starting one. A partnership agreement can restrict selling or transferring of a partnership interest. State law may limit an LLC's life. 	<ul style="list-style-type: none"> The partnership pays no income tax. Profits pass through to partners for individual payment of tax. Tax to partners cannot be deferred by retaining business earnings. Pass-through items retain the same character to the partner as they had to the partnership. A general partner's distributive share of profits is subject to self-employment (SE) tax. Limited partners' share of profits not subject to SE tax unless in the form of guaranteed payments. Payment for partner services to the partnership is not W-2 income, but may be guaranteed payments, profits, or special allocations. Losses flow through to partners and can be used to offset other income such as W-2 wages, interest, dividends, and capital gains. Exceptions: Losses cannot be used to offset income from activities subject to passive loss, at-risk loss, and hobby loss rules. Partner may qualify for the 20% qualified business income deduction (QBID).
<p>S corporation</p> <ul style="list-style-type: none"> Form 1120-S, <i>U.S. Income Tax Return for an S Corporation</i> IRC Subchapter S, §1361 through §1379 	<ul style="list-style-type: none"> A corporation that has elected to be taxed as an S corporation by filing Form 2553, <i>Election by a Small Business Corporation</i>. Ownership is through owning shares of stock. Limited to 100 shareholders. (Spouses and their estates and all members of a family, as defined in IRC section 1361(c)(1)(B), and their estates can be treated as one shareholder for this test.) Stock is limited to one class of stock with equal rights to distributions and liquidation proceeds. Shareholders are limited to individuals, estates, certain trusts, and certain charities. Corporations and certain partnerships are ineligible to own stock. Other ownership and organization issues are the same as a C corporation. 	<ul style="list-style-type: none"> An S corporation generally pays no tax. Profits flow through to the shareholders. Pass-through items retain the same character to the shareholder as they had to the corporation. Distributions are not subject to self-employment tax. Shareholders who perform services are paid as employees and income is reported on a W-2. Losses flow through to shareholders and may be used to offset other income, subject to passive, at-risk, and hobby loss exception rules. Shareholder may qualify for the 20% qualified business income deduction (QBID).
<p>C corporation</p> <ul style="list-style-type: none"> Form 1120, <i>U.S. Corporation Income Tax Return</i> IRS Pub. 542, <i>Corporations</i> IRC Subchapter C, §301 through §385 	<ul style="list-style-type: none"> A legal association carrying on a trade or business organized under state law. Ownership is through owning shares of stock, and there is no limit on number of shareholders, or type of taxpayer or entity. Forming a corporation may require complex and expensive legal procedures. Corporations must hold board meetings, shareholder meetings, and keep corporate minutes. Corporations are subject to federal and state regulations. The life of a corporation is perpetual. Transfers of ownership can be as easy as selling or inheriting stock. Liquidating a corporation is usually a taxable event, and contributions in exchange for stock may be taxable. Raising additional capital can be as easy as issuing new shares of stock. 	<ul style="list-style-type: none"> Shareholders who perform services are paid as W-2 employees subject to payroll taxes and reporting rules. Reasonable wages must be paid and not inflated to reduce corporate tax liability. Net profits are subject to tax at the corporate rates. Profits distributed as dividends are taxed again on the shareholder's tax return. Tax to the shareholders can be deferred by retaining earnings for business purposes. Losses do not pass through to shareholders. Business losses must be carried over to a year with profits. Capital losses must be carried over to a year with capital gains. At-risk limitations, hobby loss, and passive loss rules do not apply.

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Business Entity Pros and Cons



Business Entity Pros and Cons

Sole Proprietorship

Pros	<ul style="list-style-type: none"> • No formal creation process. • Easy to operate and dissolve. • No separate tax return. • Easy to integrate business use of home deductions. • No double taxation of profits.
Cons	<ul style="list-style-type: none"> • No liability protection, except through insurance. • Self-employment tax is assessed on entire profit of the business. • Transfer of ownership can be complex. • Limited access to fringe benefits for owners.
Good Fit	<ul style="list-style-type: none"> • Seasonal or part-time businesses. • Businesses with little liability. • Home-based businesses. • Businesses intended to operate for the owner's life only.

Single-Member LLC

Pros	<ul style="list-style-type: none"> • Simple creation process. • Easy to operate and dissolve. • No separate tax return. • Easy to integrate business use of home deductions. • Liability protection for member, except for malpractice. • No double taxation of profits.
Cons	<ul style="list-style-type: none"> • Self-employment tax is assessed on entire profit of the business. • Transfer of ownership can be complex. • Limited access to fringe benefits for owners. • Laws regulating LLCs vary widely among states.
Good Fit	<ul style="list-style-type: none"> • Businesses with potential liability in operations. • Businesses intended to operate for the owner's life only.

Multi-member LLC

Pros	<ul style="list-style-type: none"> • Limited liability for all members, except for malpractice or debt guarantees. • Unlimited number of members. • Separate entity from members, allowing for greater flexibility in operations. • Ownership is in the form of membership interest and can be transferred more easily than ownership in a single-member LLC. • No double taxation of profits.
Cons	<ul style="list-style-type: none"> • Requires a separate tax return. • Laws regulating LLCs vary widely among states.
Good Fit	<ul style="list-style-type: none"> • Businesses requiring equity capital. • Businesses with potential liability in operations. • Businesses intended to exist beyond the lives of the members. • Businesses expecting changes in ownership over time.

General Partnership

Pros	<ul style="list-style-type: none"> • Easy to create. • No limit on partner number or type. • Can be used to hold investments in other businesses and consolidate multiple lines of business. • Flexible allocation of profit, loss, and distributions. • Favorable tax treatment when liquidated. • No double taxation of profits.
Cons	<ul style="list-style-type: none"> • Requires a separate tax return. • Unlimited liability for all partners. • Difficult to dissolve or change ownership without substantial planning. • Requires tracking of basis for partners, both inside and outside the partnership. • Individual partner's share of income is subject to self-employment taxes.
Good Fit	<ul style="list-style-type: none"> • Two established businesses who wish to work as one. • Partners wishing to consolidate multiple entities into one entity.



Business Entity Pros and Cons

Limited Liability Partnership

Pros	<ul style="list-style-type: none"> • Liability protection for limited partners. • Separate entity from partners. • Ownership can be transferred within the rules of the partnership agreement. • Limited partners' liability is limited to their investment in the business. • Limited partners pay self-employment tax on guaranteed payments only. • No double taxation of profits.
Cons	<ul style="list-style-type: none"> • Must have one general partner with unlimited liability. • Limited liability status for damages can be lost for a variety of administrative reasons. • Restrictions on partners based on entity type. • Requires a separate tax return. • Requires tracking of basis for partners, both inside and outside the partnership.
Good Fit	<ul style="list-style-type: none"> • Businesses with partners not actively involved in business. • Businesses with equity capital needs. • Businesses with exposure to liability.

C Corporation

Pros	<ul style="list-style-type: none"> • No liability for non-active stockholders. • No restrictions on ownership. • Ownership can be transferred through the sale of stock. • Separate entity from stockholders. • Fringe benefits for owner-officers. • Can have ownership interest in any other business entity. • Perpetual existence. • Raising capital can be achieved by issuing stock.
Cons	<ul style="list-style-type: none"> • Double taxation of profits. • Complex and expensive to create and maintain. • Requires regular board of directors' meetings and minutes. • Requires a separate tax return.
Good Fit	<ul style="list-style-type: none"> • Businesses with ownership in multiple other entities. • Businesses with significant exposure to liability. • Businesses intended to exist eternally.

S Corporation

Pros	<ul style="list-style-type: none"> • Liability protection similar to that of C corporations. • No double taxation of profits. • Ownership is easily transferred through the sale of stock. • Separate entity from stockholders. • Self-employment tax is not assessed on the entire profit of the business. • Losses can offset shareholders' other taxable income.
Cons	<ul style="list-style-type: none"> • Complex and expensive to create and maintain. • Requires a separate tax return. • Requires regular board of directors' meetings and minutes. • Requires tracking of basis for stockholders. • Ownership is limited to specific types of entities. • Deductibility of fringe benefits for owner-employees is limited.
Good Fit	<ul style="list-style-type: none"> • Businesses with significant exposure to liability.

Business Formalities

A common problem with a closely-held business is failure to adhere to business formalities. Trouble can occur when business and personal funds are intermingled, the business is not adequately capitalized, or reasonable compensation for services is not paid.

For example, separation of funds can be a key in preserving the liability protection of the "corporate veil." Courts can pierce the corporate veil if they find the corporation is an "alter ego" of the shareholder, which is likely to occur if shareholders pay personal expenses from the corporation checkbook or vice versa.

Transactions such as capital contributions or loans between the business and the owners can also be recharacterized by the IRS, creating unexpected negative tax consequences.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 72.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.

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Business Financing— Don't Intermingle Funds



Business Financing— Don't Intermingle Funds

Intermingling Funds

A common problem with single-owner and other closely-held corporations is intermingling of funds. This occurs when a corporate shareholder uses his or her personal checking account for corporate deposits or payment of corporate expenses.

Separation of funds can be a key in preserving the liability protection of the corporate veil. Courts can pierce the corporate veil by finding that the corporation is an “alter ego” of the shareholder, essentially stating that the corporation is not separate and distinct from the individual as evidenced by the intermingling of finances.

Also, a shareholder who deposits personal funds or pays personal expenses from the corporate checking account is intermingling funds. For the same reasons as the reverse, courts can cite this as evidence that the corporation is not a separate and distinct entity from the individual.

Tax Problems Caused by Intermingling Funds

Unintended tax consequences can occur when personal and corporate funds are intermingled. When a shareholder provides funds to or on behalf of a corporation, there are several different types of tax treatment that may apply, depending on the circumstances. For example, when a shareholder provides funds to a corporation, it can be classified as one of the following transactions.

- Capital contribution.
- Loan to the corporation.
- Repayment of a loan from the corporation.
- Expense reimbursement.
- Purchase.

When a shareholder purchases an item for the corporation from his or her personal funds, that shareholder is considered to have provided funds, or made a contribution, to the corporation. Classification is determined by how the transaction is structured and the circumstances surrounding the transaction. Providing funds to corporations without careful planning can cause unintended tax consequences.

If an individual takes funds from a corporation checking account, the transaction can be classified as:

- Taxable dividend.
- Nontaxable distribution.
- Nontaxable expense reimbursement.
- Wages.
- Loan to the shareholder.
- Repayment of a loan from the shareholder.

Failure to carefully structure transactions when taking disbursements from a corporation can result in otherwise nontaxable transactions becoming taxable, in addition to opening the corporation up for a court to pierce the corporate veil.

Example: *Lucy owns a home and garden store. She recently incorporated in order to shield herself from liabilities of the business. Lucy meant to open a corporation checking account, but she never got around to it. Since she had been doing business with her suppliers for many years as a sole proprietor, she continued to purchase supplies and inventory on account and pay the invoices from her personal checking account. Unfortunately, Lucy had a particularly bad year, and she was successfully sued for \$1 million by a customer injured by a Venus Flytrap purchased at Lucy's store. She also fell under audit by the IRS.* continued



Business Financing— Don't Intermingle Funds

Since Lucy's equity in the store was only \$1,000, the plaintiff's attorney asked the court to pierce the corporate veil. The court agreed, stating that as evidenced by the intermingling of funds, the corporation did not operate as a separate legal entity and was a mere alter ego for Lucy. Lucy became personally liable for the damages caused by the carnivorous plant.

When Lucy made purchases for her business from personal funds, she had been writing off those amounts as expenses on her corporation tax return. The IRS determined that the amounts paid represented capital contributions, not payment of expenses, and adjusted her taxable income upward for the year under investigation. Lucy's accountant tried to cheer her up by noting that in some cases, expenses paid by a shareholder have been disallowed altogether and the deductions permanently lost.

Court Case: A taxpayer operated a tax preparation business as a sole proprietor. The taxpayer later incorporated but continued to have clients make checks out to him personally and treated funds received from the business as his own. No evidence of any employment agreement existed between the taxpayer and his corporation. The court ruled that the taxpayer operated his business as a sole proprietor and the income earned should be treated as earned not by the corporation but by the individual and be subject to self-employment tax. (*Reginald Jarrett, et al*, T.C. Summary 2008-94)

Personal use of corporate assets. A similar situation with intermingling funds occurs when personal assets are used by the corporation and vice versa. If corporate assets are used for personal purposes, the IRS can reclassify expenses reported on the corporation tax return as expenses attributable to the shareholder rather than the corporation. On the other hand, if a corporation uses personal assets owned by the shareholder, this could indicate lack of separation of the shareholder and corporation, opening up the possibility of having the corporate veil pierced.

Court Case: The taxpayer was engaged in several business activities, including real estate, entertainment services, and interior design. She incorporated her business in New York under the name Real Services, Inc. The taxpayer's books were not well-kept, and she frequently used the corporation checking account to intermingle funds. Business deposits were made into the account, but checks were written for items such as birthday presents for family members, tuition costs for the daughter of a friend, and contact lenses for her friend. The taxpayer was audited by the IRS and taxes were assessed on unreported income.

The taxpayer argued she was not individually liable for the taxes. Instead, her corporation, Real Services, Inc., should be liable because the corporation received the funds in question. The court decision determined the corporation was a sham and stated the corporation had the characteristics of an alter ego, including:

"The intermingling of corporate and personal funds, undercapitalization of the corporation, failure to observe corporate formalities, such as the maintenance of separate books and records, failure to pay dividends, insolvency at the time of a transaction, siphoning off funds by the dominant shareholder, and in the inactivity of other officers and directors." (*Pappas*, T.C. Memo. 2002-127)

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- Sale or purchase of a residence or other real estate.
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- Notice from IRS or other revenue department.
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Employee or Independent Contractor



Employee or Independent Contractor?

In order for a business owner to know how to treat payments made to workers for services, he or she must first know the business relationship that exists between the business and the person performing the services. A worker's status determines what taxes are paid and who is responsible for reporting and paying those taxes.

A worker performing services for a business is generally an employee or an independent contractor. If a worker is classified incorrectly, the IRS may assess penalties on the employer for nonpayment of certain taxes.

Penalties and Interest

When the IRS determines that a worker is actually an employee rather than an independent contractor, the employer is subject to penalties for failure to withhold and remit income, FICA (Social Security and Medicare) and FUTA (federal unemployment tax) taxes, interest on the underpaid amounts, and penalties for failure to file information returns. The state will also seek to collect workers' compensation and unemployment compensation premiums for unreported wages.

Independent Contractor

An independent contractor is self-employed and is generally responsible for paying his or her own taxes through estimated tax payments. A business issues Form 1099-NEC, *Nonemployee Compensation*, to any one independent contractor, subcontractor, freelancer, etc., to whom the business made \$600 or more in payments over the course of the tax year. The business is not generally responsible for withholding income tax or FICA.



Employee

A worker treated as an employee will be issued Form W-2, *Wage and Tax Statement*, for wages paid. The business hiring the worker is responsible for withholding income tax and FICA. The employer is also liable for FUTA and various state employment taxes. Also, the employee may be eligible for certain fringe benefits offered by the employer, such as health care.

Factors to Determine Worker Status

The general rules for classifying workers as independent contractors or common-law employees center on who has the right to control the details of how services are to be performed. The factors can be grouped into three categories.

- 1) **Behavioral control.** Factors that indicate a business has the right to control a worker's behavior include the following.
 - **Instructions that the business gives to the worker.** Employers generally control when and where work is to be done, what tools or equipment to use, what workers to hire or to assist with the work, where to purchase supplies and services, what work must be performed by a specified individual, and what order or sequence to follow.
 - **Training that the business gives to the worker.** Employees may be trained to perform a service in a particular manner. Independent contractors generally use their own methods.
- 2) **Financial control.** Factors that indicate a business has the right to control the business aspects of a worker's job include the following.
 - **Extent of the worker's unreimbursed business expenses.** Independent contractors are more likely to incur expenses that are not reimbursed, such as fixed



Employee or Independent Contractor

overhead costs that the worker incurs regardless of whether work is currently being performed.

- **Extent of the worker's investment.** Independent contractors often have significant investment in facilities used to perform services for someone else, such as maintaining a separate office or other business location.
 - **Extent to which the worker makes his or her services available to the public.** Independent contractors are generally free to offer their services to other businesses or consumers. They often advertise and maintain a visible business location.
 - **Method of payment for services performed.** Employees generally are guaranteed a regular wage and work for an hourly fee or a salary. Independent contractors are generally paid a flat fee for a specific job. Exceptions apply to some professions, such as accountants and lawyers who charge hourly fees for their services.
 - **Extent to which the worker can make a profit.** Independent contractors can make a profit or a loss.
- 3) **Type of relationship between the parties.** Factors that indicate the type of relationship include the following.
- **Written contracts** that describe the relationship and intent between the worker and the business hiring the worker.
 - **Employee-type benefits provided to worker.** Employers often provide fringe benefits to employees, such as health insurance, pensions, and vacation pay.
 - **Permanency of the relationship.** Employer-employee relationships generally continue indefinitely.
 - **Extent services performed by the worker are a key aspect of the business hiring the worker.** A worker who is key to the success of a business is more likely to be controlled by the business, which indicates employee status. For example, an accounting firm hires an accountant to provide accounting services for clients. It is more likely that the accounting firm will present the accountant's work as its own and would have the right to control or direct that work.

Example: Harold owns a restaurant and hires Jim, a gardener, to mow the lawn and weed the landscaping once a week. The contract states that Jim will arrive at the restaurant on Monday mornings, mow the lawn, pull weeds, and tend to the landscaping. In exchange, Harold agrees to pay Jim \$50 for this service each week. Jim supplies his own lawnmower, weed eater, and hedge clippers. Jim decides what time he arrives and how long the job will take him. Harold does not supervise Jim in his tasks or dictate to him how they are to be done. Jim is an independent contractor.

Example: Jeffrey owns Jeffrey's Gardening Service and employs three gardeners to perform services for his business. Jeffrey pays his gardeners a fixed wage and withholds taxes, FICA, and various benefits and remits those withholdings to the appropriate government agencies. In addition, Jeffrey provides his employees with the tools and equipment they need to perform their work, instructs his employees which jobs to go to, and supervises them while they are doing their work. Jeffrey's workers are employees.

Incorrect Treatment of Employees as Independent Contractors

A worker who receives a 1099-NEC instead of a W-2 has two options.

- 1) Agree with the way the business has classified the worker, file Schedules C and SE, and pay self-employment tax on the earnings, or
- 2) File Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. The IRS will then decide if the worker should have been treated as an employee, subject to income and FICA tax withholding. If the IRS agrees that the worker really is an employee, the employer will be liable for employment taxes. However, if the IRS determines that the worker is really an independent contractor, the worker will be liable for paying SE tax.

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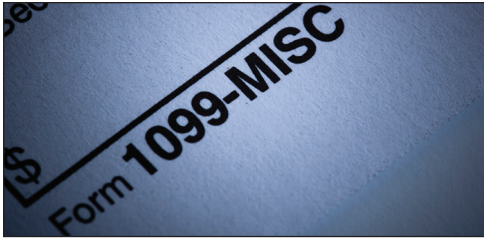
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Form 1099-MISC and Form 1099-NEC Reporting



Use Form 1099-NEC, *Nonemployee Compensation*, to report nonemployee compensation payments. These payments are no longer reported on Form 1099-MISC, *Miscellaneous Information*. See *Nonemployee compensation*, next page.

Trade or Business Reporting Only

Report on Form 1099-MISC or Form 1099-NEC only when payments are made in the course of your trade or business. Personal payments are not reportable. You are engaged in a trade or business if you operate for gain or profit. However, nonprofit organizations are considered to be engaged in a trade or business and are subject to these reporting requirements. Other organizations subject to these reporting requirements include trusts of qualified pension or profit-sharing plans of employers, certain organizations exempt from tax under IRC section 501(c) or 501(d), farmers' cooperatives that are exempt from tax under IRC section 521, and widely held fixed investment trusts. Payments by federal, state, or local government agencies are also reportable.

Exceptions: Some payments do not have to be reported on Form 1099-MISC or Form 1099-NEC, although they may be taxable to the recipient. Payments for which a Form 1099-MISC or Form 1099-NEC is not required include payments to a corporation (including a limited liability company (LLC) that is treated as a C or S corporation). But see *Reportable Payments to Corporations*, next column.

Form 1099-MISC, *Miscellaneous Information*, Reporting

2022 filing due date. Form 1099-MISC is due to the IRS by February 28, 2023, if filing by paper, or March 31, 2023, if filing electronically. The due date for furnishing statements to payees is January 31, 2023.

Who must file? File Form 1099-MISC, *Miscellaneous Information*, for each person to whom you have paid during the year:

- At least \$10 in royalties or broker payments in lieu of dividends or tax-exempt interest,
- At least \$600 in:
 - Rents,
 - Prizes and awards,
 - Other income payments,
 - Medical and health care payments,
 - Crop insurance proceeds,
 - Generally, the cash paid from a notional principal contract to an individual, partnership, or estate,
 - Gross proceeds to an attorney. See *Payments to Attorneys*, next page,
 - Any fishing boat proceeds,
 - Cash payments for fish (or other aquatic life) you purchase from anyone engaged in the trade or business of catching fish,
 - IRC section 409A deferrals, or
 - Nonqualified deferred compensation.

In addition, use Form 1099-MISC or Form 1099-NEC to report that you made direct sales of at least \$5,000 of consumer products to a buyer for resale anywhere other than a permanent retail establishment.

Withholding. You must also file Form 1099-MISC for each person from whom you have withheld any federal income tax under the backup withholding rules regardless of the amount of the payment.

Reportable Payments to Corporations on Form 1099-MISC

The following payments made to corporations generally must be reported on Form 1099-MISC.



Form 1099-MISC and Form 1099-NEC Reporting

- Cash payments for the purchase of fish for resale,
- Medical and health care payments,
- Gross proceeds paid to an attorney, and
- Substitute payments in lieu of dividends or tax-exempt interest.

Form 1099-NEC, *Nonemployee Compensation, Reporting*

2022 filing due date. Form 1099-NEC is due to the IRS and the payee by January 31, 2023.

Who must file? File Form 1099-NEC for each person to whom you have paid at least \$600 during the year for:

- Services performed by someone who is not your employee (including parts and materials), or
- Payments to an attorney. See *Payments to Attorneys*, next column.

Nonemployee compensation. Includes fees, commissions, prizes, awards, and other forms of compensation for services performed by a nonemployee as well as taxable fringe benefits. Includes professional service fees, such as fees to attorneys (including corporations), accountants, architects, contractors, or engineers, and directors' fees. Includes fee-splitting or referral fees paid by one professional to another and exchanges of services between individuals in the course of their trades or businesses. Includes oil and gas payments for a working interest, whether or not services are performed.

Withholding. You must also file Form 1099-NEC for each person from whom you have withheld any federal income tax under the backup withholding rules regardless of the amount of the payment.

Reportable Payments to Corporations on Form 1099-NEC

The following payments made to corporations generally must be reported on Form 1099-NEC.

- Attorneys' fees, and
- Payments by a federal executive agency for services (vendors).

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Payments to Attorneys

The term "attorney" includes a law firm or other provider of legal services. Attorneys' fees of \$600 or more paid in the course of your trade or business are reportable on box 1 of Form 1099-NEC.

Gross proceeds paid to attorneys. Report in box 10 of Form 1099-MISC payments that:

- Are made to an attorney in the course of your trade or business in connection with legal services, but not for the attorney's services, for example, as in a settlement agreement,
- Total \$600 or more, and
- Are not reportable by you in box 1, Form 1099-NEC.

Payments to corporations for legal services. The exemption from reporting payments made to corporations does not apply to payments for legal services. Therefore, you must report attorneys' fees (in box 1, Form 1099-NEC) or gross proceeds (in box 10, Form 1099-MISC) as described earlier to corporations that provide legal services.

Penalties

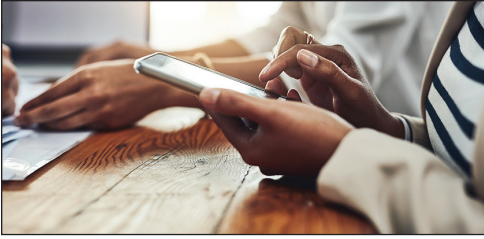
If you fail to file correct information returns and/or furnish correct payee statements by the due date and you cannot show reasonable cause, you may be subject to a penalty. The penalty for late filing or furnishing within 30 days of the due date is \$50 per return, with a maximum penalty of \$588,500. Taxpayers who show intentional disregard of the filing requirements can be assessed a penalty of \$580 per return, with no maximum amount of penalties.

A penalty for failure to file a correct information return is separate from the penalty for failure to furnish the correct payee statement. For example, if you fail to file a correct Form 1099-MISC with the IRS and do not provide a correct Form 1099-MISC statement to the payee, you may be subject to two separate penalties.

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Limited Liability Companies (LLCs)



Limited Liability Companies (LLCs)

What is a Limited Liability Company?

A limited liability company (LLC) is a business entity organized in the United States under state law. Unlike a partnership, all of the members of an LLC have limited personal liability for its debts. Depending on elections made and the number of owners, an LLC may be classified for federal income tax purposes as a partnership, corporation, or an entity disregarded as separate from its owner.

LLCs	
Ownership	<ul style="list-style-type: none"> • Unlimited number of members. • Non-U.S. citizens or residents allowed. • Can be owned by other corporations, partnerships, trusts, or LLCs.
Class of ownership interest	Different membership classes allowed.
Transfer of ownership	Member approval often required.
Formalities	Recommended: <ul style="list-style-type: none"> • Adopt operating agreement. • Issue membership shares. • Hold and document annual member meetings.
Existence	Some states require dissolution date. Events such as death or withdrawal of member can cause LLC to dissolve.
Income allocation	May decide to allocate income in any method agreed to by members.
Self-employment taxes	Members subject to SE tax on guaranteed payments and also distributive share of income.

This information applies to LLCs in general, and different rules may apply to special situations, including banks, insurance companies, or nonprofit organizations that are LLCs. Check your state's requirements.

Forming an LLC

Choose a business name. Your business name must be different from any existing LLC in your state, it must indicate that it is an LLC, and must not include words restricted by your state.

File the articles of organization. The articles of organization is a document that is filed with your Secretary of State that makes your LLC a legal entity and includes information such as your business name, address, names of members, and your resident agent. There is usually a filing fee.

Create an operating agreement. Most states do not require operating agreements, but they are highly recommended, especially for multi-member LLCs. The operating agreement structures your LLC's finances and organization, and provides rules and regulations for its operation. Sometimes tax treatment can be dictated by a written operating agreement. Default tax rules of multi-member LLCs will split income and expenses evenly, unless otherwise noted in an operating agreement.

Hold and document annual member meetings. If the operating agreement requires an annual meeting, these meetings must be held and documented. Failure to adhere to provisions in the operating agreement and other formalities could result in loss of liability protection for your LLC.

Apply for an EIN. An employer identification number (EIN) is a nine-digit number assigned by the IRS used to identify the tax accounts of employers and certain others who have no employees. If you will hire employees or have an LLC with multiple members, you need to apply for an EIN. See IRS Form SS-4, *Application for Employer Identification Number*, or apply online at www.irs.gov.



Limited Liability Companies (LLCs)

Classification of an LLC

Default classification rules. An LLC with at least two members is classified as a partnership for federal income tax purposes. An LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes). See *Single Member LLCs—Disregarded Entities*, below.

Elected classification. If an LLC does not want to be classified under the above default classifications, it can elect to be classified as an association taxable as a corporation or as an S corporation. After an LLC has determined its federal tax classification, it can later elect to change that classification. See IRS Form 8832, *Entity Classification Election*.

LLCs Classified as Partnerships

If an LLC has at least two members and is classified as a partnership, it generally is subject to the same filing and reporting requirements as partnerships. For certain purposes, members of an LLC are treated as limited partners in a limited partnership. For example, LLC members are treated as limited partners for purposes of material participation under the passive activity limitation rules.

Change in default classification. If the number of members in an LLC classified as a partnership is reduced to only one member, it becomes an entity disregarded as separate from its owner. However, if the LLC has made an election to be classified as a corporation and that elective classification is in effect at the time of the change in membership, the default classification as a disregarded entity will not apply. Other tax consequences of a change in membership, such as recognition of gain or loss, are determined by the transactions through which an interest in the LLC is acquired or disposed of.

Single Member LLCs—Disregarded Entities

If an LLC has only one member and is classified as an entity disregarded as separate from its owner, its income, deductions, gains, losses, and credits are reported on the owner's income tax return. For example, if the owner of the LLC is an individual, the LLC's income and expenses would be reported on the following schedules filed with the owner's Form 1040.

- Schedule C, *Profit or Loss From Business (Sole Proprietorship)*,
- Schedule E, *Supplemental Income and Loss*, or
- Schedule F, *Profit or Loss From Farming*.

Employment tax and certain excise taxes. If the LLC pays wages to employees, employment taxes must be reported and paid in the name and EIN of the LLC rather than in the name and EIN of the single member owner. The single-member LLC is also required to use the LLC's name and EIN to register for certain excise taxes.

Self-employment tax. An individual owner of an LLC treated as a disregarded entity is not an employee of the LLC. The owner is subject to self-employment tax on the net earnings in the same manner as a sole proprietorship.

Taxpayer identification number. For all income tax purposes, a single-member LLC classified as a disregarded entity must use the owner's Social Security Number (SSN) or EIN. This includes all information returns and reporting related to income tax.

LLCs Classified as Corporations

An LLC with either a single member or more than one member can elect to be classified as a corporation rather than be classified as a partnership or disregarded entity under the default rules.

An LLC classified as a corporation is subject to the same filing and reporting requirements as a corporation. The entity may elect to be treated as an S corporation if it otherwise qualifies.

C corporation. If the entity is treated as a C corporation, it is taxed on its taxable income and distributions to members are includible in each member's gross income to the extent of the corporation's earnings and profits (double taxation).

S corporation. If the entity elects to be an S corporation, the corporation is generally not subject to an income tax. The income, deductions, gains, losses, and credits of the corporation pass through to the members.

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Partnerships



What You Need to Know About Partnerships

A partnership is the relationship existing between two or more persons who join together to carry on a trade or business. Each person contributes money, property, labor, or skill and expects to share in the profits and losses of the business.

A partnership must file an annual information return to report the income, deductions, gains, or losses from its operations, but it does not pay income tax. Instead, it passes through any profits or losses to its partners. Each partner includes his or her share of the partnership's income or loss on his or her tax return.

Partners are not employees and should not be issued a Form W-2 (nor a Form 1099). The partnership must furnish copies of Schedule K-1 (Form 1065) to the partners by the date Form 1065 is required to be filed, including extensions.

A partnership or individual partner may find the following information helpful to determine some of the forms which may be required to be filed.

Partnership Forms

Annual Return of Income—Form 1065, *U.S. Return of Partnership Income*

Every partnership that engages in a trade or business, or has gross income, must file an information return on Form 1065 showing its income, deductions, and other required information.

A partnership is not considered to engage in a trade or business and is not required to file a Form 1065 for any tax year in which it neither receives income nor pays or incurs any expenses treated as deductions or credits for federal

income tax purposes. However, a partnership not currently engaged in a trade or business may want to file Form 1065, even though not technically required to do so, in order to avoid unnecessary correspondence from the IRS.

Employment Taxes

- Social Security and Medicare taxes and income tax withholding—Form 941, *Employer's Quarterly Federal Tax Return*. Generally, each quarter, all employers who pay wages subject to income tax withholding or Social Security and Medicare taxes must file Form 941 by the last day of the month that follows the end of the quarter.
- Federal unemployment tax (FUTA)—Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*. Generally, the FUTA tax applies to the first \$7,000 paid to each employee during a calendar year after subtracting any payments exempt from FUTA tax.
- Depositing employment taxes. Employers must deposit federal income tax withheld, plus both the employer and employee portion of Social Security and Medicare taxes, plus or minus any prior period adjustments to tax liability. All taxpayers must use the Electronic Federal Tax Payment System (EFTPS) to make federal tax deposits.
- State payroll tax requirements. The partnership should check with each state in which it conducts business or has employees to ensure the state requirements are met.

Information Returns, Form 1099

The partnership may have to file information returns if, in the course of its trade or business, it makes payments of rents, commissions, or other fixed or determinable income totaling \$600 or more to any one person during the calendar year. Generally, Form 1099-MISC, *Miscellaneous Information*, or Form 1099-NEC, *Nonemployee Compensation*, is used.



Partnerships

Excise Taxes/State Sales Taxes

Excise taxes are taxes paid when purchases are made on a specific good, such as gasoline. There are also excise taxes on activities, such as on wagering or on highway usage by trucks. Sales taxes are imposed by states on sales of particular merchandise or services. The partnership needs to be aware of when these taxes may need to be collected and/or remitted to the proper authorities.

Individual Forms

Income Tax—Form 1040, U.S. Individual Income Tax Return, and Schedule E, Supplemental Income and Loss

Schedule E (Form 1040) is used by the partner to report income or loss from the partnership as provided to the partner on Schedule K-1. Losses from partnerships are limited to the partner's basis. Other separately stated items from Schedule K-1 are reported on various forms and schedules of the partner's Form 1040.

Unreimbursed business expenses paid by a partner are deductible if the expenses were required to be paid under the partnership agreement.

Self-Employment Tax—Schedule SE (Form 1040), Self-Employment Tax

A partner's distributive share of partnership income is included in calculating his or her net earnings from self-employment.

Estimated Tax—Form 1040-ES, Estimated Tax for Individuals

Estimated tax is the method used to pay tax on income that is not subject to withholding, such as partnership income.

Partnership Advantages/Disadvantages

Advantages	Disadvantages
<ul style="list-style-type: none"> • Flexibility. A partnership can make special allocations or distributions among partners for non pro-rata shares of income and deductions. • Simplicity. For tax purposes, a formal partnership agreement is not required. A verbal agreement is generally all that is required to form a partnership, although a written agreement is recommended. • Flow-through income. Income and deductions from a partnership flow through to the partners on Schedule K-1. 	<ul style="list-style-type: none"> • Liability. A general partner is liable for debts of the partnership, including debts that have been incurred by another person. An LLC formed under state law can shield partners from liability. • Self-employment tax. The distributive share of income from a partnership is subject to SE tax for general partners. • Commitment. It is often said that a partnership is easier to get into than to get out of. Written partnership agreements should contain an escape clause.

General and Limited Partners

- **General partner.** A general partner is a partner who is personally liable for partnership debts. A general partner is subject to SE tax on guaranteed payments and on the distributive share of partnership income.
- **Limited partner.** A limited partner is liable only for the amount of money or other property that the partner contributed, or is required to contribute, to the partnership. A limited partner is subject to SE tax on guaranteed payments but is not subject to SE tax on the distributive share of income.
- **LLC members.** An LLC with more than one owner is treated as a partnership by default unless the LLC elects to be taxed as a corporation. Members of an LLC are subject to SE tax on guaranteed payments, but uncertainty exists as to whether and when LLC members are subject to SE tax on the distributive share of income. For more information, ask your tax preparer for the handout titled *Limited Liability Companies (LLCs)*.

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S Corporations



What You Need to Know About S Corporations

S corporations are corporations that elect to pass income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income.

To qualify for S corporation status, the corporation must meet the following requirements.

- It must be a domestic corporation.
- It must have only allowable shareholders.
 - Allowable shareholders include individuals, certain trusts, and estates.
 - Unallowable shareholders include partnerships, other corporations, and nonresident aliens.
- It must have no more than 100 shareholders.
- It must have only one class of stock.
- It may not be an ineligible corporation, such as certain financial institutions, insurance companies, and domestic international sales corporations.

In order to become an S corporation, the corporation must submit Form 2553, *Election by a Small Business Corporation*, signed by all the shareholders.

Corporate Formalities

Some or all of the benefits of establishing a corporation are lost when corporate formalities are not strictly followed. When a corporation is formed, a separate entity is created, with legal rights and responsibilities that are distinct and separate from the shareholders.

Corporate Veil

Corporations are often formed for purposes of protecting shareholders from liability. However, if formalities are not followed, the corporation is not adequately capitalized, or personal and corporation funds are intermingled, the corporate veil can be easily “pierced” by a court, which results in personal liability for the shareholders.

Reasonable Wages

Since a corporation is a separate legal entity, shareholders performing services for the corporation are treated as employees and must be paid reasonable wages for the duties performed. Even with a single-shareholder corporation, federal and state payroll taxes must be withheld and a year-end W-2 must be submitted, just as with any other employee.

IRS Issues

If tax formalities are not followed, such as reasonable wages being paid to shareholders, the IRS can reclassify income and expenses, causing unwanted tax consequences.



S Corporations

S Corporation Forms

Annual Return of Income—Form 1120-S, U.S. Income Tax Return for an S Corporation

A corporation or other entity must file Form 1120-S if:

- It elected to be an S corporation by filing Form 2553,
- The IRS accepted the election, and
- The election remains in effect.

Estimated Taxes

An S corporation may need to make estimated tax payments if it expects to owe taxes on certain built-in gains or passive income. Corporations must use electronic funds transfers to make all federal tax deposits, including installment payments of estimated tax.

Employment Taxes

- Social Security and Medicare taxes and income tax withholding—Form 941, *Employer's Quarterly Federal Tax Return*. Generally, each quarter, all employers who pay wages subject to income tax withholding or Social Security and Medicare taxes must file Form 941 by the last day of the month that follows the end of the quarter.
- Federal unemployment tax (FUTA)—Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*. Generally, the FUTA tax applies to the first \$7,000 paid to each employee during a calendar year after subtracting any payments exempt from FUTA tax.
- Depositing employment taxes. Employers must deposit federal income tax withheld, plus both the employer and employee portion of Social Security and Medicare taxes, plus or minus any prior period adjustments to tax liability. All taxpayers must use the Electronic Federal Tax Payment System (EFTPS) to make federal tax deposits.
- State payroll tax requirements. The corporation should check with each state in which it conducts business or has employees to ensure the state requirements are met.

Individual Forms

Income Tax—Form 1040, U.S. Individual Income Tax Return, and Schedule E, Supplemental Income and Loss

Schedule E (Form 1040) is used by the shareholder to report income or loss from the S corporation as provided to the shareholder on Schedule K-1 (Form 1120-S). Losses from S

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corporations are limited to the shareholder's basis. Other separately stated items from Schedule K-1 (Form 1120-S) are reported on various forms and schedules of the shareholder's Form 1040.

For tax years 2018 through 2025, unreimbursed business expenses paid by an S corporation shareholder are not deductible as employee business expenses.

Estimated Tax—Form 1040-ES, Estimated Tax for Individuals

Estimated tax is the method used to pay tax on income that is not subject to withholding, such as S corporation income.

S Corporation Advantages/Disadvantages

Advantages	Disadvantages
<ul style="list-style-type: none"> • <i>Liability protection.</i> An S corporation offers the same liability protection as a regular C corporation. • <i>Pass-through taxation.</i> An S corporation does not pay tax at the entity level. Income, loss, and deductions pass through to the shareholder. The double taxation of a C corporation is eliminated. • <i>Net operating losses (NOLs).</i> S corporation NOLs pass through to be claimed on the shareholder's tax return. • <i>No self-employment tax on S corporation income.</i> Net income passing through from an S corporation is not subject to payroll or self-employment tax. A reasonable wage must be paid to employee-shareholders. 	<ul style="list-style-type: none"> • <i>One-class-of-stock rule.</i> An S corporation may have only one class of stock. All shareholders must have equal rights to distributions. Special allocations are not allowed. Some loans can violate the rule and cause termination of the S election. • <i>Debt basis.</i> A shareholder's basis for deducting losses will only be increased by a direct loan to the S corporation. • <i>Carryovers.</i> Items such as net operating losses from C corporations are not allowed to be used in an S corporation. • <i>All income taxed.</i> Income is passed through and taxed to the shareholder, whether or not it is distributed. • <i>Fringe benefits.</i> Greater than 2% S corporation shareholders are treated as partners for purposes of fringe benefits, and many fringe benefits are not available.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 72.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.



January 2023

Section 1031: Don't Miss This Depreciation Election

As you likely remember, the Section 1031 exchange allows you to sell a piece of appreciated real estate and defer all the taxes as long as you invest the entire proceeds in like-kind property.

And then consider this: a cost segregation study allows you to separate qualifying real estate into separate components with shorter depreciable lives that speed up deductions and in many cases create immediate write-offs.

Can you (a) defer a large gain via Section 1031 and (b) immediately create a large write-off on the new asset with a cost segregation study?

You can, but you have to make sure you don't miss this one important step.

1031 Exchange Overview

The Section 1031 exchange allows you to sell appreciated real estate and defer all taxable gains when you fully reinvest the sales proceeds into new qualifying real estate.¹

Example 1. You purchased a rental property five years ago for \$200,000. The property has appreciated tremendously in the past five years and is now worth \$500,000.

You depreciated the rental by \$30,000, so its adjusted basis is now \$170,000. If you sell for \$500,000, you'll have a taxable gain of \$330,000.

But you don't sell outright. Instead, you utilize a 1031 exchange to make the sale and roll the sales proceeds (and the taxable gain) into the purchase of an eight-unit apartment building that costs \$1,000,000.

Key point. Many savvy investors continue using 1031 exchanges until death, when their relatives inherit the asset with a stepped-up basis.² And then, because of that stepped-up basis, those relatives can likely sell that asset federal-income-tax-free.

Cost Segregation Overview

Residential real estate is depreciated over a life of 27.5 years, and commercial real estate is depreciated over a life of 39 years.³

Example 2. You purchase a small apartment building for \$1,000,000. A qualified appraisal shows that 80 percent is building and 20 percent is land.

This makes your depreciable basis \$800,000. (You cannot depreciate land.)

You write off the \$800,000 basis over 27.5 years, giving you annual write-offs of \$29,091.

An applied cost segregation study breaks that \$800,000 building into components such as appliances, flooring, lighting systems, and land improvements. The components have lives of 20 years or less, qualifying them for faster depreciation and bonus depreciation as well.⁴

For 2022, bonus depreciation is 100 percent, but it drops to 80 percent for 2023.⁵

Key point. Cost segregation studies use the depreciation rules in effect when you place the property in service, not when you do the study.⁶ But you realize the tax benefits in the year of the study.

Example 3. Let's say that of the \$800,000 apartment building basis, 25 percent (\$200,000) goes to shorter-life assets and \$600,000 to the 27.5-year depreciable life category. Because you placed this building in service in 2022, you can use bonus depreciation to immediately deduct \$200,000 for the short-lived assets.

This would result in a first-year write-off of \$221,818 (\$200,000 + \$21,818 = wow!) and a \$21,818 write-off for Year 2 through Year 27.5.

Calculating Basis in a 1031 Exchange

When you complete a 1031 exchange, the basis in your new asset is calculated by reducing its value by the deferred gain. That new basis amount can be accounted for in two different ways, described below.

Method 1: Track two assets. With this method, the remaining basis of the old asset continues on its original timeline and the new "additional" basis of the new asset starts on a new schedule.⁷

Example 4. Your old asset had an adjusted basis of \$170,000 and 22.5 years of depreciable life remaining when you sold it (via the Section 1031 exchange).

Under the track-two-assets method, you would continue tracking that same \$170,000 and depreciating it across that same 22.5 years of remaining life.

Your new asset with a purchase price of \$1,000,000 would be reduced by the amount of deferred gain of \$330,000, and by the separate, old asset basis of \$170,000, to get to your new/excess basis amount of \$500,000.

Let's say that 80 percent of the \$500,000 new/excess basis is building and 20 percent is land. You would depreciate the \$400,000 building (80 percent x \$500,000) over 27.5 years.

Method 2: Track one asset. Here, you make the IRS regulation 1.168(i)-6(i)(2) election.⁸ This election allows you to treat the sum of the exchanged basis and the new/excess basis as one asset, both put into service at the same time.

Example 5. Your old asset's remaining basis of \$170,000 would be combined with your new/excess basis of \$500,000 (\$400,000 for building and \$100,000 for land). You depreciate the \$570,000 building basis (\$170,000 + \$400,000) over 27.5 years.

In the example above, you lose out because you are depreciating everything over 27.5 years.

Cost Segregation Can Change the Game

If you will use cost segregation on the newly acquired Section 1031 asset, you may want to make the 1.168(i)-6(c)(5)(iv) election because that applies cost segregation to the entire basis.⁹

Example 6. Under the track-one-asset method, your depreciable basis is \$570,000. If the cost segregation study shows that 25 percent of the basis is bonus depreciation or Section 179 qualifying property, you write off

- \$142,500 immediately,
- \$15,545 immediately, and
- \$15,545 in subsequent years.

Example 7. Under the track-two-assets method, you apply the cost study to the additional investment's portion of the depreciable basis (\$400,000, in this example). If the cost segregation study shows that 25 percent of the basis is bonus depreciation or Section 179 qualifying property, you write off

- \$100,000 immediately in bonus depreciation or Section 179 expensing;
- \$10,909 immediately in 27.5-year depreciation;
- \$7,555 immediately in depreciation of the old \$170,000 basis;
- \$10,909 each year for 26.5 years; and
- \$7,555 each year for 20.5 years.

Here, you can see that with cost segregation, the track-one-asset method is the winner—assuming you will keep the property in your real estate portfolio until death.

But we have to point out: there is more to consider that could change the result. For example, how long will you keep the property? With a short holding period, recapture on bonus depreciation and Section 179 expensing comes into play and could impact your selection of method.

Takeaways

Combining a Section 1031 exchange with a cost segregation study can produce great results.

Continuous use of the Section 1031 exchange enables you to continue upgrading your real estate portfolio without incurring any federal taxes on the upgrades. And you can keep doing this until you die.

When you upgrade your real estate using the Section 1031 exchange, you have the opportunity to use a cost segregation study to create large deductions in the year of exchange.

If you are going to use cost segregation on an asset acquired via a 1031 exchange, you need to consider the IRS Reg. Section 1.168(i)-6(c)(5)(iv) election to treat the sum of your old basis and your new basis as one asset.

Client Letter on This Article for Your Use. [Click Here.](#)

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- 1 IRC Section 1031(a)(1).
 - 2 IRC Section 1014(a).
 - 3 IRC Sections 168(b)(3); 168(c).
 - 4 IRC Section 168(k).
 - 5 IRC Section 168(k)(6).
 - 6 See Chief Counsel Notice 2004-024.
 - 7 Reg. Sections 1.168(i)-6(b)(7); 1.168(i)-6(b)(8).
 - 8 Reg. Section 1.168(i)-6(i)(2).
 - 9 IRS Reg. Sections 1.168(i)-6(i)(1); 1.168(i)-6(c)(5)(iv).
-



SMALL BUSINESS RECORDKEEPER

The purpose of this worksheet is to help you organize your tax deductible business expenses. In order for an expense to be deductible, it must be considered an "ordinary and necessary" expense for your trade or business.

Tax Tips:

- Use a separate checking account for your business. If you combine business and personal expenses, the IRS may believe that certain legitimate business deductions are actually non-deductible personal expenses.
- Get a separate credit card for your business. That way, 100% of your credit card interest and annual fees on the business card are deductible.
- Keep track of all of your expenses, even when you're not sure they're deductible. Your Tax Professional can help you claim the right expenses.
- Some deductions on property may be limited if you use them for personal tasks. For example, on a home computer, the deduction allowed is directly related to the percentage of time you use the computer for business.
- If you haven't incorporated, you can't deduct any "wages" you pay yourself.
- Don't forget to establish a health insurance or pension plan for your business, even if you're the only one working in the business. Your costs are generally deductible, whether or not you itemize. Talk to your Tax Professional for more information.
- Keep receipts and other information that substantiate the amount of and business purpose of your expenses.

Income

Date	Description	Amount

Date	Description	Amount

H&R Block ADVANTAGE®



Your Personal Action Plan

Expenses

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Advertising													
Cleaning													
Commission & Fees													
Contractor Payments													
Dues & Subscriptions													
Gifts													
Insurance													
Legal & Professional Services													
Loan Interest													
Meals & Entertainment													
Rent Paid													
Repairs & Maintenance													
Supplies													
Taxes & Licenses													
Tools													
Utilities & Telephone													
Other: _____													

This H&R Block Advantage document provides information that could help you improve your tax and financial situation. Its contents should be considered in conjunction with information you receive from other sources that are familiar with your specific circumstances. Tax services offered through subsidiaries of H&R Block Services, Inc.

Action Plan (2014)

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H&R Block ADVANTAGE®



Your Personal Action Plan

Business Property

Date Purchased	Description	Purchase Price*	Date First Used for Business

Vehicle Information	
Year of Vehicle	
Make/Model of Vehicle	
Date Placed in Service	
Purchase Cost	
Owned/Financed or Leased	
Commuting Miles	
Personal Miles	

*Include any sales tax or shipping charges

Mileage Log

Date	Description	Miles	Gas/Oil	Parking/ Tolls	Repairs & Maintenance	Misc*

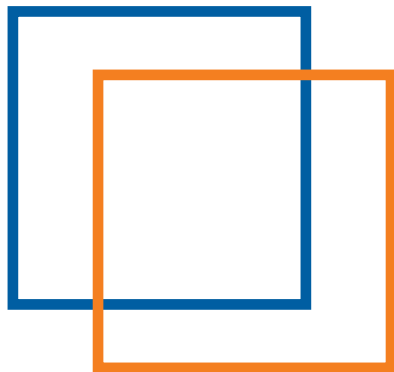
*Miscellaneous expenses can include: lease payments, insurance, garage rent, registration, personal property tax, smog certificate, and state inspections.

This H&R Block Advantage document provides information that could help you improve your tax and financial situation. Its contents should be considered in conjunction with information you receive from other sources that are familiar with your specific circumstances. Tax services offered through subsidiaries of H&R Block Services, Inc.

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Big Tax Changes To Know for 2023



An Exclusive Special Report from
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Alert: A Massive New FinCEN Filing Requirement Is Coming

The Corporate Transparency Act (CTA) is a new law passed in 2021 that requires corporations, LLCs, and other business entities to provide information about their owners to the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN).

The CTA did not take effect immediately. Rather, Congress gave the FinCEN time to write regulations and also gave businesses a heads-up about the new law.

FinCEN has now issued proposed regulations on how it intends to implement the CTA. The new proposed regulations hold several unpleasant surprises for businesses and the lawyers and accounting firms that advise them.

What the CTA Is About

The CTA is part of a major government effort to crack down on corruption, money laundering, terrorist financing, tax fraud, and other illicit activity. The CTA targets the use of anonymous shell companies that facilitate the flow and sheltering of illicit money in the United States.

Currently, few states require corporations, LLCs, or other entities to disclose information about their beneficial owners—that is, the human beings who actually own or control them—or the people who form them. And there has never been a federal requirement to do so. As a result, anonymous shell companies abound, and it can be impossible for law enforcement to discover who really owns them.

This will soon change. The CTA empowers FinCEN to establish a massive database containing beneficial owner information for most types of smaller business entities. These include U.S.-based businesses and foreign entities that register to do business in the U.S. The database will not be publicly accessible; it is solely for the use of law enforcement, national security and intelligence agencies, and federal regulators enforcing anti-money-laundering laws.

The CTA focuses on smaller business entities, since they are most likely to be shell companies. The law contains 23 exemptions for most types of larger businesses. These include publicly traded corporations and other businesses that are heavily regulated by the federal government.¹ Also exempt is any business that²

- has more than 20 full-time employees (employees who work 30 hours per week or 130 hours per month),
- has a physical presence at a business office in the United States, and

- has filed a federal tax or information return the prior year showing more than \$5 million in gross receipts or sales (net of returns and allowances, and not counting foreign sales).

Violations of the CTA can result in a \$500-a-day penalty (up to \$10,000) and up to two years' imprisonment.³

Surprise #1: The CTA Is Not Just for Corporations and LLCs

The CTA mandatory reporting requirements apply to corporations and limited liability companies. This includes the almost 2.5 million LLCs that have only one member and are taxed as Schedule C sole proprietorships (“disregarded entities”).

But the CTA doesn't end there. It also applies to any other non-exempt entity that is created by filing a document with a state secretary of state or similar state agency.⁴ FinCEN says that this includes limited liability partnerships, limited liability limited partnerships, business trusts, and most limited partnerships because such entities are normally created by a filing with a secretary of state.⁵

In short, almost every small business that is not a sole proprietorship or general partnership will have to comply with the CTA.

How many businesses are we talking about? FinCEN estimates as many as 30 million!

Surprise #2: The CTA May Take Effect Sooner than Anticipated

It's likely that the regulations will become final sometime in the second half of 2022. The final date will trigger the deadline for complying with the CTA's reporting requirements.

The CTA applies to both newly formed entities and existing companies. The deadline for compliance differs for each.

Key point. The deadlines do not coincide with the deadlines for filing tax returns.

New companies. Once the proposed regulations become final, new companies have to file their beneficial owner reports within 14 calendar days after being formed.⁶ Thus, if you're forming a new corporation, LLC, limited partnership, or other entity during the second half of 2022 that requires a filing with your secretary of state, you'll likely have to file a report with FinCEN.

Existing companies. The proposed regulations require existing companies to file a report no later than one year after the effective date of the final regulations.⁷ This is so even though the CTA itself provides that existing companies have two years to comply after the regulations become final.⁸ So existing companies will have to file their initial reports by mid- to late 2023.

Of course, it's possible that FinCEN will delay the final date of the regulations to 2023 or even later if it becomes clear no one is ready for them to go into effect during 2022.

Surprise #3: Beneficial Owners Are Broadly Defined

The CTA requires affected business entities to file a “beneficial owner information” report including each beneficial owner’s full legal name, date of birth, and residential street address, as well as a unique identifying number from an acceptable legal document such as a driver’s license or passport.⁹ The proposed regulations make it clear that a company can have multiple beneficial owners, and it may not always be easy to identify them all.

There are two broad categories of beneficial owners:¹⁰

1. Any individual who owns 25 percent or more of the company.
2. Any individual who, directly or indirectly, exercises substantial control over the company.

The CTA didn’t define “substantial control.” The proposed regulations define it quite broadly, to include¹¹

- senior officers of the company;
- individuals who have authority over appointment or removal of any senior officer, or of a majority of the company’s board of directors; and
- individuals who have substantial influence over important matters affecting the reporting company, including major expenditures, investments, or borrowing; sale or other transfer of assets; selling, dissolving, or reorganizing the company; selecting or terminating business lines or ventures; entering into or terminating significant contracts; compensation for senior officers; or amending the company’s governing documents.

Moreover, a person’s substantial control need not be exercised directly. It can be indirectly exercised through a variety of means.

Surprise #4: Tight Deadline for Updated Beneficial Owner Reports

If changes occur in the information included in a beneficial owner information report, the proposed regulations require that an updated report be filed with FinCEN within 30 calendar days after the change.¹²

For example, if a beneficial owner moves, an updated report will have to be filed within 30 days. FinCEN estimates that about 9 percent of all beneficial owners will have a change of address each year requiring an updated report. Updated reports also will have to be filed when a beneficial owner dies.

FinCEN estimates that over 11.4 million updated reports will have to be filed each year.

Surprise #5: The Report Must Identify Those Who Help Form Corporations and LLCs

In addition to the company's beneficial owners, the "company applicant" will have to be identified in the beneficial owner information report. This is "any individual who files the document that creates the domestic reporting company" or directs or controls others to do so.¹³ This would appear to include an attorney who files articles of incorporation to create a corporation or articles of formation to establish an LLC.

Neither the CTA nor proposed regulations contain any exemption for legal or accounting firms, except for public accounting firms registered under Section 102 of the Sarbanes-Oxley Act of 2002.¹⁴ According to FinCEN, only 851 accounting firms are so registered.

Get Ready—It's Coming

Whether it starts in late 2022 or 2023, a massive new filing requirement is coming for small businesses.

The FinCEN estimates that during the first year the CTA is in effect, over 25.8 million reports will have to be filed at a cost of \$1.264 billion. In subsequent years, over 3.2 million initial reports and 11.4 million updated reports will have to be filed, at a total annual cost of over \$364 million.

If you're a beneficial owner of a company subject to the CTA (in other words, a reporting company), you should provide your identifying information to the company so it can file the beneficial owner report.

Instead of providing your information directly to the company, you'll have the option of applying to FinCEN for a FinCEN identifier and using that instead. You'll have to provide FinCEN with all the required information, and it will assign you a unique number to give to the reporting company. You'll need to keep this information up-to-date with FinCEN.

Reporting companies should identify every individual who meets the definition of "beneficial owner" and inform them of the need to provide the required information or obtain a FinCEN identifier.

Takeaways

Here are five things to know from this article:

1. FinCEN has issued proposed regulations showing how it intends to implement the CTA—a law enacted in 2021 requiring smaller businesses to disclose the names, addresses, and other identifying information of their beneficial owners for inclusion in a FinCEN database that will be accessible only to law enforcement.
2. The CTA will take effect when the proposed regulations become final, which may be as early as mid-2022.

3. After the CTA takes effect, all new smaller businesses will have to file a beneficial owner report with FinCEN within 14 days of formation. All existing smaller businesses will have to file a report within one year.
4. Beneficial owners will include individuals who own 25 percent of a business entity, and all those who exercise substantial control over it.
5. Beneficial owner reports will have to be updated within 30 days if there is a change in the reported information, including a change in an owner's address.

¹ Prop. Reg. Section 31 CFR 1010.380(c)(2)(i)-(xx).

² Prop. Reg. Section 31 CFR 1010.380(c)(2)(xxi).

³ 31 U.S.C. Section 5336(h).

⁴ Prop. Reg. Section 31 CFR 1010.380(c)(1)(i)(C).

⁵ FinCEN, Fact Sheet: Beneficial Ownership Information Reporting Notice of Proposed Rulemaking (NPRM), (Dec. 7, 2021).

⁶ Prop. Reg. Section 31 CFR 1010.380(a)(1)(i).

⁷ Prop. Reg. Section 31 CFR 1010.380(a)(1)(iii).

⁸ 31 U.S.C. Section 5336(b)(1)(B).

⁹ 31 U.S.C. Section 5336(b)(2)(A).

¹⁰ Prop. Reg. Section 31 CFR 1010.380(d).

¹¹ Prop. Reg. Section 31 CFR 1010.380(d)(1).

¹² Prop. Reg. Section 31 CFR 1010.380(a)(2).

¹³ Prop. Reg. Sections 31 CFR 1010.380(b)(1)(ii); 31 CFR 1010.380(e).

¹⁴ Prop. Reg. Section 31 CFR 1010.380(c)(2)(xv).

\$80 Billion to the IRS: What It Means for You

For the business owner and tax practitioner, the most important part of the Inflation Reduction Act of 2022 was not the tax credit for flashy new electric cars.

It was something much more basic: a long-term budget commitment to help the struggling, failing IRS.

The Inflation Reduction Act invests an additional \$80 billion in the IRS over the next 10 years. This is the biggest budget increase the IRS has ever received. To put this in perspective, it is almost six times the IRS's annual \$13.8 billion budget.

Some politicians have raised the specter of 87,000 new gun-toting revenue agents scouring the land, looking for tax evaders. This is patently ridiculous.

But the new funding will impact all taxpayers. The average taxpayer should benefit because the IRS will be able to upgrade its operations and improve its woeful levels of service.

On the other hand, the well-above-average taxpayer should look out: the bulked-up IRS will be gunning for you.

How Will the IRS Use the Additional Money?

The new IRS funding will be appropriated as follows:¹

- \$3,181,500,000 for taxpayer services
- \$45,637,400,000 for enforcement
- \$25,326,400,000 for operations support
- \$4,750,700,000 for business systems modernization

The appropriated funds will remain available until September 30, 2031.

This is a mandatory appropriation. This means that Congress can't reduce the appropriation without passing a new law to do so.

There are no limits on how much the IRS can spend in any given year. The Biden administration plans to have the IRS phase in the new spending by implementing no more than \$1.5 billion the first year and gradually building up to \$15 billion by year 10.² The IRS is going to issue a detailed spending plan within six months.

Note that \$35 billion of the new money is not for enforcement. Among other things, the IRS plans to use these funds to update its antiquated IT systems (some of which date back to the 1960s), improve phone service, and speed up the processing of paper tax returns.

Taxpayers should see improvements in IRS services relatively soon. Over the next six months the IRS plans to hire 5,000 additional phone representatives, fully staff every IRS Tax Assistance Center, and improve the processing of paper returns by implementing scanning technology.

How Much Will the IRS Grow?

The IRS budget fell by 18.5 percent over the past decade, leading to a 20 percent decline in the agency's workforce. As of 2021, the IRS had only 78,661 employees. By comparison, it had 90,290 employees in 2012 and 116,673 in 1992. Staff losses have been most significant for revenue officers, who collect taxes (a 50 percent decline to 8,200), and revenue agents, who audit complex returns (a 35 percent decline).

Today, the IRS has fewer auditors than at any time since World War II.³

The IRS will be adding new employees, but not anywhere close to the 87,000 number bandied about in the media. Much of the new hiring will just offset attrition. The IRS has an aged workforce and expects a whopping 35,000 employees to retire in the next six years, along with another 17,000 who'll leave before retirement. That's 52,000 employees who'll need to be replaced.⁴

Thus, the IRS needs to hire 8,600 new employees per year just to stay even over the next six years. If all goes well, at the end of 10 years the IRS may grow by 20,000 to 30,000 employees, but it will still be smaller than it was in 1992. But the number of revenue agents could increase to 17,000 by 2031—over twice as many as today.

Will Audits Increase?

In a word: yes. Treasury Secretary Yellen has promised that IRS audit rates will remain at “historical levels” for taxpayers earning less than \$400,000 per year.⁵ “Historical levels” is an ambiguous term. Does it encompass the audit levels of the past decade or so?

In 2010, audit rates were at 1 percent compared with the current historic lows of about 0.25 percent. Thus, audits for those earning less than \$400,000 could increase fourfold, albeit from a very low level.

In any event, audit rates will definitely rise for taxpayers earning more than \$400,000 per year. This may take some time. The investment in the IRS is expected to raise some \$124 billion over the next 10 years.

Planning for the Restored IRS of the Future

If you earn \$400,000 or more, your chances of being audited over the next five or 10 years will likely go up, perhaps substantially.

You should keep complete and accurate records and file timely and complete tax returns. (Of course, this is something you should do anyway.)

Here are a few special areas of concern.

Cryptocurrency

The first page of the draft Form 1040 for 2022 asks the following revised cryptocurrency question: “At any time during 2022, did you (a) receive (as a reward, award, or compensation); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?”

When the IRS places a question about an asset on the first page of Form 1040, you know it’s a high-priority item. You can expect increased IRS audits dealing with cryptocurrency transactions.

If you’re one of the millions of Americans who engage in such transactions, it’s important to keep good records and report any income you earn.

S Corporation Compensation

If you’re an S corporation shareholder-employee, you’re likely saving on employment taxes by characterizing part of your compensation as a corporate cash distribution rather than employee wages or bonus. The smaller your salary, the more Social Security and Medicare tax you save.

You’re supposed to pay yourself a reasonable employee salary. If the IRS concludes part of your distribution is really a disguised salary payment, it can recharacterize it as salary and retroactively impose employment taxes, penalties, and interest.

For over 20 years, the IRS has been officially concerned with S corporations paying their shareholder-employees unreasonably low salaries. In the past, it threatened to increase audits of S corporations. But, doubtless due to budget constraints, it never really happened. In 2018, the audit rates for S corporations were a minuscule 0.65 percent.

This time it could be different. If the beefed-up IRS starts looking for low-hanging audit fruit to pick, S corporation salaries would be a likely choice.

You should have your S corporation pay you an arguably reasonable salary and benefits, and document how you arrived at the amount.

Syndicated Conservation Easements

One hot-button item for the IRS right now is syndicated conservation easements. Even in its currently reduced state, the IRS has been fighting them tooth and nail. They are listed as one of the IRS's dirty dozen tax scams for 2022.⁶

These are real estate partnerships that acquire land and donate the development rights to a qualified organization. The investors in the partnerships then obtain a charitable deduction for the value of the easement. The promoters of some of these deals have used wildly inflated appraisals to increase their tax benefits.

Some investors have claimed charitable deductions four times the amount of their investment. The IRS says that it examines 100 percent of these deals and plans to continue doing so for the foreseeable future.

Note that there are other ways to benefit from a conservation easement. For example, you could donate, to a qualified organization, development rights to a parcel of land that you own.

Offshore Accounts

U.S. citizens and residents are taxable on their worldwide income and are required to report foreign bank accounts to the U.S. Treasury. Concealing assets in offshore accounts is another item on the IRS's list of dirty dozen tax scams.

If you have more than \$10,000 in one or more offshore accounts, you must file a Report of Foreign Bank and Financial Account (FBAR) each year. Failure to do so can result in substantial penalties: \$100,000 or 50 percent of the total balance of the account per violation.

In recent years, the IRS has gone after both banks and bank account holders who hide assets in offshore accounts. In future years, we can expect the IRS to place even greater emphasis on identifying and tracking such offshore assets.

Business Partnerships

Partnerships and multi-member LLCs taxed as partnerships (which describes most of them) can expect increased scrutiny from the IRS in the future.

Currently, partnerships are hardly ever audited. The partnership audit rate has been about 0.4 percent to 0.5 percent for many years.

The IRS's latest five-year strategic plan calls for an increased focus on business partnerships that make up a disproportionate share of unpaid taxes.

The IRS began this process in late 2021 when it launched the Large Partnership Compliance (LPC) program, using data analytics to select 2019-tax-year large partnership returns for audit. You can expect the IRS to devote more resources to this program in the future.

Takeaways

The Inflation Reduction Act gives the IRS an additional \$80 billion to spend over the next 10 years. Some \$35 billion will be used to upgrade IRS operations, and \$45 billion is earmarked for enforcement.

The IRS may grow by 20,000 to 30,000 employees by 2032, and the number of revenue officers who collect unpaid taxes could more than double.

The IRS promises that audits of taxpayers earning less than \$400,000 per year will remain at historical levels. But this could mean they increase by as much 400 percent over their current low levels.

Taxpayers who earn more than \$400,000 will be in the IRS's crosshairs in future years. Areas it is likely to focus on include cryptocurrency, S corporation compensation, offshore accounts, syndicated conservation easements, and business partnerships.

¹ Pub. L. No. 117-169 (08/16/2022).

² U.S. Department of the Treasury, "The American Families Plan Tax Compliance Agenda," p. 16 (2021).

³ *Ibid.*, p. 11.

⁴ IRS Commissioner Rettig written testimony before the House Ways and Means oversight subcommittee (Mar. 17, 2020), p. 3.

⁵ Remarks by Secretary of the Treasury Janet L. Yellen (Sept. 15, 2022).

⁶ IR-2022-125.

New Law Improves Energy Tax Benefits for Biz Owners and Landlords

The newly enacted Inflation Reduction Act contains tax credits and depreciation benefits for owners of commercial property and residential rental property.

If you implement various types of renewable energy improvements, you can qualify for hefty tax credits or deductions.

One caution: the rules are complex. That said, bear with the rules because the benefits are worthwhile.

Business Energy Investment Tax Credit

The business energy investment tax credit (ITC) is used primarily for solar panel installations on commercial buildings and residential rentals.

The ITC has been available and continues for small wind power installations, fuel cells, microturbine, waste energy recovery, geothermal, and combined heat and power. The new law extends the ITC to stand-alone battery storage, biogas (such as landfill gas), and microgrid controllers.¹

The new law retroactively increases the base ITC from 26 percent to 30 percent of depreciable basis for projects that are placed in service after 2021, provided that construction commences before 2025.² To realize the full tax credit, you must continue to own the property for five years after the energy installation, or the government will recapture some or all of the credit.³

Special Rule for Larger Energy Projects

To obtain the 30 percent ITC, larger energy projects must comply with new prevailing wage and apprenticeship requirements.⁴ These apply only to energy facilities with a maximum net output of at least one megawatt.

Key point. Typical solar or other alternative energy projects for commercial buildings and residential rentals don't produce this much power. For example, a solar installation for a large warehouse typically produces no more than 100 kilowatts to 400 kilowatts—less than half of one megawatt.

If the wage and apprenticeship rules do apply, failure to comply reduces the ITC from 30 percent to 6 percent.⁵

Increasing the ITC to 40 Percent, 50 Percent, or More

Starting in 2023 (in other words, coming soon), businesses can also utilize stackable “bonus” ITC adders that can increase the total ITC to a whopping 40 percent, 50 percent, or more.

- **Domestic content bonus.** You can earn a 10 percent ITC bonus (bringing the ITC to 40 percent) if a project satisfies the domestic content requirement. (100 percent of the steel and iron used must be U.S.-sourced. Manufactured components must be at least 40 percent U.S.-sourced.) But the Treasury secretary can provide exceptions to these rules if they result in cost increases of over 25 percent or if comparable products are not readily available in the U.S.⁶
- **Low-income community bonus.** You earn a 10 percent ITC bonus if a solar or wind facility is located in, or services, a low-income community or Native American land. Low-income communities are those with at least a 20 percent poverty rate or whose residents earn less than 80 percent of the statewide median income.⁷
- **Qualified low-income residential building project bonus.** You earn a 20 percent ITC bonus for solar or wind installations for residential buildings if (a) the building owner participates in various federal low-income housing programs, or (b) 50 percent of the affected building households have income of less than 200 percent of the federal poverty line or less than 80 percent of the area’s median gross income.⁸
- **Energy community bonus.** You can earn a 10 percent ITC bonus if the project is located in or on (a) a brownfield site, (b) an area with significant employment related to fossil fuels, or (c) a coal-related census tract.⁹

Special depreciation benefit. The year you place your solar or other energy installation in service, you may depreciate it. Ordinarily, you reduce the basis of depreciable property by the full amount of any credit. But the ITC reduces the energy property’s basis by only half the credit amount, increasing your depreciation deductions.¹⁰

Five-year depreciation. IRC Section 48 energy property gets a five-year depreciation period under MACRS (this is generous because solar panels usually last 25 to 30 years).¹¹

Bonus depreciation. Here’s more good news. The 80 percent first-year bonus depreciation is available for energy improvements for residential rental or commercial property placed in service during 2023; the depreciation is 60 percent for 2024.

Example. Sally owns a small commercial building in downtown Detroit. She spends \$50,000 to install solar panels in 2023. The project qualifies for the 10 percent domestic content bonus and the 10 percent low-income community bonus.

- Sally’s total ITC is 50 percent. She gets a \$25,000 ITC.
- The depreciable basis in her building is reduced by only 50 percent of her ITC, so her basis is \$37,500. She uses 80 percent bonus depreciation to deduct \$30,000 in 2023.
- She depreciates her remaining \$7,500 basis over five years.

Can't Use the ITC? Sell It

The ITC is non-refundable, but it is transferable. That is, you may transfer all or part of your ITC to another taxpayer for cash.

The buyer of your ITC need not be a business or be involved in the renewable energy industry (but the person or entity may not be related to you).

The buyer must pay you for the ITC in cash. You are not taxed on the payment. It's tax-exempt income for you.

The credit must be transferred by the due date of the tax return for the taxable year in which the credit is determined. A credit may be transferred only once.¹²

Replacement

The ITC in its current form expires in 2024. It will be replaced with a new, technology-neutral clean electricity ITC.

Under the new credit, any project producing electricity will qualify for a 30 percent clean energy ITC if its greenhouse gas emissions rate is not greater than zero. The clean energy ITC will phase out by the later of¹³

- 2032, or
- when the electric power sector emits 75 percent less carbon than 2022 levels.

Energy-Efficient Commercial Buildings Deduction

Since 2006, owners of commercial buildings have been able to claim an immediate first-year deduction for part of the cost of making existing or new buildings more energy-efficient. The Inflation Reduction Act significantly increases the amount of this deduction starting in 2023.

Note that this is simply an accelerated tax deduction, not a tax credit.

Other Choices

Building owners can deduct many of these same expenses in one year using Section 179 expensing without having to comply with the complex rules for the Section 179D deduction. But there is an annual limit on the Section 179 deduction (\$1,080,000 for 2022).

Bonus depreciation is also available to deduct many of these expenses in one year, but it will be reduced from 100 percent in 2022 to 80 percent in 2023 (and to 60 percent in 2024).

Commercial and Multi-Family

The Section 179D deduction is only for commercial buildings and multi-family residential buildings of four stories or more. It is not available for rentals of single-family homes, multi-family buildings of three stories or less, mobile homes, or manufactured homes.¹⁴

Building owners qualify for the deduction when, as part of a plan to reduce total energy costs, they upgrade a building's¹⁵

- interior lighting system;
- heating, cooling, ventilation, or hot water system; or
- building envelope—for example, roofs, walls, floors.

Old 50 Percent Rule

Under the old deduction, building owners had to improve a building's energy efficiency by 50 percent as compared with a hypothetical reference building that meets an efficiency engineering standard established by the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE Standard 90.1).

New, Easier 25 Percent Rule

Under the revised deduction, building owners only have to improve energy efficiency by a minimum of 25 percent.¹⁶ And the maximum deduction amount increases for every percentage point of energy efficiency above the 25 percent benchmark.¹⁷

Old Deduction

The old deduction was capped at \$1.88 per building square foot in 2022.

New Deduction

Starting in 2023, the deduction cap is increased to \$5 per building square foot (subject to annual inflation adjustments). But to claim the \$5-per-square-foot deduction, building owners must comply with prevailing wage and apprenticeship requirements. If those requirements are not met, a building owner may claim only a \$1-per-square-foot maximum deduction.¹⁸

Prevailing Wage Rules

The prevailing wage rules require that any laborers and mechanics employed by the taxpayer, contractors, and subcontractors be paid prevailing wages (as determined by the Department of Labor¹⁹) during installation, alteration, or repair of the project.

The apprenticeship rules require that qualified apprentices be hired to perform a minimum percentage of the work on the project, as follows:

- 10 percent in 2022
- 12.5 percent in 2023

- 15 percent in 2024 and later

Failure to satisfy these requirements can be cured by making payments to each worker previously paid below the prevailing wage and remitting penalty payments to the IRS.

The IRS will issue guidance on how these requirements will work in practice. Projects that begin construction within 60 days after the IRS publishes such guidance are not subject to the prevailing wage and apprenticeship requirements.²⁰

Inspection

To obtain the Section 179D deduction, the building must be inspected by a “qualified individual” who certifies to the IRS that you’ve complied with all the requirements.²¹ You’ll likely need to hire a heating and ventilating engineer, refrigeration engineer, illuminating engineer, or other similar expert to get this deduction. You should do this before undertaking an energy-efficiency retrofit project.

Defined Designers Can Claim the Deduction

One unique aspect of the Section 179D deduction is that designers of government buildings have been able to claim it.

The Inflation Reduction Act extends this deduction to designers of buildings for any tax-exempt entity, including Indian tribal governments, churches and other religious organizations, and not-for-profit schools and universities. The entity must allocate the deduction to the designer.²²

For these purposes, designers include architects, engineers, design-build contractors, and performance contractors.

Electric Vehicle Charger Credit

The Inflation Reduction Act extends through 2032 the tax credit for installing an electric vehicle charging station in a commercial or rental building garage or parking lot.²³

Prevailing Wage Rules Apply Here Too

Starting in 2023, the credit remains 30 percent of the cost of installing such chargers, but only if the project complies with prevailing wage and apprenticeship requirements (these are the same requirements discussed above).

If the project does not comply with these requirements, the law reduces the credit from 30 percent to 6 percent. The maximum annual credit is now capped at \$100,000, and the cap applies per charger unit.²⁴ Under prior law, there was a \$30,000 annual cap for an entire location regardless of the number of chargers.

More Chargers Qualify

The credit is also extended to include bi-directional chargers that can be used to power a home and feed energy back into the electricity grid.²⁵ The credit now also applies to chargers for two- and three-wheeled vehicles.²⁶

New Geographic Requirement

The electric charger credit is subject to a new geographic requirement that will greatly limit its availability. Starting in 2023, it will be available only for property located in low-income or rural areas.²⁷

Low-income census tract. The charging station must be located in a low-income census tract that has a poverty rate of at least 20 percent or a median family income of less than 80 percent of the statewide median.

Rural area. Alternatively, the charging station must be in a non-urban area. This is an area not designated as an urban area by the U.S. Commerce Department in the most recent census. Less than 20 percent of the U.S. population lives in such rural areas.²⁸

General Business Credit

The electric vehicle charger credit is part of the general business credit.²⁹ The basis of the property for which a credit is claimed must be reduced by the amount of the credit.³⁰

Takeaways

The Inflation Reduction Act extends and expands business ITCs for installing solar and other renewable energy facilities in commercial and rental buildings. The new law retroactively increases the ITC from 26 percent to 30 percent for projects begun after 2021 and before 2025.

Starting in 2023, you can earn bonus credits giving you 40 percent, 50 percent, or more in ITC. You earn the bonus credits for projects that

- comply with domestic content requirements,
- are located in low-income communities,
- participate in federal housing programs, or
- are located in communities involved with fossil fuels.

The ITC in its current form expires in 2025, to be replaced with a new technology-neutral, 30 percent clean electricity ITC.

The Energy Efficient Commercial Buildings Deduction can now be obtained for projects that increase a building's energy efficiency by 25 percent instead of 50 percent. Starting in 2023, the cap on the deduction is increased to \$5 per building square foot if prevailing wage and

apprenticeship requirements are met. If these requirements are not met, a building owner may claim only a \$1-per-square-foot maximum deduction.

The credit for installing electric vehicle charger units in commercial or rental buildings is extended to 2032. Starting in 2023, the following rules govern:

- The 30 percent credit is available only for projects that comply with prevailing wage and apprenticeship rules; otherwise, it is reduced to 6 percent.
- The credit is available only for property located in low-income or rural areas.
- The annual cap on the credit is increased to \$100,000 per charging unit.

¹ IRC Sections 48(a)(2)(A)(i)(VI); 48(a)(2)(A)(i)(IX); as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13102.

² IRC Sections 48(a)(2)(A); 48(a)(9); as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13102.

³ IRC Section 50(a)(1)(A).

⁴ IRC Sections 48(a)(10); 48(a)(11); as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13102.

⁵ IRC Section 48(a)(9)(B)(i), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13102.

⁶ IRC Section 48(a)(12), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13102.

⁷ IRC Section 48(e), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13102.

⁸ Ibid.

⁹ IRC Sections 48(a)(14); 45(b)(11)(B), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13102.

¹⁰ IRC Section 50(c)(3).

¹¹ IRC Section 168(e)(3)(B)(vi).

¹² IRC Section 6418, added by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13801.

¹³ IRC Section 48E, added by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13702.

¹⁴ IRC Section 179D(c)(1); IRS Notice 2006-52, Section 5.02.

¹⁵ IRC Section 179D(c)(1)(C).

¹⁶ IRC Section 179D(c)(1)(D), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13303(a)(2).

¹⁷ IRC Section 179D(b)(2), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13303(b)(2).

¹⁸ IRC Section 179D(b), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13303(b).

¹⁹ U.S. Department of Labor, Prevailing Wages.

²⁰ IRC Section 179D(b)(4), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13303(b)(4).

²¹ IRS Notice 2006-52.

²² IRC Section 179D(d)(3), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13303(b)(6).

²³ IRC Section 30C(i), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13404(a).

²⁴ IRC Sections 30C(a); 30C(b); 30C(g); as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13404.

²⁵ IRC Section 30C(c)(2), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13404(c).

²⁶ IRC Section 30C(f)(2), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13404(f)(2).

²⁷ IRC Section 30C(c)(3), as amended by the Inflation Reduction Act of 2022 (Pub. L. No. 117-169), Section 13404(e).

²⁸ The Commerce Department will issue, in December 2022, a map and listing of all urban areas based on the 2020 Census; see <https://www.census.gov/programs-surveys/geography/guidance/geo-areas/urban-rural.html>.

²⁹ IRC Section 30C(d)(1).

³⁰ IRC Section 30C(e)(1).

Buying an Electric Vehicle? Know These Tax Law Changes

Are you thinking of buying an electric vehicle or a plug-in hybrid?

And are you looking to benefit from the \$7,500 tax credit? If so, you have much to consider—thanks to the newly enacted Inflation Reduction Act.

Let's get started.

The Electric Vehicle Credit for 2023 and Later

A new clean vehicle credit goes into effect in 2023 and continues through 2032. Although the credit maximum remains \$7,500, the credit is massively changed. Due to the changes, many taxpayers will no longer be able to claim the credit. And there may be fewer electric vehicles available that qualify for the credit.

Key point. Business taxpayers have a decision to make when buying an electric vehicle in 2023 or later. They can choose either the new clean vehicle credit or the new qualified commercial clean vehicle credit.¹

200,000 Cap Eliminated

The old credit was limited to the sale of 200,000 electric vehicles per manufacturer. The new credit eliminates this cap. Thus, for example, electric vehicles manufactured by GM, Toyota, and Tesla can qualify for the credit if they meet the price cap and other requirements.

Credit Amount

The maximum credit for 2023 and later remains at \$7,500. But it has two components:²

1. A \$3,750 credit if the electric vehicle complies with the domestic sourcing requirements for critical minerals used in the battery, as explained below
2. A \$3,750 credit if the electric vehicle satisfies domestic content requirements for battery components

According to the Alliance for Automotive Innovation, no electric vehicle currently available for purchase will qualify for the full \$7,500 credit on January 1, 2023. Electric vehicle manufacturers are working feverishly to change this. The critical minerals requirements may prove particularly difficult to comply with over the next few years. The domestic content requirements should be easier.

Thus, there may be a number of electric vehicle models that qualify for only a \$3,750 credit.

Key point. The business buyer avoids the component problem when using the qualified commercial clean vehicle credit.³

Buyer Income Caps

The credit may not be claimed by taxpayers whose modified adjusted gross income (AGI) is more than⁴

- \$300,000 for joint-return filers and surviving spouses,
- \$225,000 for heads of household, or
- \$150,000 for unmarried taxpayers and married taxpayers who file separately.

Modified AGI is adjusted gross income plus foreign earned income that is otherwise excluded from U.S. taxation. You can use your modified AGI for the prior year if it is lower.

Key point. The business buyer avoids the AGI caps when using the qualified commercial clean vehicle credit.⁵

Electric Vehicle Price Caps

The tax code does not allow the new clean vehicle credit if the manufacturer's suggested retail price (MSRP) for the vehicle exceeds⁶

- \$80,000 for a van,
- \$80,000 for a sports utility vehicle (SUV),
- \$80,000 for a pickup truck, or
- \$55,000 for any other vehicle.

The IRS will provide guidance on which electric vehicles fall within these categories. Note that these caps are cliffs, not phaseouts. The credit is totally eliminated if the applicable MSRP is even one dollar over the cap.

Key point. The business buyer avoids the dollar caps when using the qualified commercial clean vehicle credit.⁷

Domestic Content Requirement for Electric Vehicle Batteries

The credit is designed to encourage the manufacture of electric vehicles in the United States. Thus, it imposes domestic content requirements on critical minerals and components used in electric vehicle batteries. The IRS will issue guidance on how these rules will work.

Critical minerals include lithium, copper, cobalt, and nickel used in electric vehicle batteries. Currently, the U.S. imports the vast majority of these minerals from China, Brazil, Chile, Australia, and South Africa.

The new credit requires that a specific percentage of critical minerals be sourced in North America or from countries with which the U.S. has a free trade agreement. The sourcing percentage rises from 40 percent in 2023 to 80 percent in 2027 and later. This requirement will likely cause production bottlenecks and drive up the cost of electric vehicles.

In addition, a specific percentage of battery components must be manufactured or assembled in North America. The percentage rises from 50 percent in 2023 to 100 percent in 2029 and later.⁸

Beginning in 2025, any electric vehicle with battery minerals from a “foreign entity of concern” will be excluded from the tax credit. These foreign entities include China, Russia, North Korea, and Iran. The same rule applies starting in 2024 for battery components.⁹ This should knock China completely out of the U.S. electric vehicle battery supply chain by 2025.

Domestic Assembly Requirement

The final assembly of the electric vehicle must occur within North America.¹⁰ In other words, the component parts must be put together at a plant or factory located in the U.S., Canada, or Mexico. This will be an easier requirement for electric vehicle manufacturers to meet than the battery sourcing rules.

Credit for Used Electric Vehicles

For the first time, a clean vehicle credit will be available to individual purchasers of used electric vehicles (i.e., not corporations) starting in 2023. This credit is limited to electric vehicles that cost \$25,000 or less and that are at least two years old. Very few used electric vehicles currently come in under that \$25,000 price cap, although this may change in future years.

The credit is the lesser of \$4,000 or 30 percent of the purchase price. To claim the credit, the individual taxpayer must purchase the used electric vehicle from a dealer, not from a private party.¹¹ In addition, the purchaser’s AGI must be less than¹²

- \$150,000 for joint-return filers and surviving spouses,
- \$112,500 for heads of household, or
- \$75,000 for single taxpayers and married taxpayers who file separately.

The used electric vehicle credit may be claimed only once per used electric vehicle—that is, by the first purchaser of the used electric vehicle. Additionally, the purchaser must not have claimed a used electric vehicle credit during the prior three years.

Used electric vehicles don’t have to satisfy either the same domestic content requirement for batteries as new electric vehicles or the North American assembly rules.

New Rule for 2024 and Later

Point-of-sale credit. Starting in 2024, an electric vehicle purchaser may transfer their credit to the dealer, who will in turn offer up to a \$7,500 cash rebate or price reduction, or treat the

purchaser as having made a down payment in the amount of the credit.¹³ This way, electric vehicle purchasers will benefit from the credit immediately rather than having to wait until they file their tax returns.

Key point. This is a tremendous boon for lower-income purchasers because the credit is non-refundable and some taxpayers may not owe enough tax to use the entire \$7,500 credit when they file their taxes.

What If You Qualify for Both the Personal and Business Electric Vehicle Credits?

You could qualify for the electric vehicle tax credit using either the clean vehicle credit or the commercial clean vehicle credit. Note the word “either.” It’s either one or the other, not both.¹⁴

Ordinarily, if you’re able to find an electric vehicle that qualifies for the full \$7,500 personal clean vehicle credit and you come within the income limits, you should claim the personal credit. The commercial clean vehicle credit can never be larger than the personal credit (unless the electric vehicle weighs over 14,000 pounds), but it can be smaller.

The commercial clean vehicle credit is equal to the lesser of¹⁵

- 15 percent of the vehicle’s basis (30 percent if the vehicle is fully electric), or
- the incremental cost of the vehicle (the excess of the electric vehicle’s purchase price over the price of a comparable non-electric vehicle).

The maximum credit is \$7,500—the same as the personal credit.

For example, if you purchase an \$80,000 fully electric van and use it 25 percent for business, your depreciable basis is \$20,000. Your maximum commercial clean vehicle credit is \$6,000 (30 percent x \$20,000).

But if you claim the personal clean vehicle credit, you’ll get \$7,500—which you need to allocate, claiming 25 percent as a business credit and 75 percent as a personal credit.¹⁶

Key point. With no taxable income, you would get zero benefit from the non-refundable personal tax credit. But you can carry the non-refundable business credit back one year and forward until used for up to 20 years.¹⁷

Also, if you purchase your electric vehicle during 2024 or later, you’ll be able to transfer the personal clean vehicle credit to the dealer and get up to \$7,500 in a price reduction or rebate at the time of purchase. This is not possible with the commercial clean vehicle credit—you must claim the commercial credit when you file your tax return.

Takeaways

Here are six things to know from this article:

1. A new clean vehicle tax credit takes effect in 2023. The maximum amount of the new credit is also \$7,500, but many new requirements are imposed, including

- electric vehicle price caps,
- electric vehicle purchaser income caps, and
- domestic sourcing requirements for electric vehicle batteries.

2. Beginning in 2023, the new clean vehicle credit eliminates the 200,000 vehicles per manufacturer cap. Popular electric vehicles manufactured by GM, Toyota, and Tesla will qualify for the 2023 credit if they meet the price cap and other requirements.

3. Starting in 2023, individual taxpayers can purchase certain used electric vehicles from dealers (not individuals) and claim a credit of up to \$4,000 if their income is below an annual cap.

4. Starting in 2024, electric vehicle purchasers will be able to transfer their credit to the dealer, who will in turn offer them up to \$7,500 in a cash rebate or price reduction, or treat the credit as a down payment.

5. Business taxpayers have the option of qualifying for the tax credit under either the personal clean vehicle credit or the commercial clean vehicle credit.

6. The commercial clean vehicle credit avoids the North American assembly rules, income limits, and price-of-vehicle limits.

¹ For the business option, see our article titled [New Law: Business Tax Credits for Your Electric Vehicle Purchases](#).

² IRC Section 30D(b).

³ See [New Law: Business Tax Credits for Your Electric Vehicle Purchases](#).

⁴ IRC Section 30D(f)(10).

⁵ See [New Law: Business Tax Credits for Your Electric Vehicle Purchases](#).

⁶ IRC Section 30D(f)(11).

⁷ See [New Law: Business Tax Credits for Your Electric Vehicle Purchases](#).

⁸ IRC Section 30D(e)(3).

⁹ IRC Section 30D(d)(7).

¹⁰ IRC Section 30D(d)(1)(G).

¹¹ IRC Section 25E(a).

¹² IRC Section 25E(b).

¹³ IRC Section 30D(g).

¹⁴ IRC Section 45W(d)(3).

¹⁵ IRC Section 45W(c).

¹⁶ IRC Section 30D(c)(1).

¹⁷ IRC Sections 38(b)(30); 39(a)(1).

Get Ready to Say Goodbye to 100 Percent Bonus Depreciation

Bonus depreciation became a tax thing in 2002, starting with 30 percent depreciation on certain new property.

From January 1, 2015, through September 27, 2017, lawmakers set a 50 percent rate on certain new property.

And then, the big “hip, hip, hooray!” Starting after September 27, 2017, you could claim 100 percent bonus depreciation on (wait for this) both new and used property.

But now, sadly, get ready to say goodbye to the “hip, hip, hooray!”

Starting in 2023 (which is right around the corner), lawmakers scheduled bonus depreciation to decline 20 percent each year, as follows:¹

Year Property Placed in Service	Bonus %
1/1/2015 through 9/27/2017 (new property only)	50%
9/28/2017 through 2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027 and later	0%

Example. If you had purchased \$100,000 of qualifying equipment for your business and place it in service in 2022, you were able to deduct \$100,000 in 2022 using 100 percent bonus depreciation. If you waited until 2023, bonus depreciation delivers an 80 percent deduction.

Does this mean you should have rushed out to purchase business property before 2022 ended, to take advantage of the 100 percent bonus? Not necessarily. You likely have an alternative that is not going away and that can be as good as bonus depreciation: IRC Section 179 expensing.

IRC Section 179 Expensing Versus Bonus Depreciation

Both IRC Section 179 expensing and bonus depreciation allow you to deduct in one year the cost of most types of tangible personal property, plus off-the-shelf computer software.² You can use both methods to deduct

- new and used property acquired by purchase from an unrelated party,³ and
- various types of non-structural improvements to non-residential (think commercial) buildings after they are placed in service.⁴

Moreover, the two deductions are not mutually exclusive. You can apply Section 179 to qualifying property up to the annual limit and then claim bonus depreciation for any remaining basis.⁵

Starting in 2023, when bonus depreciation will be less than 100 percent, any basis left after applying Section 179 and bonus depreciation is deducted with regular MACRS depreciation over several years.

But there are some significant differences between bonus depreciation and Section 179 expensing.

Annual Section 179 Limit

The most significant difference between Section 179 expensing and bonus depreciation is that Section 179 expensing is subject to an annual dollar limit. The Tax Cuts and Jobs Act doubled the limit to \$1 million in 2018. The inflation-adjusted limit for 2022 is \$1,080,000.⁶ It is estimated to be \$1,160,000 in 2023.

Additionally, because Section 179 is intended to help smaller businesses, there is also a limit on the total amount of Section 179 property a business can purchase each year when claiming the deduction.

You must reduce your available Section 179 deduction by one dollar for every dollar by which your annual purchases exceed the applicable limit. The limit is \$2,700,000 for 2022.⁷ Thus, if you place in service \$3,780,000 of Section 179 property in 2022, you have to reduce your available Section 179 deduction by \$1,080,000 ($\$3,780,000 - \$2,700,000 = \$1,080,000$). Net result: you have no available Section 179 deduction.

The Section 179 purchase limit is estimated to be \$2,890,000 in 2023.

There is no dollar limit on bonus depreciation. But the Section 179 limits are so large that they don't impact smaller businesses.

Section 179 Expensing May Not Create a Loss

Section 179 expensing is limited to the annual net taxable income earned by the taxpayer's business (not counting the Section 179 deduction). This can be misleading for many taxpayers because for the Section 179 deduction, business income includes W-2 income.

The key point is that the Section 179 deduction may not exceed defined business income and still create a loss for the year. Section 179 amounts that may not be deducted are carried forward indefinitely to future years.⁸

Bonus Depreciation Can Create a Loss

Bonus depreciation is unlimited in amount and may result in a business loss. In the past, this was a significant difference because a business could carry a net operating loss (NOL) back to prior years and claim a refund for taxes paid in those years.

But starting in 2021, you may no longer carry NOLs back; you may only carry them forward indefinitely. In addition, NOLs may offset only up to 80 percent of taxable income for any year.⁹

More Than 50 Percent Rule

To qualify for Section 179 expensing, you must use your qualifying Section 179 property more than 50 percent for business. If your business use of the property falls to 50 percent or below during the property's recovery period, you have to give back some or all of your Section 179 deduction through what the IRS calls "recapture."¹⁰

There is no 50 percent business-use requirement for bonus depreciation except for listed property—primarily, passenger vehicles.

Bonus Depreciation Applies Class-Wide

If you use bonus depreciation, you must use it for all assets that fall within the same class. You may not pick and choose individual assets.

Section 179 expensing doesn't apply class-wide. Thus, you may pick and choose which assets you wish to deduct using Section 179 within the same asset class. This is a potential advantage.

Passenger Automobiles

The term "passenger automobile" means any four-wheeled vehicle that is manufactured primarily for use on public streets, roads, and highways, and that is rated at 6,000 pounds unloaded gross vehicle weight or less (think curb weight).¹¹

But in the case of a truck, van, SUV, or crossover vehicle, the passenger automobile 6,000-pound rule applies to "gross vehicle weight"—which, in street terms, is generally referred to as the gross vehicle weight rating (GVWR).¹²

Bonus depreciation is limited to \$8,000 for such tax code-defined passenger automobiles no matter how much they cost. This limit will be the same in 2023.¹³ So there is no point in purchasing a defined passenger automobile in 2022 instead of 2023 to take advantage of bonus depreciation.

SUVs and Other Heavy Vehicles

You may use 100 percent bonus depreciation on trucks, vans, SUVs, and crossover vehicles with a GVWR of 6,001 pounds or more. You can also use 100 percent bonus depreciation on cars with a curb weight of 6,001 pounds or more.

In contrast, in 2022, the Section 179 deduction is limited to \$27,000 for trucks, vans, SUVs, and crossover vehicles with a GVWR of 6,001 to 14,000 pounds. (The \$27,000 limit does not apply to pickup trucks with a bed of at least six feet or to vans that seat more than nine behind the driver.)¹⁴

For cars, the Section 179 deduction does nothing. Yes, nothing. For cars, it replaces depreciation—so, you get no additional benefit.¹⁵

The Section 179 expensing limit is estimated to be \$28,900 in 2023.

Key point. You can achieve 100 percent bonus depreciation in 2022, but in 2023 bonus depreciation drops to 80 percent. So to get the maximum deduction in 2023, you need a combination of Section 179 expensing, bonus depreciation and MACRS depreciation.

Example. Burt purchases a \$50,000 SUV in 2023 and uses it 100 percent for business, which makes for easy numbers. He deducts \$28,900 with Section 179 expensing and then \$16,880 with 80 percent bonus depreciation (80 percent x \$21,100 = \$16,880). He depreciates his remaining \$4,220 basis using the 200 percent declining balance method, resulting in an \$844 deduction. His total deduction is \$46,624 (\$28,900 + \$16,880 + \$844).

Had he purchased the SUV in 2022, he would have gotten a \$50,000 deduction using 100 percent bonus depreciation.

Land Improvements

Most types of real property (i.e., Section 1250 property), including land improvements, do not qualify for the Section 179 deduction. (But you may use Section 179 expensing to deduct interior improvements to non-residential real property.)

In contrast, you can use bonus depreciation to deduct land improvements with a 15-year class life. These improvements include sidewalks, fences, driveways, landscaping, and swimming pools.

When You Should Have Taken Advantage of 100 Percent Bonus Depreciation for 2022

There are a few situations where it may be advisable to purchase and place property in service by the end of 2022 to take advantage of 100 percent bonus depreciation:

- If your business needs to purchase more than \$3,780,000 of property, it won't be able to use Section 179 expensing at all. But you can use 100 percent bonus depreciation if you place the property in service in 2022. When you're purchasing this much property, an additional 20 percent deduction for 2022 can really add up. If you wait until 2023, you'll get only 80 percent bonus depreciation.
- If your business needs to purchase more than \$1,080,000 in property in 2022, its Section 179 deduction will be exhausted and you'll have to use bonus depreciation for purchases over \$1,080,000. Again, when you're purchasing this much property, an additional 20 percent deduction for 2022 can really add up.
- If you need to purchase land improvements, you won't be able to deduct them with Section 179. Purchasing them this year will enable you to deduct them immediately using bonus depreciation.
- If you need to purchase a business-use SUV that weighs between 6,001 and 14,000 pounds, your deduction will be somewhat larger if you purchase the vehicle in 2022 instead of 2023, because bonus depreciation is 80 percent in 2023.
- If you want the maximum possible 2022 deduction for property you use less than 50 percent for business (excluding vehicles and other listed property), you should have purchase it in 2022 and take advantage of the 100 percent bonus depreciation.

Keep in mind that it's not enough to have purchased property by December 31, 2022, to claim bonus depreciation or Section 179 expensing. You must also have placed the property in service in your business by year-end.

You don't have to actually use the property, but it must be ready for use in your business.¹⁶

That said, we recommend actual use, such as driving at least one business mile, to eliminate any discussion of "ready for use."

Takeaways

Here are five takeaways from this article:

1. One hundred percent bonus depreciation ended on December 31, 2022. It was reduced to 80 percent in 2023 and will decline 20 percent each succeeding year through 2027, when it will be zero.
2. Section 179 expensing remains an alternative or supplement to bonus depreciation.
3. If you need to purchase a business-use SUV with a GVWR between 6,001 and 14,000 pounds, your deduction will be somewhat larger if you purchased it in 2022 and take advantage of 100 percent bonus depreciation.
4. Section 179 expensing is subject to annual dollar limits that don't apply to bonus depreciation. If your business needs to purchase property over the limits, it will get a 20 percent larger first-year deduction if it did so in 2022 (versus 2023) and takes advantage of 100 percent bonus depreciation.
5. Bonus depreciation for passenger vehicles is capped at \$8,000 for 2022 and future years, so there is no point in purchasing such a vehicle in 2022 to get a larger deduction.

¹ IRC Section 168(k)(6)(A).

² IRC Sections 168(k)(2)(A)(i); 179(d)(1).

³ IRC Section 168(k)(2)(A)(ii).

⁴ IRC Sections 168(e); 179(e).

⁵ Rev. Proc. 2002-33.

⁶ Rev. Proc. 2021-45.

⁷ Ibid.

⁸ IRC Section 179(b)(3).

⁹ IRC Section 172(a)(2).

¹⁰ IRS Reg. 1.179-1(e).

¹¹ IRC Section 280F(d)(5).

¹² Ibid.

¹³ IRC Section 168(k)(2)(F)(i).

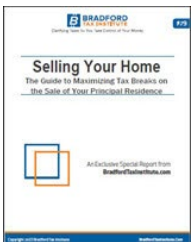
¹⁴ IRC Section 179(b)(5). Rev. Proc.2021-45.

¹⁵ IRC Section 280F(d)(1).

¹⁶ Reg. Section 1.167(a)-11(e)(1)(i).

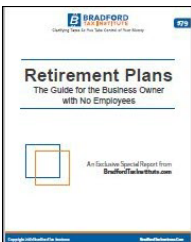
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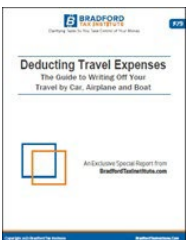
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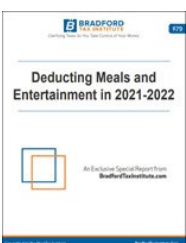
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