Quickfinder®

Small Business Quickfinder® Handbook (2020 Tax Year)

Updates for December 2020 Legislation and Other Recent Guidance

Instructions: This packet contains "marked up" changes to the pages in the *Small Business Quickfinder® Handbook* that were affected by December 2020 legislation, which was enacted after the *Handbook* was published. Additionally, changes were made based on other guidance issued after the Handbook was published. To update your *Handbook*, you can make the same changes in your *Handbook* or print the revised page and paste over the original page.

the income or incurred the expense. So, for example, if a late filing penalty is nondeductible when paid by an individual, it retains its nondeductible character when passed through the partnership to the individual partner [IRC Sec. 702(b)].

Each partner pays tax on his distributive share of income in the year earned or received (depending on whether the partnership uses the accrual or cash method of accounting), regardless of when the income is distributed. Accordingly, when a partnership distributes cash or property to a partner, the transaction is generally not taxable. IRC Sec. 1446(f)(1) was added to mandate a 10% withholding tax on any portion of a gain on a disposition of an interest in a partnership with effectively connected United States income. However, withholding is generally not required if the transferor furnishes an affidavit to the transferee stating, among other things, that the transferor is not a foreign person (Notice 2018-29). The rules do not apply to the transfer of a publicly traded partnership (PTP). See *Partnership Distributions* on Page B-15.

Form 1065 (U.S. Return of Partnership Income) reports business income, deductions, credits, gains, and losses resulting from partnership operations. Form 1065 includes a separate Schedule K-1 for each partner, which shows each partner's distributive share of income, along with certain other separately stated items. The partnership must furnish a copy of Schedule K-1 to each partner by the due date, including extensions, of the partnership return.

An individual reports ordinary income from a partnership on Schedule E of Form 1040. Other items of income or loss are reported on the appropriate forms or schedules. For example, capital gains shown on a partner's K-1 are reported on Schedule D of a partner's Form 1040.

Business Interest Expense Limitation

The Tax Cuts and Jobs Act of 2017 (TCJA) added IRC Sec. 163(j), which limits the annual deduction of business interest expense to the sum of a taxpayer's: (1) business interest income, (2) 30% or 50% of adjusted taxable income (if a positive amount), and (3) floor plan financing interest of vehicle dealers. The limitation applies:

- To businesses regardless of form, with several exceptions.
- First at the partnership or S corporation level and again at the partner or shareholder level.
- Generally to taxpayers with average annual gross receipts for the three-tax-year period ending with the prior tax year of over $25 million adjusted for inflation ($26 million for 2020).

Law Change Alert: The CARES Act has amended IRC Sec. 163(j) for tax years beginning in 2019 and 2020, increasing the adjusted taxable income (ATI) limitation to 50% for those years. This rule doesn't apply to partnerships in 2019.

Taxpayers may elect, at the time and in such manner as prescribed by the IRS, not to have the 50% limitation apply to any tax year. Partnerships make this election at the partnership level, but only for tax years beginning in 2020. This election, once made, may be revoked only with IRS consent. The election not to apply the 50% ATI limitation for a tax year must be made for each tax year.

In December 2018, the IRS issued proposed regulations on the Section 163(j) limitation. The IRS finalized those regulations in July 2020 and issued two new sets of proposed regulations on the limitation. The final regulations made several changes and clarifications to the 2018 proposed rules.

The final regulations are effective on November 13, 2020, and generally apply to tax years beginning on or after November 13, 2020 (2021 for calendar-year taxpayers). However, for tax years beginning after 2017 and before November 13, 2020, taxpayers can rely either on the final regulations (in their entirety) or the 2018 proposed regulations (in their entirety). Even if taxpayers choose to apply the 2018 proposed regulations to years beginning before November 13, 2020, they can apply final Reg. 1.163(j)-1(b)(1)(iii), which modifies the definition of ATI, to those years. In January 2021, the IRS issued additional final regulations that generally apply to tax years beginning on or after March 22, 2021, but which taxpayers can choose to apply to earlier tax years (TD 9943).

Excess business interest expense (EBIE) is the amount of disallowed business interest expense of the partnership for a tax year. Any EBIE is carried forward indefinitely.

Form to use. The limitation is computed on Form 8990 [Limitation on Business Interest Expense Under Section 163(j)].

Note: The CARES Act provides that a partner treats 50% of its allocable share of a partnership's EBIE for 2019 as an interest deduction in the partner's 2020 tax year without limitation. The remaining EBIE remains subject to the applicable Section 163(j) limitation. A partner may elect out of the 50% EBIE rule by timely filing an original or amended return and not applying the 50% EBIE rule (see Rev. Proc. 2020-22, Sec. 6, for details and additional ways to elect out).

Business interest. Interest is considered business interest if it is on debt that is properly allocable to a trade or business as defined in IRC Sec. 163(j)(7), *not* to a trade or business (1) in which the taxpayer is an employee, (2) that is an electing (a) real property trade or business or (b) farming business or (3) that furnishes or sells certain public utility products or services. Business interest does not include investment interest.

Adjusted taxable income. This is taxable income computed without regard to any [IRC Sec. 163(j)(8)]:

1) Item of income, gain, deduction, or loss not properly allocable to a trade or business.
2) Business interest income or expense.
3) NOL under IRC Sec. 172.
4) QBI deduction under IRC Sec. 199A.
5) Allowable depreciation, amortization, or depletion for tax years beginning before 2022 (after this date, these expenses reduce adjusted taxable income and thus may significantly limit the allowable deduction for business interest expense). Under the 2018 proposed regulations, this add-back didn't include any depreciation, amortization, or depletion that was capitalized under the Section 263A Uniform Capitalization (UNICAP) rules. The final regulations remove that rule.
6) Other adjustments in regulations issued or to be issued.

Note: Rev. Proc. 2020-22, Sec. 6, provides procedures for taxpayers to elect to use their ATI for the last tax year beginning in 2019 as the ATI for any tax year beginning in 2020, subject to modifications for short tax years.

Tax shelters. A tax shelter isn't eligible for the $25 million gross receipts exception ($26 million for 2020). For this purpose, tax shelter means [IRC Secs. 448(d)(3) and 461(i)(3)(B)]:

1) An enterprise (other than a C corporation) whose interests have been offered for sale in a transaction required to be registered with a state or federal agency that regulates the sale of securities,
2) A syndicate, or
3) An entity formed to avoid or evade federal income tax.

Syndicates. While it's uncommon for a partnership to run afoul of item 1 or 3 above, a partnership may unintentionally be a *syndicate*, which is an entity (other than a C corporation) that allocates more than 35% of its losses during the tax year to limited partners or limited entrepreneurs [Prop. Reg. 1.1256(e)-2]. Gains or losses from sales of capital assets or Section 1221(a)(2) assets (real or depreciable property used in a business) are not taken into account for the 35% of losses calculation. A *limited entrepreneur* is one who has an interest in an enterprise other than as a limited partner and does not actively participate in the management of the enterprise [IRC Sec. 461(k)(4)].

Limited partners/entrepreneurs who actively participate in the management of the entity (or who actively participated for at least five years or certain relatives of whom actively participated) are not

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Services Rendered

If an individual performs services in exchange for a capital interest in a partnership, the value of the service is taxable compensation to the partner. The amount is deductible as a guaranteed payment by the partnership, and becomes the partner's basis in the partnership interest [Reg. 1.721-1(b)].

The granting of a profits interest in exchange for services is generally not a taxable event, unless (Rev. Proc. 93-27):

1) The profits interest relates to a substantially certain and predictable income stream from partnership assets, such as high-quality debt securities or a high-quality net lease,
2) The partner disposes of the profits interest within two years of receipt or
3) The profits interest is a limited partnership interest in a publicly traded partnership under IRC Sec. 7704(b).

Capital interest. An interest that would give the holder a share of the proceeds if the partnership's assets were sold at FMV and the proceeds were distributed in a complete liquidation.

Profits interest. A partnership interest other than a capital interest. Generally, a profits interest will not produce income unless the partnership is successful in generating profits.

The determination of whether an interest is a capital or profits interest is made at the time the interest is granted, even if the interest is substantially nonvested, and the grant of the interest or the event that causes the interest to become substantially vested won't be treated as a taxable event (Rev. Proc. 2001-43). Proposed regulations issued in 2005 and Notice 2005-43 will obsolete Rev. Procs. 93-27 and 2001-43 upon finalization. Tax professionals should watch for developments.

Carried Interests

Historically, many private equity funds, hedge funds, and real estate investment funds have been structured as limited partnerships. So-called *carried interest arrangements* typically allow fund managers to give up their right to receive current fees for their services to the partnership and instead receive an interest in future partnership profits (a profits-only interest). This arrangement is called a *carried interest* because the fund manager does not pay anything for the profits interest. To add to the appeal, the fund manager is generally not taxed upon the receipt of the interest because the receipt of a profits-only interest is generally not considered to be a taxable event.

The tax objective of a *carried interest arrangement* is to trade current fee income that would be treated as high-taxed ordinary income and be subject to federal employment taxes for a partnership profits-only interest that is expected to generate future long-term capital gains and/or qualified dividends that will be taxed at preferential rates.

For tax years beginning after 2017, IRC Sec. 1061 requires a more than three-year holding period for long-term capital gain treatment on gains passed through by or recognized upon the disposition of an *applicable partnership interest* (API), regardless of the Section 83 rules or any Section 83(b) election in effect. (*API* is the Code term for a carried interest.) In effect, capital gains attributable to an API that do not meet the three-year holding period are recharacterized from long-term to short-term.

API defined. An API is any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an owner taxpayer or pass-through taxpayer in connection with substantial services performed by that taxpayer or any related person in an applicable trade or business (ATB), unless an exception applies [~~Prop.~~ Reg. 1.1061-1(a)]. An ATB is an activity conducted on a regular, continuous, and substantial basis that consists of raising or returning capital and either (1) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition) or (2) developing specified assets [IRC Sec. 1061(c)(2)]. An activity is conducted on a regular, continuous, and substantial basis if it can qualify as a trade or business under IRC Sec. 162 [~~Prop.~~ Reg. 1.1061-2(b)].

Under ~~Prop.~~ Reg. 1.1061-1(a), an API includes a partnership interest transferred to the taxpayer in exchange for substantial services performed by a pass-through entity. Also, if a partnership interest is transferred to or held by an owner taxpayer, a pass-through taxpayer, or any related person in connection with the performance of services, that person is presumed to have provided substantial services [~~Prop.~~ Reg. 1.1061-2(a)(1)(iv)]. Once a partnership interest qualifies as an API, it remains an API even if the API holder stops performing services for the partnership, and API gains and losses retain their character as they are allocated from one pass-through entity to another and then to the owner taxpayer [~~Prop.~~ Reg. 1.1061-2(a)].

IRC Sec. 1061(c)(4) provides that a partnership interest held directly or indirectly by a corporation is not an API. However, ~~Prop.~~ Reg. 1.1061-3(b)(2) provides that the term *corporation* does not include S corporations or certain passive foreign investment companies.

Specified assets include securities, commodities, investment and rental real estate, cash and cash equivalents, options or derivative contracts with respect to any such assets, and partnership interests to the extent of the partnership's proportionate interest in such assets [IRC Sec. 1061(c)(3)].

Practice Tip: A carried interest is recognized by taxpayers in their role as partners. Individual partners apply the carried interest rules when determining long-term or short-term treatment on their individual tax returns.

An API does not include (~~Prop.~~ Reg. 1.1061-3):

1) An interest transferred to a person in connection with the performance of substantial services by that person as an employee of another entity that is conducting a trade or business (other than an ATB) and the person provides services only to that other entity.
2) An interest directly or indirectly held by a corporation. S corporations and certain passive foreign investment companies aren't treated as corporations for Section 1061 purposes.
3) Capital interest gains and losses, which are capital interest allocations under ~~Prop.~~ Reg. 1.1061-3(c)(3), ~~pass-through interest capital allocations under Prop. Reg. 1.1061-3(c)(5),~~ or capital interest disposition amounts under ~~Prop.~~ Reg. 1.1061-3(c)(4).
4) Partnership interests acquired by a taxable purchase for FMV if immediately before the purchase, the requirements of ~~Prop.~~ Reg. 1.1061-3(d) are met.

Holding period rules. IRC Sec. 1061 can potentially recharacterize long-term gains as short-term gains when (1) a partnership sells capital assets or (2) the owner of an API (carried interest) sells or otherwise disposes of the API. When the partnership disposes of an asset, the partnership's holding period is considered for applying the three-year holding period requirement for an API owner. This includes the disposition of an API by the partnership. Following this approach, unless the lookthrough rule discussed in the next paragraph applies, an API owner's holding period in the API is the applicable holding period upon the disposition of the API (~~Prop.~~ Reg. 1.1061-4).

When an interest in an API is sold, the owner's holding period for the API is generally used to determine whether any long-term capital gain on the sale is recharacterized as short-term. But, under August 2020 proposed regulations, if more than 80% of the API's assets (based on FMV) that would produce capital gain or loss subject to the Section 1061 recharacterization rules have a holding period of three years or less, then the holding period of the assets is considered (a lookthrough rule). In that case, even though the owner of the API held its interest for over three years, some or all of any long-term capital gain on its disposition could be recharacterized as short-term. Under final regulations issued in January 2021, the lookthrough rule can apply when an API that has been held for more than three years is sold, but only if the API's holding period would be less than three years if the holding period were determined by excluding any period before the date that an unrelated nonservice partner is legally obligated to contribute substantial money or property (directly or indirectly) to the partnership to which the API relates [Reg. 1.1061-4(b)(9)]. See Reg. 1.1061-4(c)(2)(i), Example 1.

Related party rules. If the disposition of an API (carried interest) is a transfer to a related party, the partner could recognize short-term capital gain even if the holding period is longer than three years [IRC Sec. 1061(d)]. Under this rule, the transferor must include certain capital gains in income (as short-term gain). The amount of short-term capital gain included in income is the excess of (1) the net built-in long-term capital gain in assets held for three years or less attributable to the transferred interest over (2) any amount of long-term capital gain recognized on the transfer that is treated as short-term capital gain under IRC Sec. 1061(a). A person is related to the transferor if (1) the person is a member of the transferor's family within the meaning of IRC Sec. 318(a)(1), which includes spouses, children, grandchildren, and parents; or (2) the person performed a service within the current calendar year or the preceding three calendar years in any ATB in which or for which the transferor performed a service (such as fund management colleagues).

Reporting rules. ~~Prop.~~ Reg. 1.1061-6 requires API holders and pass-through entities that have issued an API to provide information to the IRS as may be required in forms, instructions, or other guidance. The pass-through entity is also required to furnish information to the API holder. ~~According to the preamble to the proposed regulations,~~ This information should be provided as an attachment to the API holder's Schedule K-1.

Built-In Gain or Loss

Under IRC Sec. 704(c), allocations of income, gain or loss, and deductions with respect to contributed property must account for any difference between the adjusted basis and the FMV of the property (built-in gain or loss).

Note: The total combined allocations to the partners cannot be more than the amount allowable to the partnership for tax purposes.

Methods of Allocation

Reg. 1.704-3 provides three methods to prevent shifting of tax consequences among partners with respect to pre-contribution gain or loss:

1) Traditional method,
2) Traditional method with curative allocations, and
3) Remedial allocation method.

The traditional method requires allocating precontribution gain or loss upon the disposition of contributed property to the contributing partner. An example of applying this method follows.

Example: Keith and Sally form K-Sal Partners to build a commercial office building on land Sally owns. Keith and Sally are equal partners. Keith contributes $200,000, and Sally contributes land with a $200,000 FMV and a $250,000 tax basis. K-Sal borrows $800,000 and completes the building using the loan proceeds and Keith's $200,000 contribution. Thus, the property's tax basis is $1,250,000, and the book basis is $1,200,000. Immediately upon completion, K-Sal sells the property for $1.5 million.

The book and tax gain on sale is allocated as follows:

	Keith		Sally	
	FMV	Tax Basis	FMV	Tax Basis
Capital contribution	$ 200,000	$ 200,000	$ 200,000	$ 250,000
Book gain on sale	150,000	—	150,000	—
Tax gain on sale	—	150,000	—	100,000
Ending capital account	$ 350,000	$ 350,000	$ 350,000	$ 350,000

The $300,000 book gain is allocated equally between Keith and Sally. Keith, the noncontributing partner, is then allocated tax gain ($150,000) equal to his book gain. The remaining tax gain ($100,000) is allocated to Sally. Sally's $50,000 of basis in excess of the property's FMV on the contribution date effectively reduces the taxable gain she recognizes when the property is sold. Note that any other allocation would produce disparities between ending book and tax-basis accounts.

Substantial Built-In Loss

In general, a partnership must adjust the basis of its property following the transfer of a partnership interest if it has a substantial built-in loss. A substantial built-in loss exists if the partnership's adjusted basis in the property exceeds its FMV by more than $250,000 [IRC Sec. 743(d)]. Under the TCJA, a substantial built-in loss also exists if the recipient of the interest would be allocated a net loss in excess of $250,000 upon a hypothetical disposition of all partnership assets in a fully taxable transaction for cash equal to the assets' FMV immediately after the transfer of the interest. The provision applies to transfers of partnership interests after December 31, 2017.

Section 1245 Recapture

A partner's share of recaptured Section 1245 gain is the lesser of (1) the partner's share of total gain from disposition of the property or (2) the partner's share of depreciation from the property [Reg. 1.1245-1(e)].

Optional Adjustments to Basis of Partnership Property (Section 754 Election)

Because of differences between basis and FMV of assets in a partnership, inequities can result when partnership interests are sold or transferred.

Example: Donna, Char, and Bev are equal partners. The partnership's only asset is Property Y, with a basis of $6,000 and FMV of $9,000.

Jill purchases Donna's partnership interest for $3,000 (⅓ of FMV of assets). Even though Jill paid $3,000 for her interest in the partnership, her share of the basis of Property Y is only $2,000 ($6,000 × ⅓).

If the partnership sells Property Y for $9,000 (FMV), Jill's distributive share of the gain will be $1,000 ($9,000 sales price – $6,000 basis = $3,000 gain × ⅓ interest). Jill reports $1,000 taxable gain on her return and her basis in the partnership is increased by $1,000.

Compare the tax effects if Jill had purchased such property as a sole proprietor instead of acquiring it through a partnership. Her basis in the asset would be $3,000 and gain on the sale would be zero ($3,000 selling price – $3,000 basis).

Under a Section 754 election, the purchaser's basis in partnership property is adjusted to reflect the purchase price of the partnership interest. This reduces negative tax effects when basis in acquired partnership property is less than the amount paid for the partnership interest. For instance, in the example above, if a Section 754 election was in place, Jill's basis in Property Y for purposes of depreciation, gain or loss would be $3,000 ($2,000 *common* basis + $1,000 special basis adjustment).

To revoke a Section 754 election, the partnership must file Form 15254 (Request for Section 754 Revocation). For more information on the Section 754 election and the tax planning opportunities, see Tab P.

Capital Account Revaluations

When property is contributed to a partnership, the book capital account of the contributing partner is increased by the FMV of the contributed property (net of liabilities assumed by the partnership), rather than by the adjusted basis of the contributed property [Reg. 1.704-1(b)(2)(iv)]. This rule allows the contributing partner to receive a book capital ownership interest in the partnership based upon the FMV of his contribution, rather than the tax basis of the contribution. Under this rule, the contributed property is revalued for book purposes at the time of contribution. The rules also allow

of $25 million or less (as adjusted for inflation—$26 million or less in 2020) are not subject to this limitation. See *Business Interest Expense Limitation* on Page B-5 for additional information and applicable elections that are available.

Charitable Contributions

C corporations are allowed to deduct charitable contributions. The deduction generally is limited to 10% of the corporation's taxable income [IRC Sec. 170(b)(2)(A)].

Law Change Alert: The CARES Act temporarily increases the limit to 25% of taxable income for certain qualified contributions made in 2020. A *qualified contribution* is any charitable contribution (1) that is paid in cash during calendar year 2020 to an organization described in IRC Sec. 170(b)(1)(A) [Section 501(c)(3) and certain other charitable organizations] and (2) for which the taxpayer has elected to apply this provision with respect to the contribution. However, contributions to a Section 509(a)(3) supporting organization or a donor advised fund are not qualified contributions. Qualified contributions are allowed as a deduction only to the extent that the aggregate of those contributions does not exceed the excess of 25% of the corporation's taxable income [as computed under IRC Sec. 170(b)(2)] over the amount of all other charitable contributions allowed to the corporation as deductions for the contribution year. If the aggregate amount of qualified contributions exceeds this limitation, the excess is taken into account under the carryover rule of IRC Sec. 170(d)(2), subject to its limitations.

Disaster Relief Alert: The taxable income limit does not apply to qualified contributions made from January 1, 2018 through February 18, 2020 or qualified disaster relief contributions made from January 1, 2020 through February 25, 2021 for relief efforts in qualified disaster areas. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)* on Page Q-1 and *December 2020 Legislation* on Page Q-1

Taxable income for limitation purposes is calculated without regard to the deductions for [IRC Sec. 170(b)(2)(D)]:

- Charitable contributions.
- Dividends received.
- Premium on repurchase of convertible debt.
- Foreign-derived intangible income and global intangible low-taxed income.
- Dividends paid on certain public utility preferred stock.
- Net operating loss carrybacks.
- Capital loss carrybacks.
- Income attributable to domestic production activities of specified agricultural or horticultural cooperatives.

Unused contributions from this limitation can be carried forward for five years. No carryback is allowed [IRC Sec. 170(d)(2)].

State and local tax credits. The IRS clarified that payments made by business taxpayers to charities or government entities in exchange for credits against their state and local taxes are generally deductible as business expenses (IR-2018-178).

Research property. An exception to the contribution limit applies to contributions of scientific equipment for use in experimentation or for certain research training. This exception is only available for C corporations other than PHCs or service organizations as described in IRC Sec. 414(m)(3) [IRC Sec. 170(e)(4)]. These contributions are subject to the special computation rules discussed at *Charitable Contributions of Inventory* on Page C-14.

Intellectual property. In addition to the initial deduction, a taxpayer who has donated qualified intellectual property may claim a subsequent charitable contribution based on a percentage of the net income received by the charity (other than certain private foundations) from the property [IRC Sec. 170(m)].

Substantiation requirements. Strict rules exist for substantiating charitable contributions. For all monetary contributions, the corporation must maintain a bank record or a receipt, letter or other written communication from the donee organization indicating the organization's name, the date of the contribution, and the amount [IRC Sec. 170(f)(17)]. There is no *de minimis* exception. For contributions of $250 or more of either cash or property, the taxpayer must have a contemporaneous written acknowledgement from the donee (a canceled check will not suffice) [Reg. 1.170A-13(f)].

Charitable contributions of property over $5,000. C corporations are required to obtain a qualified appraisal for donated property if the claimed deduction exceeds $5,000. If the claimed deduction of property other than cash, inventory or publicly traded securities exceeds $500,000, a qualified appraisal must be attached to the donor's tax return.

Conservation easements. A deduction is available for qualified donations. See *Conservation easements* on Page N-15.

Charitable Contributions of Inventory

The deduction for a charitable contribution of inventory or other ordinary income producing property is generally limited to the adjusted basis of the property.

A provision in the Code allows a C corporation (not an S corporation) to donate inventory to charity and deduct up to one-half of FMV above cost as a charitable contribution [IRC Sec. 170(e)(3) and Reg. 1.170A-4A]. For purposes of this provision, depreciable property under IRC Sec. 1221(a)(2) also qualifies for the deduction.

The following rules must be met [IRC Sec. 170(e)(3)]:

1) The charity must be a Section 501(c)(3) organization;
2) The charity must use the donated property solely for the care of the ill, the needy or infants;
3) The charity cannot exchange the donated property for money, other property or services;
4) The corporation must be given a written statement from the charity that says it will follow rules 2 and 3;
5) If the property is subject to the Federal Food, Drug, and Cosmetic Act regulations, all such regulations must be satisfied; and
6) Use of the donated property must be related to the purpose or function that gives the charity its exempt status.

The charitable deduction is computed by taking the FMV of the donated property at the time of contribution and subtracting one-half the gain that would not have been long-term capital gain if the property had been sold at its FMV. The deduction is further limited to twice the basis of the donated property.

If the donated property has any potential recapture of ordinary income under IRC Secs. 617, 1245, 1250 or 1252 (depreciation recapture), the FMV for the above computation purposes must first be reduced by the recapture amount before making the above charitable deduction computation [IRC Sec. 170(e)(3)(D)].

Note: If the inventory's cost is incurred in the same year as the contribution, the amount is included in cost of goods sold (COGS) and the contribution is not subject to a percentage of taxable income limitation. If the contribution is made from beginning inventory, the item is removed from inventory and shown as a charitable contribution subject to the applicable percentage of taxable income limitation [Reg. 1.170A-1(c)(4)].

Law Change Alert: The CARES Act increased the limits on contributions of food inventory for 2020.The taxable income limitation of 15% for food inventory has been increased to 25%.

Example: GIJ Corporation donates beginning inventory (FMV $1,000, basis $200) to Toys for Tots. If GIJ had sold the inventory for its FMV, the amount of gain that would not be long-term capital gain is $800 ($1,000 – $200). One-half of $800 is $400. The charitable deduction would be $600 ($1,000 – $400) except for the fact that the deduction is limited to twice its basis ($200 × 2 = $400). GIJ can take a charitable contribution deduction of $400 and must reduce its COGS by $200.

Observation: Some corporations making donations that qualify for the enhanced deduction for inventory may, because of the percentage of taxable income limitation, prefer to limit their deduction, and the required cost of goods sold adjustment to the inventory's basis. While it studies this issue, the IRS will not challenge either method (Notice 2008-90).

Capital Gains and Losses

C corporations pay tax on capital gains at the same tax rate as ordinary income. The corporate tax rate on net capital gains is 21%.

Capital losses are allowed only to the extent of capital gains. A current-year deduction for a net capital loss is not allowed. A net capital loss may be carried back three years and forward five years as a short-term capital loss. Carry back a capital loss to the extent it does not increase or produce an NOL in the carryback year. Special rules apply to foreign expropriation capital losses and RICs (IRC Sec. 1212).

Like-Kind Exchanges

For exchanges completed after 2017, like-kind exchanges are available only with respect to real property held for productive use in a trade or business or for investment (that is, not held primarily for sale). If a corporation engages in a Section 1031 like-kind exchange with a related party and either party disposes of the property within two years, nonrecognition treatment may be nullified. See *Like-Kind Exchanges* in Tab 7 of the *1040 Quickfinder® Handbook*.

Net Operating Losses (NOLs)

A corporation is not subject to the same adjustments required for individuals when calculating an NOL. A corporation does not adjust its tax loss for the year when a capital loss occurs because corporations are not allowed to currently deduct net capital losses.

Corporations compute NOLs in the same manner as taxable income, with the following adjustments:

1) Corporations cannot deduct NOL carrybacks or carryforwards from other years.
2) Corporations can take the deduction for dividends received without regard for the limits based on 50% or 65% of taxable income that normally apply.
3) Corporations can figure the deduction for dividends paid on certain preferred stock of public utilities without limiting it to its taxable income for the year.

Example: Business activity of SOY Corp. (calendar year taxpayer) in 2020:

Income and dividends		$ 100,000
Advertising	$ 25,000	
Office expenses	35,000	
Wages	60,000	
Dividends-received deduction	30,000	
Other expenses	10,000	
Total expenses		($ 160,000)
2020 NOL		($ 60,000)

Using an NOL. Under pre-TCJA law, a corporation generally carried 100% of an NOL back two years and forward up to 20 years.

Law Change Alert: The CARES Act has amended IRC Sec. 172(b)(1) for tax years beginning in 2018, 2019, and 2020 requiring taxpayers to carry back NOLs arising in those tax years to the five preceding tax years, unless the taxpayer elects to waive or reduce the carryback period. To the extent unused as a carryback, these NOLs are carried forward indefinitely.

For losses arising in tax years beginning after 2017 (other than losses of non-life insurance companies), the TCJA limited the NOL deduction to 80% of taxable income, determined without regard to the NOL deduction itself. The CARES Act suspended the 80% limitation on NOL deductions for tax years beginning in 2018, 2019, and 2020. The 80% limitation will be reinstated for tax years beginning after 2020, for NOLs arising in tax years beginning after 2017.

The CARES Act also made a technical correction aligning the effective dates of the NOL carryback and the 80% limitation provision. Fiscal year-end corporations with an NOL arising in a tax year beginning in 2017 and ending in 2018 can carry back that NOL for two years. **Note:** Farmers who elected a two-year NOL carryback prior to the CARES Act may elect to retain that two-year carryback rather than claim the five-year carryback provided in the CARES Act. Farmers who previously waived an election to carry back an NOL may revoke the waiver (COVID-related Tax Relief Act of 2020 Sec. 281).

Rev. Proc. 2020-24 provides guidance on these changes and describes how taxpayers can elect to either waive the carryback period for NOLs entirely or exclude from the carryback period for those losses any years in which the taxpayer has an income inclusion under IRC Sec. 965(a).

Notice 2020-26 provides relief for certain taxpayers to allow them to take advantage of amendments made to the NOL provisions by the CARES Act. Specifically, this Notice grants a six-month extension for filing an application for a tentative carryback adjustment with respect to the carryback of an NOL that arose in any tax year that began during calendar year 2018 and that ended before July 1, 2019.

NOL carryovers and charitable contributions. The IRS stated that a corporation with several years of NOL carryovers and charitable contribution carryovers must determine a charitable contribution carryover adjustment using a chronological, year-by-year NOL absorption computation. Using an aggregate basis standard to determine the adjustment is not accurate. Charitable contributions are treated as absorbed when included in the NOL carryover to subsequent years (CCA 201928014).

Claiming the deduction. For a tax year from which an NOL carryback is available, it may be claimed by filing Form 1139 (Corporation Application for Tentative Refund) or Form 1120X (Amended U.S. Corporation Income Tax Return).

- *Form 1139.* A corporation can get a refund faster by filing Form 1139. The IRS will process the refund request on Form 1139 within 90 days of the later of (1) filing or (2) the last day of the month that includes the due date (including extensions) for filing the return for the year in which the loss arose. Form 1139 generally must be filed no later than one year after the NOL year (see preceding discussion of Notice 2020-26 for an exception).
  COVID-19 Tax Alert: In response to COVID-19, the IRS is allowing taxpayers who are filing Form 1139 pursuant to the CARES Act to submit eligible refunds claims via fax to (844) 249-6236. Other submissions will not be processed. See **https://www.irs.gov/newsroom/temporary-procedures-to-fax-certain-forms-1139-and-1045-due-to-covid-19** for more information.
- *Form 1120X* may only be filed after the corporation has filed its original return and must be filed within three years of the due date of the tax return (for the NOL year) including extensions. It often takes up to three to four months for the IRS to act on the refund request when filed on Form 1120X.

C corporation with NOL makes S election. C corporation NOLs cannot be used in an S corporation tax year except that such NOLs are allowed as deductions against net recognized built-in gain for purposes of the built-in gains tax applicable to S corporations [IRC Sec. 1374(b)(2)]. However, unused C corporation NOLs continue to carry forward and, if unexpired, can be used by the C corporation if the S election terminates.

Corporate AMT

Form 4626

The TCJA repealed the corporate AMT for tax years beginning after 2017. IRC Sec. 55(a) was modified to provide that the AMT is imposed only on taxpayers other than corporations.

Payroll Tax Returns

See IRS Pub. 15 (Circular E) (Employer's Tax Guide); IRS Pub. 15-A (Employer's Supplemental Tax Guide); IRS Pub. 15-B (Employer's Tax Guide to Fringe Benefits); and IRS Pub. 15-T (Federal Income Tax Withholding Methods)

Tab I Topics

COVID-19 Payroll Relief

The Families First Coronavirus Response Act (FFCRA) provides two payroll tax credits for eligible employers that are required to pay emergency sick leave and expanded family and medical leave wages to certain employees for COVID-19 related reasons. Additionally, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) creates an employee retention credit to encourage employers to retain their employees and maintain wages throughout the 2020 COVID-19 crisis.

All three credits are fully refundable and are allowed against the employer portion of social security taxes (6.2% rate) and railroad retirement tax on all wages and compensation paid to all employees for the quarter. If the amount of the credit exceeds the employer portion of these federal payroll taxes, then the excess is treated as an overpayment and refunded to the employer. To provide immediate access to the COVID-19 credit amounts, employers can retain payroll tax funds that would normally be required to be deposited (including FITW, FICA taxes withheld from employees' wages, and employer FICA taxes). If a credit balance remains after retaining those funds, the employer can file Form 7200 (Advance Payment of Employer Credits Due to COVID-19) to request advance payment of the remaining credit amount. Employers generally claim the credits on quarterly Forms 941. Small employers that file Form 944 annually, as well as agricultural employers that file Form 943 annually, will claim the credits on those forms.

Expanded family and medical leave for employees. The FFCRA, which requires employers with fewer than 500 employees and non-federal public agencies to provide both paid and unpaid leave to certain employees who take leave for COVID-19 related reasons between April 1, 2020 and December 31, 2020 (optional in 2021), has two

Payroll Tax Calendar

Federal withholding and FICA deposits:[1] See *Deposit Deadlines (Forms 941, 944, and 945)* on Page I-4. See also Reg. 31.6302-1.

- Employers that report $50,000 or less in employment taxes in the look-back period must deposit taxes monthly.
- Employers that report amounts greater than $50,000 in the look-back period must deposit taxes semi-weekly.
- Any time payroll taxes accumulate to $100,000 or more, the deposit must be made by the close of the next banking day. This is known as the *one-day rule*.

FUTA deposits:[1] For more information, see *FUTA deposit rules* on Page I-9.

- Employer must generally deposit FUTA taxes if at any time the FUTA tax liability exceeds $500 in a calendar quarter.
- Liability of $500 or less in a calendar quarter may be carried to the next quarter.

Federal payroll tax return due dates:

January 31:1

- Form W-2 must be given to each employee.
- Form W-3 (Transmittal of Wage and Tax Statements).
- Copy A of all Forms W-2 issued.
- Form 941 (Employer's QUARTERLY Federal Tax Return) fourth quarter (or Form 944 (Employer's ANNUAL Federal Tax Return) if applicable; or Form 945 (ANNUAL Return of Withheld Federal Income Tax) if applicable (10 additional days if all deposits timely). (See Pub. 15.)
- Form 940 (Employer's ANNUAL Federal Unemployment (FUTA) Tax Return) (10 additional days if all deposits timely). (See Pub. 15.)
- Form 943 (Employer's ANNUAL Federal Tax Return for Agricultural Employees) if applicable (wages paid to one or more farmworkers and subject to social security and Medicare taxes or federal income tax withholding under the $150-or-more test or the $2,500-or-more test).
- Forms 1099-NEC (Nonemployee Compensation) Copy B (or an acceptable substitute) must be given to payees and Copy A must be filed with Form 1096 transmittal.

February 28.[1] Form 8027 (Employer's ANNUAL Information Return of Tip Income and Allocated Tips) if applicable (March 31 if filed electronically). Copy A of Forms 1099 (except Forms 1099-NEC reporting nonemployee compensation) must be filed with Form 1096 transmittal (March 31 if filed electronically).

April 30.[1] Form 941 (Employer's QUARTERLY Federal Tax Return) first quarter (10 additional days if all deposits timely). (See Page I-7.)

July 31.[1] Form 941 (Employer's QUARTERLY Federal Tax Return) second quarter (10 additional days if all deposits timely).

October 31.[1] Form 941 (Employer's QUARTERLY Federal Tax Return) third quarter (10 additional days if all deposits timely).

State due dates: Unemployment, withholding, etc.
(Practitioner to fill in.)

[1] The deposits or filings are due on business days (that is, a calendar day that is not a Saturday, Sunday, or legal holiday in DC).

parts. The first part, Emergency Family and Medical Leave Expansion Act (EFMLEA), addresses eligible employees (employed for at least 30 calendar days) who are unable to work or telework due to care needs for a child under age 18. The need for leave must arise because an elementary or secondary school or daycare has been closed, or the child's regularly compensated childcare provider is unavailable due to a COVID-19 related reason.

After the first 10 days of leave (which can be unpaid), the employer must provide up to an additional 10 weeks of expanded family and medical leave. Required paid leave is calculated based on an amount not less than ⅔ of an employee's regular pay rate for the number of hours the employee would normally work during the 10-week period, but not more than $200 per day and $10,000 in total.

Sick leave for employees. The second part of the FFCRA, Emergency Paid Sick Leave Act (EPSLA), requires private employers with fewer than 500 employees, and public employers of any size, to provide 80 hours of paid sick leave to full-time employees (prorated for part-time employees) who are unable to work or telework due to specified COVID-19 related reasons.

The maximum required sick pay varies based on the reason for the absence. Employees must be compensated at their regular rate, up to a maximum of $511 per day and $5,110 in total if they are—

- Subject to a federal, state, or local quarantine or isolation order;
- Advised by a health care provider to self-quarantine due to COVID-19; or
- Experiencing COVID-19 symptoms and seeking a medical diagnosis.

Employees caring for an individual described in the first two preceding bullet points, caring for a child whose school or place of care is closed or unavailable, or experiencing a "substantially similar condition" specified by the government must receive ⅔ of their regular pay, up to $200 per day and $2,000 in total.

Employee leave credits. The FFCRA provides refundable credits against the 6.2% portion of an employer's FICA tax for the amount of wages required to be paid to employees while they are taking leave beginning on April 1, 2020 through December 31, 2020. The COVID-related Tax Relief Act of 2020 Sec. 286 extends the credits for employers who provide paid leave through March 31, 2021. While employers are not mandated to provide paid sick or family COVID-19 related leave in 2021, those who do may claim the tax credit through March 31, 2021. In addition to the amounts paid to employees under the FFCRA, the credit can be increased by the portion of the employer's qualified health plan expenses that are allocable to sick or family leave wages. The credit is also increased by the employer's 1.45% Medicare portion of FICA allocated to qualified sick leave or family leave wages. Wages paid for either sick leave or family leave are not subject to the employer portion of social security tax (6.2% rate). See the guidance for completing Line 13c (Form 941) in *Reporting for COVID-19 provisions* on Page I-8.

Exemptions. Businesses with fewer than 50 employees may be exempt if the family leave or sick leave mandate under the FFCRA would jeopardize the viability of the business as a going concern. In addition, businesses with fewer than 25 employees do not have to hold the positions open for employees who take family leave if certain conditions are met.

Employee Retention Credit. The Employee Retention Credit is a fully refundable tax credit for employers equal to 50% of qualified wages (including allocable qualified health plan expenses) that eligible employers pay their employees. The credit applies to qualified wages paid after March 12, 2020, and before July 1, 2021. The maximum amount of qualified wages taken into account with respect to each employee for all calendar quarters is $10,000, so the maximum credit for an eligible employer for qualified wages paid to any employee is $5,000. **Note:** Beginning on January 1, 2021 the Taxpayer Certainty and Disaster Tax Relief Act of 2020 extends and expands certain provisions, including increasing the ERC rate from 50% to 70% and the limit on per-employee creditable wages from $10,000 for the year to $10,000 for each quarter. See the *Handbook Updates* section of the Quickfinder website (**tax.thomsonreuters.com/quickfinder**) for tables summarizing key provisions of the December 2020 legislation.

An *eligible employer* for purposes of the Employee Retention Credit is an employer that carries on a trade or business during calendar year 2020, including tax-exempt organizations, that either: (1) fully or partially suspended operating during any calendar quarter in 2020 due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings due to COVID-19; or (2) experience a significant decline in gross receipts during the calendar quarter.

Note: Governmental employers are not eligible employers. However, tribes or tribal entities may be eligible employers if they operate a trade or business. Also, self-employed individuals are not eligible for this credit on their own earnings, but may be able to claim the credit for wages paid to their employees.

Qualified wages. Wages for social security and Medicare tax purposes paid to certain employees (including certain health plan expenses) during a quarter in which business operations are partially or fully suspended due to a government order or during a quarter in which the business experiences a significant decline in gross receipts. The definition of qualified wages is partially dependent on the average number of full-time employees.

An *eligible employer* that averaged 100 or fewer full-time employees in 2019 may include qualified wages paid to all employees during the quarter. However, an *eligible employer* that averaged more than 100 full-time employees in 2019 can only include (1) the wages paid to employees who didn't provide services for the employer due to a suspension of operations or significant decline in gross receipts, and (2) wages not exceeding what the employer would have paid the employee for working the same amount of time during the prior 30-day period.

Form changes and new forms. Form 941 and the annual payroll reports have been revised. In addition, new Form 7200 (Advanced Credit of Employer Credits Due to COVID-19) has been issued (see *Claiming an Advanced Credit on Form 7200* on Page I-6).

Deferring payment of payroll tax deposits. In addition to the allowable COVID-19 credits, an employer can defer the deposit and payment of its portion of social security taxes due during the period March 27, 2020 through December 31, 2020 (CARES Act, Sec. 2302). Half of the deferred taxes must be deposited by December 31, 2021 and the remaining amount by December 31, 2022.

Observation: This deferral is available for the employer's 6.2% portion of FICA, not on qualified sick and/or family leave wages.

In August 2020, President Trump issued a Presidential Memorandum directing the Secretary of the Treasury to defer additional payroll tax obligations. Notice 2020-65 makes relief available for employers and generally applies to wages paid September 1, 2020 through December 31, 2020. The employee social security tax deferral may apply to payments of taxable wages to an employee that are less than $4,000 during a bi-weekly pay period (or the equivalent threshold amount for other pay periods), with each pay period considered separately. No deferral is available for any payment to an employee of taxable wages of $4,000 or above for a bi-weekly pay period. The notice postpones the time for employers to withhold and pay the employees' 6.2% social security tax. The COVID-related Tax Relief Act of 2020 Sec. 274 further extends the repayment period through December 31, 2021.

Payroll Tax Deposit Requirements

Employers are required to deposit federal payroll taxes electronically using the Electronic Federal Tax Payment System (EFTPS). See *Electronic Federal Tax Payment System* on Page I-4. For the $2,500 exception to the EFTPS requirement, see *Annual Return of Withheld Federal Income Tax (Form 945)* on Page I-8.

Court Case: The employer is responsible for payment of payroll taxes and cannot avoid its responsibility by transferring the taxes to another party, such as an employee or agent, and delegating payment to that party. The employer is liable until the government receives payment [*Pediatric Affiliates*, 99 AFTR 2d 2007-2240 (3rd Cir. 2007)].

waiting to request a refund on Form 941. Form 7200 (Advance Payment of Employer Credits Due to COVID-19) is used by employers to request an advance payment of the tax credits for qualified leave wages or qualified employee retention wages. Employers that file Forms 941, 943, 944, or CT-1 may use the form. Before filing Form 7200, employers should first reduce their employment tax deposits to account for the credits. Employers can then use Form 7200 to request the amount of the credit that exceeds their reduced deposits. Employers will need to reflect advanced credits and reduced deposits on their 2020 employment tax returns.

When and how to file. The form can be filed at any time before the end of the month following the quarter in which qualified wages were paid. If necessary, the form can be filed several times during each quarter. The completed form should be faxed to (855) 248-0552. It cannot be filed electronically or by mail.

Practice Tip: The employer should maintain in its records a copy of the document confirming the transmission of the form so that it can provide this information to the IRS in case of any dispute.

Caution: Form 7200 cannot be filed to claim an advance payment after the Form 941 is filed for a quarter (or Form 943, 944, or CT-1 for the year).

Note: A payroll reporting agent can sign and submit Form 7200 on behalf of clients for which it has authority via Form 8655 (Reporting Agent Authorization) (Rev. Proc. 2005-39).

Completing Form 7200. In the heading, enter the employer's name, address, and EIN. Be certain the name and EIN match exactly what is on file with the IRS. If the employer's Form 941 is filed by a third-party payer, the name and EIN of the third-party payer should be entered on the appropriate lines.

Check the appropriate box indicating the quarter for which the advance payment is requested. Employers that file an annual return (Form 944 or 943) also must check a box indicating the quarter during which the wages that a credit is being claimed for were paid.

Part II. Enter cumulative amounts on lines 1, 2, 3, 5, and 6 (for the quarter or as of the date filed) to claim an advance for one or more of the credits. If filed after the end of a quarter but before Form 941, use totals for the quarter.

Line 1—Employee retention credit. Enter 50% of qualified wages paid cumulatively for the quarter [not to exceed 50% of $10,000 (that is, a $5,000 credit) for any employee in 2020]. See the discussion at *Employee Retention Credit* on Page I-2.

Caution: Do not include on line 1 wages that are included on line 2 for qualified sick leave, line 3 for qualified family leave, or for which a work opportunity credit is claimed. Employers who received an SBA loan under the Paycheck Protection Program (PPP) may still qualify for the credit with respect to wages that are not paid for with forgiven PPP loan proceeds.

Line 2—Sick leave credit. Enter the qualified sick leave wages paid cumulatively for the quarter. These are wages (including the cost of maintaining health insurance coverage and the employer's share of Medicare taxes) required to be paid under EPSLA subject to limits (see *Sick leave for employees* on Page I-2).

Line 3—Family leave credit. Enter the qualified family leave wages paid cumulatively for the quarter. These are wages (including the cost of maintaining health insurance coverage and the employer's share of Medicare taxes) required to be paid under EFMLEA subject to limits (see *Expanded family and medical leave for employees* on Page I-1).

Line 5—Credit amount offset by payroll taxes. Enter the total amount by which payroll tax deposits were reduced during the quarter to offset the employee retention and leave credits.

Note: Do not report on line 5 the amount of the employer portion of social security taxes the employer is deferring (See *Deferring payment of payroll tax deposits* on Page I-2.)

Line 6—Previously filed requests. Report the amount of advances previously requested on Forms 7200 during the quarter.

Correcting Form 7200. If an error is made on Form 7200, a corrected form cannot be filed. Instead, the error is corrected when Form 941 (or Form 944 or 943) is filed, and the credit amounts reported on Form 7200 are reconciled.

Recordkeeping requirements. Employers filing Form 7200 must keep adequate records supporting the data entered on the form. The records should be kept until the later of four years after (1) the due date of the Form 941 on which the credit is claimed, or (2) the date payroll taxes due with the Form 941 are paid.

The following records should be kept:

1) Documentation supporting an employee's eligibility for COVID-19 sick leave wages, and calculations and documentation supporting the amount of qualified leave wages and qualified health plan expenses included in the credit amount.
2) Documentation supporting an employee's eligibility for COVID-19 expanded family leave wages, and calculations and documentation supporting the amount of qualified leave wages and qualified health plan expenses included in the credit amount.
3) Documentation showing the employer's eligibility for the employee retention credit and calculations supporting the credit amount.
4) Copies of Forms 7200 the employer filed with the IRS.

IRS letters. An employer experiencing a delay in the processing of Form 7200 will receive a letter indicating the cause of the delay (for example, a computational error or a difference in mailing address) (IRS News Release 2020-158).

Employer's Quarterly Federal Tax Return (Form 941)

Used by employers who withhold income, social security, and Medicare tax from employee wages.

- Household employers must use Schedule H (Form 1040) (Household Employment Taxes). See *Household Employment Tax (Schedule H)* on Page I-9. However, sole proprietors filing Form 941 or Form 944 for business employees may include taxes for household employees on these returns.
- Farm employers must use Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees).

Observation: Form 941 has become much more complicated due to tax incentives created by COVID-19-related legislation. Use the information at *Reporting for COVID-19 provisions* on Page I-8 along with the worksheets in the revised Form 941 instructions to help prepare 2020 second through fourth quarter payroll reports.

Filing requirements. An employer (other than household or farm) must file Form 941 for every quarter (even if the employer pays no wages for the quarter), unless he qualifies as a seasonal employer. Seasonal employers who regularly pay no wages in certain quarters should check the box on line 18 of Form 941 every quarter the form is filed. Generally, the IRS will not inquire about unfiled returns if at least one taxable return is filed each year.

Deposit threshold. If the tax liability for the quarter is less than $2,500, it may be paid with Form 941. Otherwise, the withheld taxes must be deposited on either a semiweekly or monthly basis. See *Deposit Deadlines (Forms 941, 944, and 945)* on Page I-4.

Filing deadlines:

Quarter Ending	Due Date
March 31	April 30
June 30	July 31
September 30	October 31
December 31	January 31

Extensions. If all taxes were timely deposited for the quarter, the due dates are extended 10 days. There is no additional extension for filing Form 941.

Partial Table of Class Lives and Recovery Periods—IRS Pub. 946, Appendix B (Continued)

Asset Class	Description of assets included:	Class Life (in years)	GDS Life (MACRS)	ADS
01.21	**Cattle, breeding or dairy**	7	5	7
01.221	**Any breeding or work horse 12 years old or less** at the time it is placed in service[2]	10	7	10
01.222	**Any breeding or work horse more than 12 years old** at the time it is placed in service[2]	10	3	10
01.223	**Any race horse more than two years old** at the time it is placed in service[2]	[3]	3	12
01.224	**Any horse more than 12 years old** at the time it is placed in service that is neither a race horse nor a horse described in Class 01.222[2]	[3]	3	12
01.225	**Any horse not described in Classes 01.221, 01.222, 01.223, or 01.224**[2]	[3]	7	12
01.23	**Hogs, breeding**	3	3	3
01.24	**Sheep and goats, breeding**	5	5	5
01.3	**Farm buildings** except structures included in Class 01.4	25	20	25
01.4	**Single-purpose agricultural or horticultural structures** [within the meaning of IRC Sec. 168(i)(13)]	15	10[4]	15
10.0	**Mining.** Includes assets used in the mining and quarrying of metallic and nonmetallic minerals (including sand, gravel, stone, and clay) and the milling, beneficiation and other primary preparation of such materials	10	7	10
13.1	**Drilling of oil and gas wells.** Includes assets used in the drilling of onshore oil and gas wells and the provision of geophysical and other exploration services; and the provision of such oil and gas field services as chemical treatment, plugging and abandoning of wells, and cementing or perforating well casings.	6	5	6
13.2	**Exploration for and production of petroleum and natural gas deposits.** Includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities.	14	7	14
15.0	**Construction.** Includes assets used in construction by general building, special trade, heavy and marine construction contractors, operative and investment builders, real estate subdividers and developers, and others, except railroads	6	5	6
23.0	**Manufacturing of apparel and other finished products.** Includes assets used in the production of clothing and fabricated textile products; does not include apparel from rubber and leather	9	5	9
24.1	**Timber cutting equipment**	6	5	6
24.4	**Assets used in the manufacturing of wood products and furniture**	10	7	10
27.0	**Printing, publishing and allied industries.** Includes assets used in printing by one or more processes, such as letter-press, lithography, gravure or screen; the performance of services for the printing trade, such as bookbinding, typesetting, engraving, photo-engraving and electrotyping; and the publication of newspapers, books, and periodicals	11	7	11
39.0	**Manufacture of athletic, jewelry, and other goods.** Includes assets used in the production of: jewelry; musical instruments; toys and sporting goods; motion picture and television films and tapes; and pens, pencils, office and art supplies, brooms, brushes, caskets, etc.	12	7	12
57.0	**Distributive trades and services.** Includes assets used in wholesale and retail trade, and personal and professional services. Includes Section 1245 assets used in marketing petroleum and petroleum products	9	5	9[5]
79.0	**Recreation.** Assets used in the provision of entertainment services for a fee or admission charge, such as bowling alleys, pool halls, theaters, concert halls, and miniature golf courses. Does not include amusement and theme parks and specialized land improvements such as golf courses, sports stadiums, race tracks, ski slopes, and buildings	10	7	10
	Personal property with no class life		7	12
	Section 1245 real property with no class life		7	40
	Residential rental real property		27.5	30
	Nonresidential real property. Includes office buildings, warehouses, and qualified *office-in-home*		39	40

[1] 5 years if the original use of the asset (other than grain bins, cotton ginning assets, fences or other land improvements) began with the taxpayer after 12/31/17; 7 years otherwise.

[2] Race horses placed in service after 2008 and before 2022, regardless of age, are three-year property. Outside of that date range, race horses more than two years old when placed in service are three-year property, and race horses two years old or younger are seven-year property. A horse is more than two (or 12) years old after the day that is 24 (or 144) months after its actual birthdate.

[3] Properties described in asset classes 01.223, 01.224, and 01.225 are assigned recovery periods but have no class lives.

[4] Seven years if property was placed in service before 1989.

[5] High technology medical equipment is assigned a five-year recovery period for alternate MACRS method (ADS).

GDS *General Depreciation System.* 200% declining-balance (DB) depreciation method for three-year, five-year, seven-year and 10-year property; 150% DB for farm placed in service before 2018, 15-year and 20-year property; straight-line (SL) depreciation method for 27.5- and 39-year property; and recovery years for alternative minimum tax (AMT) depreciation for assets placed in service after 1998.

ADS *Alternative Depreciation System.* Recovery years for AMT depreciation for assets placed in service prior to 1999, C corporation *book* depreciation and exempt organizations. Can be elected for *tax* depreciation.

Note: Use this table for assets placed in service after 1986. See IRS Pub. 946 for a list of all asset recovery periods.

2020 Employer and Self-Employed Retirement Plan Chart

Defined-Benefit	Defined-Contribution (Profit-Sharing)	401(k)	403(b)
Any employer.			Tax-exempt religious, charitable, or educational organizations.
Employees at least age 21 with one year of service (1,000 hours).[9]			Employees[10] who work 20 or more hours per week, do not participate in another 401(k), 457 or 403(b) plan and will contribute more than $200 per year.
Actuarially determined contribution. Maximum benefit payout limited to 100% of average compensation for the three consecutive years of highest compensation (limited to $285,000), but not to exceed $230,000.[11]	Contributions per participant up to lesser of 100% of compensation or $57,000. Employer deduction limited to 25% of aggregate compensation (limited to $285,000 per employee) for all participants (20% of net SE income after SE tax deduction for self-employed).[11]	Employee elective deferrals limited to $19,500 (additional $6,500 if age 50 or older at end of the year). Employer deduction limited to 25% of combined wages of all employees (elective deferrals do not reduce wages for the 25% limit). Combined employer contributions and employee elective deferrals per employee limited to lesser of 100% of wages or $57,000 (additional $6,500 for employees age 50 or older by year-end).[11]	Employee elective deferrals limited to $19,500 (additional $6,500 if age 50 or older at end of the year). Special formula applies to additional employer contributions based on years of service. Combined employer contributions and employee elective deferrals per employee limited to lesser of 100% of wages or $57,000 (additional $6,500 for employees age 50 or older by year-end).[11]
10% of distribution. (See *Exceptions to 10% Withdrawal Penalty Before Age 59½* on Page K-6.)			
For self-employed and >5% owners, by April 1 of the year following the year the account owner turns age 72 (or 70½ if turned 70½ before January 1, 2020). For all other employees, April 1 of the year following the year the account owner turns age 72 or retires, whichever is later.			
Law Change Alert: The SECURE Act provides that qualified retirement plans adopted after the close of a tax year but before the due date (including extensions) of the tax return may be electively treated as having been adopted on the last day of the tax year. Return due date, including extensions for profit-sharing plan contributions. 8½ months after year-end for defined benefit plan contributions.		**Law Change Alert:** The SECURE Act provides that qualified retirement plans adopted after the close of a tax year but before the due date (including extensions) of the tax return may be electively treated as having been adopted on the last day of the tax year. December 31 to establish plan. For employer contributions, return due date including extensions.[12]	
Yes	No	Generally no.	
Yes, if plan permits. Must pay back in five years (unless used to buy a principal residence). Qualified plans are prohibited from making plan loans through credit cards or similar arrangements.			
Yes	Yes	Yes	Yes
Employers are subject to a 10% excise tax on nondeductible (excess) contributions, unless an exception applies.		*Employee's elective deferral:* No penalty or tax if 2020 excess is withdrawn by April 15, 2021 (but allocable earnings are taxable in year withdrawn). If not withdrawn by April 15, 2021, excess is taxed twice—once in the year of excess contribution and again when distributed because no cost basis is allowed for excess contribution. *Employer's contribution:* 10% penalty on excess contributions (resulting from plan failing average deferral percentage test) unless distributed (with earnings) to highly compensated employee(s) within 2½ months after the close of the plan year (taxable to employee in year of deferral). Failure to distribute excess within 12 months after close of plan year results in plan failing to qualify for that plan year and all subsequent plan years for which the excess contributions remain uncorrected.	

[9] **Law Change Alert:** The SECURE Act provides that for plan years beginning after December 31, 2020, long-term part-time employees (those with at least 500 hours of service in three consecutive 12-month periods, and who are at least age 21 by the end of the last period) must be allowed to participate and make elective deferrals in a 401(k) plan. This provision will first be impactful in 2024 after there have been three consecutive 12-month periods.

[10] Includes self-employed ministers.

[11] Nondiscrimination rules may affect contributions/deferrals for certain employees. The SECURE Act provides that for plan years beginning after 2019, the maximum default rate for automatic safe harbor enrollment is increased from 10% to 15%. However, the rate remains at 10% for the initial year that the deemed election applies to a participant.

[12] The Tax Code does not specify when the employer is required to deposit employee elective deferrals into the employee's account. However, under ERISA regulations, employee elective deferrals must be contributed to the employee's 401(k) plan account as soon as reasonably can be segregated from the employer's general assets, but not later than the 15th business day of the month immediately after the month in which the contributions either were withheld or received by the employer.
Disaster Relief Alert: Special rules apply for distributions and loans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)* on Page Q-1 and *December 2020 Legislation* on Page Q-1.

2020 Medical Reimbursement Account Comparison Chart

	Health Savings Accounts (HSAs)[1]	Archer Medical Savings Accounts (MSAs)	Health Flexible Spending Arrangements (FSAs)[2, 3]	Health Reimbursement Arrangements (HRAs)[2, 4, 5, 6]
IRC	IRC Sec. 223	IRC Sec. 220	IRC Sec. 125	IRC Sec. 105
Description	Taxpayer makes tax deductible contributions to the savings plan (or employer makes excludable contributions to the plan on behalf of the employee). Taxpayer can then withdraw funds tax free to pay for medical costs not covered by insurance.		Employee chooses to defer a portion of salary pre-tax into a savings plan. Employee can then withdraw funds tax free to pay for medical costs not covered by insurance.	Employer reimburses the employee tax free for medical costs not covered by insurance. The employee does not defer any salary into the plan.
Qualifications to Participate in Plan	Must be covered under a high deductible health plan. Cannot be covered under any other non-high deductible plan.[8] Cannot be entitled to Medicare benefits. Cannot be claimed as a dependent on another person's tax return.	Must be covered under a high deductible health plan. Must work for a small employer that offers this benefit, or be self-employed. Cannot be covered under any other non-high deductible plan. Cannot be entitled to Medicare benefits. Cannot be claimed as a dependent on another person's tax return.	Must work for an employer that offers this benefit. Not available to self-employed individuals.	
Contribution Limits	Individual = $ 3,550 Family = $ 7,100 Additional contribution limit—age 55 or older = $ 1,000 No income requirement to make deductible contributions.	Maximum annual contribution limit is 65% of the annual deductible for individuals and 75% of the annual deductible for families. Contributions are further limited to net SE earnings or compensation of employee from the business establishing the high deductible health plan.	Salary reduction contributions are limited to $2,750 for tax years beginning in 2020 (Rev. Proc. 2019-44).	The employee makes no contributions to the plan. The employer payment/reimbursement of qualified medical expenses is limited to $5,250 per eligible employee ($10,600 for family coverage) for QSEHRAs.
Health Plan Minimum Annual Deductible	Individual = $ 1,400 Family = $ 2,800 **COVID-19 Tax Alert:** For plan years beginning in 2020 and 2021, the CARES Act allows the cost of telehealth services to be covered prior to reaching the deductible.	Individual = $ 2,350 Family = $ 4,750	No annual deductible required.	
Health Plan Maximum Annual Deductible/Out-of-Pocket	Individual = $ 6,900 Family = $ 13,800 Maximum annual limit on total out-of-pocket expenses other than premiums. Maximum limit does not apply to out-of-network services.	Individual = $ 3,550 Family = $ 7,100 Maximum out-of-pocket expense limitation (other than premiums) is $4,750 for individuals and $8,650 for families.	No annual deductible required.	
Can Unused Amounts at End of Year Be Carried Forward?	Yes	Yes	Generally no; however, a plan can permit either a 2½ month post-year end grace period or up to $500 carryover.[7,9] **Note:** For 2020–2021, the grace period can be extended to 12 months after the end of the plan year.	Yes
Can Accumulated Funds Be Utilized After Employee Changes Jobs?	Yes	Yes. However, new contributions to plan are not allowed if new employer does not offer an MSA to employees.	No	No
Distributions Not Used for Medical Purposes	Included in gross income and subject to a 20% penalty. Exceptions to the penalty include distributions after beneficiary's death, disability or attainment of age 65.	Included in gross income and subject to a 20% penalty. Exceptions to the penalty include distributions after beneficiary's death, disability or attainment of age 65.	Distributions are not allowed unless receipts for qualified medical expenses are submitted to the plan administrator for reimbursement.	Included in gross income as taxable wages. No penalty applies.

[1] Notice 2008-59 provides additional guidance on health savings accounts. A nonexclusive list of circumstances in which an employer may request the return of contributed amounts due to an employer's or trustee's administrative or processing errors is provided by the IRS in INFO 2018-0033.
[2] Reimbursements for medicine or drugs are limited to prescribed drugs or insulin. See *Over-the-Counter Drugs* on Page K-15.
[3] FSAs that are not excepted benefits and do not meet the Affordable Care Act market reform provisions may be subject to penalties under IRC Sec. 4980D. See Notice 2013-54.
[4] Notice 2002-45.
[5] *Qualified Small Employer Health Reimbursement Arrangements (QSEHRAs)* on Page K-13 are not subject to Section 4980D penalties.
[6] See *Employer Reporting for Health Insurance* on Page K-15 for employer reporting requirements.
[7] *Qualified reservist distributions* to military reservists called to active duty may be made after an FSA's cut-off date. See IRC Sec. 125(h) and Notice 2008-82.
[8] Services administered by the Secretary of Veterans Affairs for a service-connected disability are not disqualifying.
[9] **Law Change Alert:** Plans can be amended to take advantage of an extended grace period and/or a $550 carryover. See *FSA use-it-or-lose-it-rule* on Page K-17.

For amounts paid or incurred after 2025, an employer's deduction for any expenses for meals provided for an employer's convenience, or provided on or near the employer's business premises through an employer-operated facility that meets certain requirements, is disallowed [IRC Sec. 274(o)]. See *Meals and Lodging* on Page K-11.

On-Premises Athletic Facilities

The value of athletic facilities provided by an employer to its employees is excluded from an employee's income [IRC Sec. 132(j)(4)]. The facility must be located on premises owned or leased by the employer, and substantially all of its use must be by employees, their spouses, and dependent children. The facility can be a tennis court, gym, pool or golf course. This exclusion does not apply if the facility is made accessible to the general public. The exclusion does not apply to any residential use facility. For example, a resort with athletic facilities does not qualify [Reg. 1.132-1(e)].

Qualified Transportation Benefits

The TCJA generally repealed the deduction for employee transportation fringe benefits for amounts paid or incurred after 2017. Consequently, no deduction is allowed for any expense incurred for providing transportation, or any payment or reimbursement to an employee in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee [IRC Sec. 274(l)(1)].

However, employer-provided qualified transportation fringe benefits are excludable from the employee's income, up to certain limits.

Public transportation. Employers can provide up to $270 per month in 2020 to help employees defray the costs of commuting (IRC Sec. 132). *Employers can:*

1) Give transit passes (including any token, fare card, voucher, or similar item plus shipping fees) each month to an employee for the monthly limit,
2) Sell tokens or transit passes to employees at a discount for the monthly limit or
3) Reimburse employees up to the monthly limit for public commuting expenses.

Caution: A cash reimbursement arrangement for transit passes is allowed as a qualified transportation fringe only if no vouchers or transit passes are readily available for direct distribution by the employer to employees [Reg. 1.132-9(b), Q/A-16(b)(1)]. The IRS has informally indicated the fact that the bus company accepts only cash or check payments does not cause the bus tickets to not be readily available to the employer for direct distribution to the employee (INFO 2016-0007).

Commuter transportation. An employer may provide a commuter highway vehicle (van pool) for transportation of employees to and from work. The combined value of employer-provided commuter transportation and transit passes excludable from income is limited to $270 per month for 2020 (IRC Sec. 132).

To qualify, these requirements must be met [IRC Sec. 132(f)(5)]:

1) Vehicle must seat at least seven adults, including driver,
2) At least 80% of van use must be for transporting employees to and from work, and
3) At least 50% of the seating capacity must be used by employees (excluding the driver).

Note: The IRS informally noted that the 80/50 rule (items 2 and 3 above) does not require the employee to use the van pool at least 50% of the time. In addition, the 80/50 rule does not apply to private or public transit-operated van pools (that is, those owned and operated by a public transit authority or a person in the business of transporting persons for compensation) (INFO 2016-0004).

Under the commuting valuation rule, each one-way trip is valued at a flat rate of $1.50 ($3.00 per round trip) (Notice 94-3). Workers do not have to include either type of assistance in gross income, as long as the statutory monthly limit is not exceeded. Amounts over the monthly limit are included in income and subject to federal income tax, federal withholding, FICA and FUTA.

Qualified parking. In addition to transportation benefits, an employer may provide $270 per month in 2020 for qualified parking expenses (IRC Sec. 132; Rev. Proc. 2019-44). *Qualified parking* is defined as parking provided to an employee on or near the business premises of the employer or on or near a location from which the employee commutes to work [IRC Sec. 132(f)(5)(C)]. This includes reimbursed costs incurred at park and ride lots. The term does not include any parking on or near property used by the employee for residential purposes.

To the extent the value of the benefit exceeds the income exclusion limit under IRC Sec. 132(f)(2) ($270 per month for 2020), the excess is included in the employee's compensation and reported on Form W-2. The employer is then allowed a compensation deduction for the amount included in the employee's income.

~~Prop.~~ Reg. 1.274-13 modifies certain guidance in Notice 2018-99, and provides a general rule and three simplified methods to determine the amount of nondeductible parking expenses when a parking facility is owned or leased by the taxpayer. The regulation generally applies to tax years beginning on or after December 16, 2020. Before then, taxpayers may rely on either Prop. Reg. 1.274-13 (for tax years beginning after December 31, 2017) or the guidance in Notice 2018-99.

Calculating nondeductible qualified parking expense. Determining the nondeductible portion depends on whether the employer pays a third party for employee parking or if the employer owns or leases the parking facility.

Employer pays a third party for parking. If an employer pays a third party for parking spaces for its employees, the Section 274(a)(4) disallowance is calculated using the total annual amount paid to the third party. The amount disallowed as an employer deduction is capped at the exclusion amount per employee ($270 per month for 2020), multiplied by the number of employees who received the exclusion. Any amount paid in excess of that amount is treated as compensation to the employee and reported as wages on Form W-2 (and deductible by the employer as compensation expense).

Example: Mason Corp. has 50 employees during the entire 2020 tax year and rents spaces in a parking garage across the street from its offices for those employees. The total cost of the spaces is $120,000 per year ($200 per month × 50 spaces × 12 months). Because the total amount paid per month for each space is below the $270 monthly exclusion amount, the total amount paid ($120,000) is disallowed as an income tax deduction on Mason Corp.'s 2020 income tax return.

Variation: If Mason Corp. leased the spaces for $300 per month, the nondeductible portion would be $162,000 ($270 × 50 × 12). The excess of $18,000 ($180,000 total parking lease expense − $162,000 nondeductible portion) is deductible as compensation and reported as wages on each employee's Form W-2 ($360 per employee for 2020).

Employer owns or leases parking facilities. Employers that own or lease all or a portion of one or more facilities where employees park must determine the total parking expenses for the facilities and use a reasonable method to determine the amount of those expenses that are disallowed under IRC Sec. 274(a)(4).

Reasonable method under Notice 2018-99. Employers that complete the following four steps are deemed to have used a reasonable method:

1) The employer determines the percentage of reserved employee spaces in relation to total parking spots and multiplies that by the

Continued on the next page

total parking expenses for the facility. The expenses allocated to reserved employee parking spaces are totally disallowed.

2) The primary use (more than 50% of actual or estimated use) of the remainder of the parking spaces is identified to determine whether they're for parking provided to the general public (for example, customers or potential customers). If the remaining spaces are open to the general public, no further disallowance is required.
3) The percentage of remaining parking spaces reserved for nonemployees (for example, visitors, partners, more-than-2% shareholders) in relation to the remaining total parking spots is determined and multiplied by the remaining parking expenses. The expense allocated to spaces reserved for nonemployees is not subject to disallowance.
4) If any parking expenses haven't been categorized as deductible or nondeductible in Steps 1–3, a reasonable determination of the employee use of the remaining parking spaces on a typical business day is determined. The remaining parking expense allocated to employee usage is disallowed.

Caution: Using the value of the employee parking benefit to determine the disallowed amount, as opposed to the employer's expense, is not considered a reasonable method.

Example: GW and Associates, an accounting firm, leases a parking lot next door to their office building. Total parking lot lease payments for the current year are $10,000. The parking lot has 100 spaces available. On a typical business day, approximately 60 employees park in the leased lot. None of the parking spaces are reserved for use by employees or clients. The following calculations are made using the steps provided in Notice 2018-99: (1) No amount is allocated to reserved employee spaces. (2) Because 60% (60 ÷ 100 spaces) of the lot is used by employees, the lot is not primarily used to provide public parking. Therefore, the general public exemption does not apply. (3) No amount is allocated to reserved nonemployee spaces. (4) Because 60% of parking spaces are used by employees on a typical business day, GW reasonably determines that $6,000 ($10,000 × 60%) of their parking expenses are disallowed.

Reasonable method under ~~Prop.~~ Reg. 1.274-13. Under the ~~proposed reliance~~ regulations, the IRC Sec. 274(a)(4) disallowance may be calculated using either the general rule, or any of the following simplified methods:

- The qualified parking limit method,
- The primary use method, or
- The cost per space method.

A taxpayer may choose to use the general rule or any of the three simplified methods for each tax year and for each parking facility. Additionally, two *special rules* may be used including (1) calculating the mixed parking expenses, and (2) aggregating the spaces by geographic location.

Under the general rule, an employer must calculate the disallowance of qualified parking expenses for each employee provided parking as a qualified transportation fringe benefit based on a reasonable interpretation of IRC Sec. 274(a)(4) and only the aggregation of spaces by geographic location special rule applies [~~Prop.~~ Reg. 1.274-13(d)(2)(i)].

The *qualified parking limit method* determines the disallowance by multiplying, for each month in the tax year, the monthly per employee limit on the exclusion ($270 for 2020) by either (1) the total spaces used by employees during the peak demand period, or (2) the total number of employees. The special rules may not be used under this method.

The *primary use method* is similar to the four-step method in Notice 2018-99. The modifications include:

1) There is no disallowance for reserved employee spaces if the primary use of the available parking space is provided to the general public and there are five or fewer reserved employee spaces with the reserved employee spaces being 5% or less of the total space.
2) Primary use of available parking spaces is measured during the peak demand period.
3) Spaces reserved for nonemployees include (but are not limited to) spaces reserved exclusively for visitors, customers, partners, sole proprietors, 2% S corporation shareholders, vendor deliveries, and passenger loading/unloading. These spaces may be exclusively reserved by a variety of methods including specific signage, a separate facility, a segregated portion of a facility, or limited access.
4) Either or both of the *special rules* for calculating mixed parking expenses or for aggregating spaces by geographic location may be used.

Under the cost per space method, the disallowance is determined by multiplying the cost per space (total parking expenses/total parking spaces) by the total number of available spaces used by employees during the peak demand period. Either or both of the special rules may be used.

Qualified bicycle commuting. The TCJA suspended the exclusion for qualified bicycle commuting expenses for tax years beginning after December 31, 2017, and before January 1, 2026. Employers that reimburse employees for such expenses during those tax years must include the reimbursements in the employees' taxable income.

Frequent Flyer Miles

Frequent flyer miles are nontaxable. However, this does not apply to frequent flyer miles or other in-kind promotional benefits (benefits earned through rental cars or hotels) converted to cash (through employer reimbursement) or awarded as an incentive award. If the IRS reverses its position in the future and holds that the benefits are taxable, it will not apply to prior years (Ann. 2002-18).

Qualified Moving Expense Reimbursements

The TCJA suspended the exclusion for qualified moving expense reimbursements from an employee's income for tax years beginning after December 31, 2017 and before January 1, 2026. An exception applies to members of the U.S. Armed Forces on active duty (and their spouses and dependents) who move pursuant to a military order and incident to a permanent change of station [IRC Sec. 217(g)].

Qualified Retirement Planning Services

Qualified retirement planning services are excludable from employees' gross wages [IRC Sec. 132(a)(7) and (m)]. *Qualified retirement planning services* are defined as "any retirement planning advice or information provided to an employee and his spouse by an employer maintaining a qualified employer plan." Qualified employer plans include annuity plans, governmental plans, 403(b) annuity contracts, simplified employee pensions (SEPs), and savings incentive match plans for employees (SIMPLEs).

Note: The provision is not meant to include related services such as tax preparation, accounting, legal, or brokerage services.

Employer Leave-Based Donation Programs

COVID-19 Tax Alert: The IRS has announced that cash payments made by an employer under a leave-based donation program will not constitute employee wages if they are paid before January 1, 2021 to Section 170(c) organizations for the relief of COVID-19 victims. Leave-sharing donations do not need to be

included in Box 1, 3, or 5 of Form W-2, and employers (but not employees) may deduct the payments as a Section 162 business expense or as a charitable contribution under IRC Sec. 170 (Notice 2020-46).

Dependent Care Assistance

IRC Sec. 129 and 45F

Under a Section 129 dependent care plan, employees can exclude from gross income up to $5,000 ($2,500 MFS) of employer-provided dependent care assistance as a tax-free fringe benefit. The excludable amount is not subject to FICA, FUTA, or federal income tax withholding. The cost of the benefit may be paid through employer contributions to the plan, salary reductions under a cafeteria plan, or a combination of the two methods.

The exclusion may not exceed the earned income of the employee or, if less, the earned income of his spouse. The plan must only cover the same type of expenses that qualify for the dependent care tax credit, which is computed on Form 2441 (Child and Dependent Care Expenses).

General requirements:

1) Plan must be in writing and for exclusive benefit of employees.
2) Plan must provide reasonable notification of the availability and terms of the program to eligible employees.
3) Employer must provide each employee, by the following January 31, with a written statement of amounts paid or expenses incurred by the employer for dependent care assistance under the plan. Employer must report this amount, or the amount deferred by the employee if the plan was amended to include a grace period, on the employee's Form W-2 in box 10 (Notice 89-111).
4) Plan may not discriminate in favor of highly compensated employees.

COVID-19 Tax Alert: Notice 2020-29 extends the claim period for taxpayers to apply unused amounts in a dependent care assistance program for expenses incurred through December 31, 2020. It also expands the ability of taxpayers to make mid-year elections for dependent care assistance programs.

Credit for Employer-Provided Child Care

The Section 45F tax credit is available for employers who provide child care for their employees. The tax credit is equal to the sum of 25% of the qualified child care expenditures plus 10% of the qualified child care resource and referral expenditures. Maximum credit is limited to $150,000 each year and is subject to the general business credit limitations [IRC Sec. 38(b)(15)]. See the *Selected General Business Tax Credits* on Page O-6 for more information.

Educational Assistance

IRC Sec. 127

An educational assistance program allows employers to pay for and deduct up to $5,250 of qualified educational expenses such as tuition, books, and supplies, and to exclude the benefit from an employee's taxable income. The education does not have to be job related to be excludable [Reg. 1.127-2(c)(4)]. The exclusion also applies to expenses for graduate level courses.

The exclusion does not apply to expenses for meals, lodging, or transportation, or to tools or supplies that an employee can keep after completing the education (except for textbooks). Expenses in excess of $5,250 are added to the employee's taxable wages unless the expense qualifies as a working condition fringe benefit (such as job-related educational expenses).

Former employees, regardless of the reason for termination, may participate in an educational assistance program and still be entitled to the income exclusion (Rev. Rul. 96-41).

COVID-19 Tax Alert: Employers may provide a student loan repayment benefit to employees on a tax-free basis. An employer may contribute up to $5,250 annually toward an employee's student loans, and the payment will be excluded from the employee's income. The $5,250 annual cap applies to both the new student loan repayment benefit as well as any educational assistance under IRC Sec. 127.

The CARES Act provision applies to any student loan payments made by an employer on behalf of an employee, whether paid to a lender or to the employee, after March 27, 2020 and before January 1, 2026 (as extended by the Taxpayer Certainty and Disaster Tax Relief Act of 2020).

Caution: To prevent a double benefit, student loan repayments for which the exclusion is allowable cannot be deducted under IRC Sec. 221 (the limited deduction provision for student loan interest).

Employee Achievement Awards

IRC Sec. 274(j)

Certain employee achievement awards for length of service or safety achievements are deductible by the employer and nontaxable to the employee. The award must be *tangible personal property* awarded as part of a meaningful presentation and given under circumstances that do not create a significant likelihood of disguised compensation. Awards that qualify are deducted by the employer as a nonwage business expense. Awards that do not qualify or have excess value are wages subject to employment taxes.

Tangible personal property does not include cash, cash equivalents, gift cards, gift coupons, gift certificates, vacations, meals, lodging, event tickets, stocks, bonds, or securities. Only arrangements that confer the right to select and receive tangible personal property from a limited assortment of items preselected or preapproved by the employer are allowed [IRC Sec. 274(j)(3)].

Length-of-service award. Does not qualify if given during an employee's first five years of employment, or if the employee received another length-of-service award during the same year or in any of the prior four years.

Safety achievement award. Does not qualify if given to a manager, administrator, clerical, or other professional employee. If more than 10% of the remaining employees have already received an award during the tax year, the award does not qualify.

Limits. The cost of achievement awards given to any one employee may not exceed $400 in a tax year if the award is not a qualified plan award. Combination of qualified and nonqualified plan awards cannot exceed $1,600 for the year. A qualified plan award is an achievement award given as part of an established written plan that does not favor highly compensated employees.

Meals and Lodging

IRC Secs. 119 and 274(n)

Deduction for Meals and Lodging

An employer can deduct the cost of furnishing meals and lodging to employees if the expense is an ordinary and necessary business expense. The deduction for furnishing meals is limited to 50% of the costs except under certain conditions [IRC Sec. 274(n)]. The deduction limit generally applies not to the person reimbursed for business meals, but to the person/entity making the reimbursement. In the event of employee leasing, the determination as to which party must bear the Section 274(n) meals disallowance depends on how expenses are accounted for and how the employee

must include the premiums in income (Rev. Rul. 91-26). Since the premium payments are included in income, benefits received under the policy are excluded from income [IRC Sec. 104(a)(3)].

Disability benefit payments made to partners and more-than-2% S shareholders under a self-insured plan should be deductible by the partnership/S corporation and includable in income by the partners/shareholders. Since the plan is not insured, the benefits are not excluded from partners'/shareholders' income under IRC Sec. 104(a)(3) [Reg. 1.105-5(b)]. However, if the plan or other arrangement has the characteristics of insurance (for example, there is adequate risk shifting), the benefits can be excluded from income (Ltr. Ruls. 200007025 and 200704017).

Note: S corporation shareholder-employees who directly or indirectly own 2% or less of the corporation are treated as employees. They can receive tax-free disability insurance coverage that is deductible by the corporation, as can any other employee (IRC Sec. 106).

Group Term-Life Insurance

IRC Sec. 79; Reg. 1.79-3(d)(2)

An employer can provide up to $50,000 of group term-life insurance coverage to employees and former employees tax free. The employer may not discriminate nor be directly or indirectly the beneficiary under the contract. Amounts provided in excess of the cost of $50,000 of life insurance are taxable to the employee as wages subject to FICA, but exempt from FITW and FUTA [IRC Secs. 3121(a), 3306(b)(2) and 3401(a)(14)]. Premiums may be paid by the employer, employee or both.

The taxable portion is determined by using the following table.

Uniform Premiums for $1,000 of Group Term-Life Insurance

—Monthly Cost per $1,000 of Coverage—

Age Bracket	Amount	Age Bracket	Amount
Under 25	$ 0.05	50 to 54	$ 0.23
25 to 29	0.06	55 to 59	0.43
30 to 34	0.08	60 to 64	0.66
35 to 39	0.09	65 to 69	1.27
40 to 44	0.10	70 and above	2.06
45 to 49	0.15		

Example: The cost of an excess of $100,000 of coverage over $50,000 for a 40-year-old taxpayer is $120 per year (100 × $0.10 × 12 = $120).

Dependent coverage. Up to $2,000 of group life insurance may be provided for an employee's spouse or dependent as a *de minimis* fringe benefit (Notice 89-110). Coverage in excess of $2,000 is taxable to the employee. To determine the taxable amount for coverage in excess of $2,000, use the table above.

Long-Term Care Insurance

IRC Sec. 7702B

Long-term care (LTC) insurance plans provide financial protection for health and social services costs incurred by employees (or their covered dependents) with chronic illnesses or disabilities that prevent them from being able to carry out daily living activities, such as bathing, dressing, or eating. Benefits usually are payable to individuals who suffer either an activities-of-daily living (ADL) impairment or a cognitive impairment. Activities-of-daily living include eating, toileting, transferring (as in moving from a bed to a chair), bathing, dressing, and continence [IRC Sec. 7702B(c)(2)(B)].

Definition of qualified LTC insurance contract. To enjoy preferential tax treatment, LTC insurance plans must be funded through qualified LTC insurance contracts that meet the requirements described in IRC Sec. 7702B(b).

Tax Treatment of Premium and Benefit Payments

Group LTC insurance plans funded by qualified LTC insurance contracts are treated as health and accident plans. An employer's premium payments made to purchase such contracts for its employees (or their spouses or dependents) are deductible as ordinary and necessary business expenses.

Self-employed persons. Self-employed persons can deduct premiums paid on behalf of their employees in the same manner as any other employer. However, because a self-employed person is not considered an employee for these purposes, no business deduction is allowed for premiums paid by self-employed persons on their own behalf. Self-employed persons generally include sole proprietors (including farmers); partners [including members of limited liability companies (LLCs) electing to be treated as partnerships]; and for fringe benefit purposes, more-than-2% S corporation shareholders.

Note: The premiums may be deductible by a self-employed person on Form 1040, Schedule 1. See *Long-Term Care Insurance and Expenses* in Tab 5 *of the 1040 Quickfinder® Handbook*.

Employees. An employer plan providing coverage under a qualified LTC insurance contract is treated as an accident and health plan. This means that premiums paid by the employer for employee coverage are exempt from FITW and are not reported as taxable wages on the employee's Form W-2. The payments are also exempt from FICA and FUTA taxes.

Cafeteria Plans

IRC Sec. 125

A cafeteria plan (or flexible-benefit plan) differs from traditional employee benefit plans in that employees can customize their benefits package. Any plan that allows employees to choose between receiving taxable compensation and funding one or more tax-free benefits is a cafeteria plan.

The plan must be maintained by an employer for the benefit of employees only, and must meet several conditions:

1) The plan must be written (Prop. Reg. 1.125-2).
2) The plan must be available to all eligible employees.
3) The plan must include two or more benefits consisting of cash and qualified benefits.

Prop. Regs. 1.125-1, 2, 5, 6, and 7 were issued in 2007 and can be relied on until final regulations are issued.

Caution: The proposed rules do not reflect changes made by the Affordable Care Act, but final regulations will take these provisions into account.

Qualified Benefits

A qualified benefit is any benefit that is not includable in the gross income of the employee by an express statutory exclusion.

FSA use-it-or-lose-it-rule. Participants must forfeit any amount remaining in their FSAs at the end of the plan year, or at the end of a subsequent grace period if provided. At the employer's option a grace period of up to 2½ months is allowed. [Prop. Reg. 1.125-1(e)(1); Notice 2005-42]. Employees can be allowed to carry over up to $550 of unused amounts in a health FSA if a grace period is not provided (Notice 2020-33). **Note:** The Taxpayer Certainty and Disaster Tax Relief Act of 2020 extends the grace period for 2020-2021 for 12 months after the end of the plan year and allows any amount to be carried over.

Extended grace period for health or dependent care FSAs. A plan may be amended to permit employees to use amounts remaining in a health FSA or a dependent care FSA at the end of a grace period (or a plan year) ending during 2020 to pay or reimburse expenses incurred through December 31, 2020 and there is an

expanded ability of taxpayers to make mid-year elections for health FSAs (IRS Notice 2020-29). An amendment for the 2020 plan year must be adopted on or before December 31, 2021 and may be effective retroactively to January 1, 2020.

Carryover of unused health FSA balance. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 allows any unused benefits or contributions to be carried over without limit for 2020-2021. Before this change, the maximum amount allowed to be carried forward from a plan year starting in 2020 to the following plan year beginning in 2021 was $550 (IRS Notice 2020-33). To incorporate the $550 limit, plans must be amended no later than the last day of the first plan year from which amounts may be carried over and may be effective retroactively to the first day of that plan year. A special amendment timing rule applies for the 2020 plan year (Notice 2020-33). The guidance also clarifies the ability of a health plan to reimburse individual insurance policy premium expenses incurred prior to the beginning of the plan year for coverage provided during the plan year. The clarification is intended to assist with the implementation of ICHRAs.

Tax Considerations

Noncash benefits provided in a cafeteria plan will be nontaxable only if they satisfy the rules for exclusion of the benefit under another Tax Code section. Each of the allowed cafeteria plan benefits could be provided under different IRC sections as nontaxable employer-paid fringe benefits, and each must meet both the cafeteria plan qualifications and their individual requirements.

In addition, a cafeteria plan may offer benefits that are nontaxable because they are attributable to after-tax employee contributions.

Example: A cafeteria plan offers participants the opportunity to purchase, with after-tax employee contributions, coverage under an accident or health plan that provides for the payment of disability benefits. If the participant becomes disabled, benefits received are nontaxable, since the premiums were paid by the employee on an after-tax basis.

Nonqualified Deferred-Compensation Plans

A nonqualified deferred-compensation (NQDC) plan is usually used as a way to compensate certain key employees. Examples include employees who have an ownership interest in the business and highly compensated executives. Since the plan is nonqualified, it is generally not subject to discrimination rules, ERISA requirements or limits on employer contributions.

IRS ATG. The IRS issued an Audit Techniques Guide (ATG) dated June 2015 that focuses on NQDC plans. The ATG provides IRS examiners with a roadmap to some of the issues and what to watch for when reviewing plans. It also indicates issues that could trigger audit challenges, which may be helpful to tax professionals and employers. Search for "nonqualified deferred" at **www.irs.gov** to access the ATG.

Requirement for Tax-Deferred Treatment

Unlike qualified plans, in order for an employee to receive tax-deferred treatment, an NQDC plan must either be unfunded, or plan assets must be subject to a substantial risk of forfeiture.

Caution: IRC Sec. 409A imposes restrictions on when deferred compensation payouts can be received and on subsequent elections to change the form of payment or delay payments. Arrangements allowing deferred compensation recipients inappropriate levels of control or access to deferred amounts do not result in income deferral.

Proposed regulations. The IRS issued proposed regulations on June 22, 2016 on NQDC plans under IRC Sec. 409A that clarify or modify specific provisions of the final regulations issued in 2007. The proposed regulations are effective when finalized; however, taxpayers may rely on them until the final rules are published (Prop. Regs. 1.409A-1, 1.409A-2, 1.409A-3, 1.409A-4, and 1.409A-6).

Constructive Receipt

Income is taxable to an employee when constructively received.

Events that can trigger constructive receipt:
- Assets become transferable.
- Risk of forfeiture lapses so that assets become secure.
- Substantial vesting occurs.
- Economic benefit occurs.

Events not considered to trigger constructive receipt:
- Payments to an account where an employee must provide future services before being eligible to receive money from the account.
- Inability to fix value of noncash compensation.
- Plan assets at risk from creditors.
- Unfunded plans.

Tax consequences to employer. Nonqualified deferred-compensation payments are deductible by the employer in the year an amount attributable to the employer contribution is includible in the employee's gross income [IRC Sec. 404(a)(5)].

Permitted Cafeteria Plan Benefits

Prop. Reg. 1.125-1(a)(3); IRS Notices 2004-2, 2004-50, and 2008-59

Tax-Free Benefits	*Taxable Benefits*
• Accident and health insurance premiums[1, 2] including for accidental death or dismemberment insurance and dental insurance. • Premiums for COBRA coverage. • Contributions to Health Savings Accounts. • Flexible spending account (FSA) arrangements for medical expenses (up to $2,750 in 2020), adoption expenses (up to $14,300 in 2020), or dependent care assistance (up to $5,000). • Contributions to a 401(k) plan. • Group-term life insurance coverage (up to $50,000). • Disability insurance coverage. • Dependent care assistance (up to $5,000). • Adoption assistance benefits (up to $14,300 in 2020).	• Premiums for group-term life insurance over the $50,000 tax-free coverage limit. • Medical coverage, group-term life insurance coverage, and benefits under a dependent care assistance program that are taxable income to the recipient employee because applicable nondiscrimination requirements for these benefits are not met.

[1] **Caution:** Qualified health plans offered through an insurance exchange generally cannot be offered as a qualified benefit under a cafeteria plan. However, an exception allows qualified employers (generally no more than 50 employees during the preceding calendar year, but states can increase this to 100 employees) offering coverage through a marketplace's Small Business Health Options Program (SHOP) to permit employees to pay for the coverage with pre-tax dollars through the employer's cafeteria plan [IRC Sec. 125(f)(3)].

[2] An employer can exclude from an employee's income payments made for the substantiated cost of health insurance coverage provided to the employee through his spouse's employer's group health plan, but only to the extent the employee's spouse paid for all or part of the coverage on an after-tax basis and not with pre-tax dollars under a Section 125 cafeteria plan (CCA 201547006).

ALV by a fraction, using four times the number of days of availability as the numerator and 365 as the denominator [Reg. 1.61-21(d)(4)]. However, employers can elect to treat the auto as having been available for 30 days (even though the actual period of availability was less than 30 days), which results in a lower imputed income amount whenever the car is available for personal use for more than seven (but less than 30) days.

Auto Lease Value Table Reg. 1.61-21(d)(2)	
Automobile FMV	*Annual Lease Value*
$ 0 to 999	$ 600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350
8,000 to 8,999	2,600
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250
If FMV > $59,999, ALV equals (.25 × FMV) + $500.	
Employer-provided fuel must be added at FMV or at 5.5¢ per mile.	

Determining the car's FMV. If the employer bought the car in an arm's-length transaction, its cost (including applicable sales tax, title fee, and other transaction costs) can be used as FMV.

If the employer leases the auto, the manufacturer's suggested retail price (including applicable sales tax, title fees, and other transaction costs) less 8% can be used as the safe-harbor FMV figure. Or, a leased auto's FMV can be determined by reference to the retail value of the auto as reported by a nationally recognized pricing source. Finally, for leased autos, the employer can use the manufacturer's invoice price (including applicable options) plus 4% as the auto's FMV (Notice 89-110).

Commuting Value Method

In rather limited circumstances, an employee's personal use of a company car can be valued at $3 per round-trip to and from work ($1.50 per one-way commute) [Reg. 1.61-21(f)]. If multiple employees commute in the same vehicle, the imputed personal use income for each is $3 per round trip/$1.50 per one-way commute.

Requirements for Commuting Value Method	
Requirement	***Description***
Employee required to commute in the employer provided vehicle	For valid business reasons, the employee is required to commute to work in the vehicle (for example, a job requires 24-hour on-call availability).
Personal use prohibited	The employer has an enforced, written policy that prevents the employee (and/or anyone whose use would be taxable to the employee, such as a spouse) from using the car for personal reasons other than commuting to and from work.[1]
No personal use occurs	The employee does not actually use the car for personal use other than commuting.[1]
Employee is not a control employee	A control employee is: • Officer with compensation ≥ $115,000 (for 2020);[2] • Director; • Employee with compensation ≥ $230,000 (for 2020) or[2] • Owner of 1% or more of the employer's equity, capital or profits.
[1] *De minimis* personal use (such as a trip to the grocery store on the way home from work) is allowed. [2] Notice 2019-59.	

Safety Requirement for Commuting

The TCJA specifically allows the employer to take an income tax deduction for expenses incurred or paid for providing transportation, or any payment or reimbursement, to an employee for travel between the employee's residence and place of employment when necessary for ensuring the safety of the employee [IRC Sec. 274(l)(1)]. Other expenses for such travel are specifically disallowed. At the time of this publication, the IRS had not provided guidance on how to determine what expenses are considered necessary to ensure the safety of an employee. Practitioners should be alert for additional information.

Cents-per-Mile Method

Sometimes, the standard business mileage rate (57.5¢ for 2020) can be used to value an employee's personal use of a company car [Reg. 1.61-21(e); Rev. Proc. 2019-46; Notice 2020-5]. If the employer does not provide or pay for fuel, the cents-per-mile rate can be reduced by up to 5.5¢ per mile.

Requirements for Cents-per-Mile Method	
Requirement	***Description***
Period of Use **OR** **Required Mileage**	The employer must expect that the car will be used regularly for business for the entire year (or, if less, the time the employer owns the car) OR The car must be driven (primarily by employees) at least 10,000 miles (pro-rated if not owned the entire year) during the calendar year.
Cap on FMV	The car's FMV may not exceed $50,400 (2020 amounts per Notice 2020-5).

In general, the employer must adopt the cents-per-mile method for an auto by the first day an employee uses it for personal purposes. Once the cents-per-mile method is used for an auto, it must be used as long as that auto is eligible for it. But, if an auto later qualifies for the commuting value method, that method can be used even though the cents-per-mile method was used earlier.

Note: See *Final regulations on personal use of employer-provided vehicles* on Page K-19.

COVID-19 Tax Alert: An employer using the ALV method for the 2020 calendar year may instead use the cents-per-mile method beginning on March 13, 2020 if, at the beginning of 2020, the employer reasonably expected that an automobile with an FMV not exceeding $50,400 would be regularly used in its trade or business throughout the year, but due to the COVID-19 pandemic the automobile was not so used (Notice 2021-7).

Recordkeeping Requirements

An employee may not exclude from income any portion of the value of an employer-provided automobile unless the use is substantiated by records.

The records should contain (Temp. Reg. 1.274-5T):

- Date of each use.
- Mileage per trip.
- Business purpose of the trip.
- Description of destination, business purpose, benefit derived, etc. (for travel outside tax home area).
- Total mileage for the year.

Records must be kept at or near the time of the use. If there are no written records, the employee may provide a statement containing information related to the automobile's use or may provide other corroborative evidence sufficient to establish use. However, without written records, the IRS may disallow the exclusion from income.

Reporting Employee Personal Use on Business Tax Return

When the personal use of a company car is included in an employee's wages as taxable compensation, the employer recovers the cost of the car as if it were used entirely for business purposes. Section A in Part V of Form 4562 on the employer's tax return would then show business-use percentage as 100%.

Retirement Plan Law Changes

SECURE Act

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, enacted December 20, 2019, contained provisions affecting individuals, employer plans, plan administration, and penalties. Here is a quick summary of the most relevant retirement plan provisions—

- Raises the required minimum distribution (RMD) age from 70½ to 72 effective for individuals who reach age 70½ after December 31, 2019.
- Modifies the post-death RMD rules for those who die after December 31, 2019 (with certain exceptions).
- Allows penalty-free plan withdrawals for expenses related to the birth or adoption of a child after December 31, 2019.
- Expanded the definition of *compensation* for IRA contribution limit purposes. Effective December 20, 2019, difficulty-of-care payments are treated as compensation for determining nondeductible IRA contributions limits even though these payments are excluded from gross income. For defined contribution plans, this applies to plan years beginning after December 31, 2005.
- Provides that compensation for IRA contribution limit purposes includes any amount included in an individual's gross income and paid to the individual in the pursuit of graduate or postdoctoral study for years beginning after December 31, 2019.
- Reinstates for one year the exclusion for qualified state or local tax benefits and qualified payments to volunteer emergency responders for tax years beginning in 2020.
- Allows a small employer automatic enrollment credit for certain retirement plans for tax years beginning after December 31, 2019.
- Annual limit on the credit for small employer pension plan start-up costs increased to a maximum of $5,000 per year for plan years beginning after December 31, 2019.
- Increases the maximum default rate under the automatic enrollment safe harbor from 10% of pay to 15% for plan years beginning after December 31, 2019.
- Requires expanded coverage by 401(k) plans for long-term part-time employees who have worked more than 500 hours per year with the employer for at least three consecutive years for plan years beginning after December 31, 2020.
- Eases notice requirements and amendment timing rules to facilitate adoption of nonelective contribution 401(k) safe harbor plans for plan years beginning after December 31, 2019.
- Allows qualified plans adopted by the filing due date to be treated as in effect as of the close of the tax year effective for plans adopted for tax years beginning after December 31, 2019.
- Allows a group of qualified plans to file a consolidated Form 5500 effective for plan years beginning after December 31, 2021.
- Increases the penalties for failure to file retirement plans to $250 per day for returns due after December 31, 2019.

CARES Act

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, enacted March 27, 2020, provided two significant relief measures for retirement plans.

Required minimum distribution (RMD) waiver. The RMD rules are waived for eligible retirement plans for calendar year 2020. An eligible retirement plans includes those described in (1) a defined contribution plan, as described in Sections 401(a), 403(a), or 403(b); (2) a Section 457(b) eligible deferred compensation plan, but only if the plan is maintained by an employer described in IRC Sec. 457(e)(1)(A); or (3) an individual retirement plan. Notice 2020-51 provides questions and answers regarding the waiver of 2020 RMDs and a sample plan amendment.

This provides relief to individuals who would otherwise be required to withdraw funds from such retirement accounts during the economic slowdown due to COVID-19. In addition to RMDs required for the 2020 tax year, the waiver includes RMDs that are due by April 1, 2020 because the account owner turned 70½ in 2019.

Retirement plan distributions penalty waiver. Consistent with previous disaster-related relief, the CARES Act waives the Section 72(t) 10% early withdrawal penalty for distributions up to $100,000 from IRAs and defined contribution qualified retirement plans [such as 401(k) plans] made for coronavirus-related purposes on or after January 1, 2020 and before December 31, 2020. Income attributable to these distributions will be subject to tax over three years, and the taxpayer may recontribute the funds to an eligible retirement plan within three years after receipt without regard to that year's cap on contributions. Employers are permitted to amend defined contribution plans to provide for these distributions.

Additionally, defined contribution plans are permitted to allow plan loans up to $100,000, and repayment of existing plan loans is extended for employees who are affected by the coronavirus.

A coronavirus-related distribution is any distribution made to an individual (1) who is diagnosed with COVID-19; (2) whose spouse or dependent is diagnosed with COVID-19; or (3) who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business owned or operated by the individual due to COVID-19, or other factors as determined by the Secretary of the Treasury. Notice 2020-50 expanded the definition of who is a *qualified individual* to take into account additional factors such as reductions in pay, rescissions of job offers, and delayed start dates with respect to an individual, as well as adverse financial consequences to an individual arising from the impact of COVID-19 on the individual's spouse or household member.

Disaster Relief Alert: Special rules apply for distributions and loans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)* on Page Q-1 and *December 2020 Legislation* on Page Q-1.

Qualified Retirement Plans

A qualified retirement plan is one of the best tax-saving tools available, since the plan contributions are deductible by the employer and tax deferred to the employee. The rules governing retirement plans are lengthy and complex. Some of the general rules are covered below. For more coverage see the *IRA and Retirement Plan Quickfinder® Handbook*.

Disaster Relief Alert: Special rules apply for distributions and loans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* on Page Q-1 and *December 2020 Legislation* on Page Q-1.

Law Change Alert: Previously a qualified plan must have been adopted prior to the end of the plan year. However, due to provisions in the SECURE Act, for plan years beginning after December 31, 2019 an employer may adopt a plan retroactively to the last day of a plan year if the plan is adopted by the due date (including extensions) of the employer's tax return for the tax year.

Qualified retirement plans fall into two basic categories:

- Defined-contribution plans.
- Defined-benefit plans.

1) *Defined-contribution plans* provide benefits based on the amount contributed to an employee's individual account plus any income, expenses, gains, losses, and forfeitures of other employees that are allocated to the account [IRC Sec. 414(i)]. Plan contributions are determined by formula and not by actuarial requirements (except for target benefit plans).

Defined-contribution plans include:
   - Profit-sharing plans.
   - Target benefit plans.
   - Stock bonus plans.
   - Employee stock ownership plans (ESOPs).
   - Thrift or savings plans.
   - 401(k) plans.

2) *Defined-benefit plan.* Any qualified retirement plan that is not considered a defined-contribution plan [IRC Sec. 414(j)]. Under a defined-benefit plan, the annual retirement benefits must be definitely determinable using a formula contained in the plan. Forfeitures under a defined-benefit plan cannot be used to increase the benefits any employee would otherwise receive under the plan. Benefits under a defined benefit plan are fixed under a definite formula. Typically, the formula expresses the benefits in one of the following ways:
   a) *Fixed benefit plan.* A certain percentage of an employee's compensation averaged over the employee's entire career or a limited number of years.
   b) *Flat benefit plan.* A specified or *flat* dollar monthly payment.
   c) *Unit credit plan.* A certain unit percentage of compensation or dollar amount for each year of service with the employer.

   The amount of the employer contributions to a defined benefit plan is determined annually by an actuary.

Annual Limitations to Qualified Plans

Defined-contribution plan. The annual addition to any participant's account is the sum of the following: (1) employer contributions, plus (2) employee contributions, plus (3) forfeitures.

IRC Sec. 415(c)(1) limits contributions and other additions to a participant's account to the lesser of $57,000 for 2020 or 100% of the participant's compensation. In addition, IRC Sec. 404(a)(3) limits the deduction for contributions to stock bonus and profit-sharing plans to the greater of 25% of compensation paid to all beneficiaries under the plan or the amount the employer is required to contribute if it is a SIMPLE plan.

If a defined-contribution plan is combined with a defined-benefit plan, IRC Sec. 404(a)(7) limits the total deductible amount to the greater of 25% of compensation paid to all beneficiaries under the plan or the amount contributed to the defined-benefit plan needed to satisfy minimum funding standards of IRC Sec. 412. Additional limits apply to employee elective deferrals under 401(k) and 403(b) plans (see the *2020 Employer and Self-Employed Retirement Plan Chart* on Page K-4).

Defined-benefit plan. Annual limitations apply to the payment of benefits with respect to an employee. Under IRC Sec. 415(b), the annual retirement benefit is limited to the lesser of:

1) $230,000 for 2020 or
2) 100% of the employee's average compensation for the highest three years.

Since a defined-benefit plan provides a predetermined annual retirement benefit, the deduction limitation for contributions to the plan under IRC Sec. 404(a)(1)(A) is the amount necessary to fund such benefits that are provided to the beneficiaries of the plan. Minimum funding standards under IRC Sec. 412 are designed to prevent employers from coming up short when the time comes to pay out benefits. For example, a self-employed individual with net earnings above $230,000 for at least three years could set up a defined-benefit plan and deduct contributions (for 2020) in the amount necessary to fund the plan so that it will provide an annual retirement benefit of $230,000.

Elective Deferrals Not Taken Into Account for Purpose of Deduction Limits

The definition of compensation is not reduced by certain employee elective deferral amounts, and the employee elective contributions are not taken into account when calculating the employer's annual deduction limitation. This rule applies to employee salary reduction contributions to:

1) 401(k) plans,
2) SARSEPs,
3) 403(b) plans (plans of exempt organizations and public schools), and
4) SIMPLEs.

This rule applies to the 25% of compensation limit on employer deductions under [IRC Sec. 404(n)]:

1) IRC Sec. 404(a)(3) for contributions to stock bonus and profit-sharing trusts,
2) IRC Sec. 404(a)(7) for combinations of defined-benefit and defined-contribution plans,
3) IRC Sec. 404(a)(9) for ESOPs where the contributions are used to repay loan principal incurred to acquire employer securities, and
4) IRC Sec. 404(h)(1)(C) for SEP contributions.

Tax Advantages of Qualified Retirement Plans

- Employers receive an immediate tax deduction.
- Income earned within the plan fund is tax deferred.
- Employees incur no tax liability until amounts are distributed.
- Qualified distributions can be rolled over tax free.
- If qualifying distributions are made in the form of stock of the employer corporation, tax on the appreciation in the value of the stock is deferred until the stock is sold.

Profit-Sharing Plans

A profit-sharing plan is a defined-contribution plan to which the company agrees to make substantial and recurring, though gen-

erally discretionary, contributions. Contributions are invested and accumulate tax deferred for eventual distribution to participants or their beneficiaries either at retirement, after a fixed number of years or upon the occurrence of some specified event (that is, disability, death, or termination of employment).

Contributions to a profit-sharing plan are usually linked to the existence of profits. However, neither current nor accumulated profits are required for a company to contribute. Even if the company has profits, it can generally forego or limit its contribution for a particular year if the plan contains a discretionary formula.

Section 401(k) Plans

What distinguishes the 401(k) plan from other qualified defined-contribution plans is its employee salary deferral feature. Employers are not required to make matching contributions to the plan, although many plans are set up where there is a combination of employee salary deferrals and discretionary employer contributions. When the employer makes contributions to the plan, they can either be in the form of a match of employee salary deferrals, or based on a percentage of employee compensation. Thus, when the employer makes discretionary contributions to a 401(k) plan, it is actually a profit-sharing plan.

Contributions to the plan are excluded from gross income for federal income tax, but must be included in the FICA taxable wage base as well as in the FUTA taxable wage base.

See the *2020 Employer and Self-Employed Retirement Plan Chart* on Page K-4 for 401(k) contribution limits.

Other Employer Retirement Plans

Disaster Relief Alert: Special rules apply for distributions and loans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)* on Page Q-1 and *December 2020 Legislation* on Page Q-1.

SIMPLEs

Savings incentive match plans for employees. Qualified employers (including self-employed individuals) may establish Section 408(p) SIMPLE retirement plans. A SIMPLE is a written salary reduction arrangement that allows eligible employees to defer compensation tax free and employers to make either matching contributions for employees who elect to participate, or nonelective contributions for all eligible employees (including those who do not elect to participate).

SIMPLEs do not fall under the complicated 401(k)-type rules that require a certain level of employee participation. A SIMPLE can operate as an IRA with an individual account set up for each employee (SIMPLE IRA) or in a 401(k) format with contributions made to a trust or annuity contract [SIMPLE 401(k)]. Both types of plans have many common requirements (differences are noted):

Qualified employers/employees:

1) The employer must have 100 or fewer employees who earned $5,000 or more during the preceding calendar year,
2) The employer cannot currently maintain another qualified plan (except for certain union employees),
3) Employees must receive at least $5,000 in compensation from the employer during any two preceding years (not necessarily the immediately preceding two years), and be reasonably expected to receive at least $5,000 in the current year, and
4) Eligible employees may participate in another employer's qualified plan, but are subject to the combined elective deferral limitations of $19,500 for 2020—Notice 2019-59) for all plans. An employee who is age 50 or older can contribute an additional $6,500 for a total of $26,000 for 2020).

Contributions:

1) Employer contributions must either:
   - Match employee contributions dollar for dollar up to 3% of employee compensation,
   - Match employee contributions up to a reduced percentage of employee compensation, not less than 1% of compensation and not for more than two out of any five years [this employer election is not available for SIMPLE 401(k) plans] or
   - Be nonelective contributions equal to 2% of compensation for all eligible employees.
2) Employee elective deferrals cannot exceed the lesser of $13,500 for 2020 ($16,500 if age 50 or over—$13,500 plus $3,000 catch-up limit) or total compensation for the year.
3) Compensation limit for qualified plans ($285,000 for 2020) does not apply to the 3% matching contributions to SIMPLE IRAs. The compensation limit does apply to the 2% nonelective contributions, and to any matching contributions to SIMPLE 401(k) plans.
4) Employer contributions are excluded from employee wages for both income and employment tax purposes (FICA and FUTA). Contributions made by employees and self-employed individuals are subject to employment taxes (SE, FICA, and FUTA). (Notice 98-4, Q&A I-1)
5) A self-employed individual's compensation for purposes of employee deferrals and employer matching is defined as the amount entered on line 6, Part I of Schedule SE (Form 1040), before subtracting any contributions made to a SIMPLE IRA on behalf of the self-employed individual.

Example: In 2020, Nell's share of partnership profits (boxes 1 and 14, Part III of Schedule K-1, Form 1065) equals $15,000, which is reported on Schedule E and line 2 of Schedule SE, Form 1040. Nell contributes $10,000 to a SIMPLE as an employee deferral. Compensation for purposes of the employer's match is $13,853 ($15,000 × .9235, line 4a of Schedule SE). The employer's 3% match equals $416 ($15,000 × .9235 × 3%). Nell's Schedule K-1 reports $10,416 in box 13, Code R as total contributions to her SIMPLE. Nell deducts $10,416 on Schedule 1, Form 1040. A similar calculation is made for Schedules C and F filers.

Distributions are taxed like IRAs (except the 10% early withdrawal penalty is increased to 25% if made within first two years of participation) [IRC Sec. 72(t)(6)].

Disaster Relief Alert: Generally, Section 72(t) will not apply to qualified distributions and certain loans from qualified plans to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)* on Page Q-1 and *December 2020 Legislation* on Page Q-1.

Law Change Alert: See *Retirement plan distributions penalty waiver* on Page K-21 for relief included in the CARES Act.

Other requirements (Notice 98-4):

1) The employer and employee contributions must be 100% vested at all times.
2) The employer (or self-employed person) must deposit employee (or his own) elective deferrals as soon as reasonably possible, but no later than 30 days after the end of the month during which the contributions were withheld from wages.
3) The employer contribution must be made by the due date of the employer's income tax return, including extensions.

Simplified Employee Pensions (SEPs)

See the *2020 Employer and Self-Employed Retirement Plan Chart* on Page K-4.

Accounting Methods and Principles

See IRS Pub. 538

Tab L Topics

Accounting Methods

An accounting method determines timing of income and expenses. An accounting method must clearly reflect income.

Consistency rule. IRC Sec. 446(a) states that for tax purposes, income must be computed under the same method used for books. However, because of conflicts between tax and financial accounting rules, such as differences between generally accepted accounting principles (GAAP) and tax treatment of certain items, the IRS generally considers the consistency rule met if the taxpayer's books can be readily reconciled with the tax return. For example, a taxpayer using an accrual method for internal books was allowed to use the cash method for tax purposes (Rev. Rul. 68-35).

A taxpayer must apply the same accounting method to all transactions within a particular trade or business. If a taxpayer owns more than one trade or business, a different accounting method may be used for each. The businesses must be separate and distinct, including separate books, and the combination of methods must clearly reflect income.

Choosing an Accounting Method

A taxpayer chooses a tax accounting method by using the particular method on its first tax return and checking the appropriate box on the return. The method actually used to compute taxable income the first year appears to control even if different from the method indicated by checking the box. Any subsequent change in accounting method generally requires IRS consent. Under certain circumstances, automatic consent for change of accounting method is available. See *Change in Accounting Method* on Page L-4.

The cash method is the simplest, and is used by most small businesses. However, not all taxpayers are allowed to use the cash method. See *Limitations on Use of Cash Method* on Page L-2.

The accrual method measures earnings more accurately than the cash method since it records income and expenses in the period to which they apply, instead of simply reflecting cash flow.

The choice of accounting methods is not limited to accrual or cash. Special methods, including combinations of methods, may be allowed or required under various provisions of the Tax Code.

For a comparison of the accrual and cash methods, see the *Cash and Accrual Accounting Methods—Treating Commonly Encountered Items* on Page A-6.

Cash method income is reported when constructively received. Constructive receipt occurs when money or property is available for use by the taxpayer without any restrictions. For example, a check is received by a cash basis taxpayer on December 31, 2020 but it is not deposited until January of 2021. Constructive receipt occurs and income is recognized in 2020.

Cash method expenses generally are deductible when actually paid. However, special rules apply to prepaid expenses. See *Prepaid Expenses* on Page L-4.

Accrual method income is reported when (1) all the events fixing the entity's right to the income have occurred and (2) the amount can be determined with reasonable accuracy [IRC Sec. 451(b)(1)(C)]. The first part of the test (the right to the income is fixed) is met on the earliest of (1) the date the required performance occurs, (2) the date payment is due, or (3) the date payment is made (Rev. Rul. 2003-10).

The all-events test for recognizing income is met no later than when the income is recognized on the taxpayer's (1) applicable financial statement (AFS) or (2) other financial statement as specified by the IRS [IRC Sec. 451(b)(1)(A)]. This is referred to as the *AFS income inclusion rule* in ~~Prop.~~ Reg. 1.451-3(b). Rev. Proc. 2018-60 outlines automatic consent procedures for accounting method changes to comply with applicable financial statement (AFS) conformity in IRC Sec. 451(b). Rev. Proc. 2018-60 also provides streamlined method change procedures for certain taxpayers where the change results in a zero Section 481(a) adjustment or if the taxpayer filing the change meets the *small business taxpayer* definition in IRC Sec. 448(c). The streamlined method procedures waive the requirement to file a Form 3115. Instead, taxpayers can comply with IRC Sec. 451(b) by filing a federal income tax return that conforms to the method. The procedures in Rev. Proc. 2018-60 are incorporated into sections 15.01 and 16.12 of Rev. Proc. 2019-43.

Note: If a taxpayer's financial results are reported on an AFS for a group of entities, the AFS for that group is the AFS for the taxpayer [IRC Sec. 451(b)(5)]. Also, if the taxpayer has a contract that contains multiple performance obligations, the allocation of the transaction price to each obligation is equal to the amount allocated to that obligation for including it in revenue in the AFS [IRC Sec. 451(b)(4)].

Practice Tip: The AFS income inclusion rule *does not*:

- Require income recognition if tax realization hasn't occurred [for example, a taxpayer is not required to recharacterize a sale as a lease (or vice versa) to conform to its AFS].
- Prevent taxpayers from using special methods of accounting, such as the installment method or long-term contract methods [IRC Sec. 451(b)(2); ~~Prop.~~ Reg. 1.451-3(b)(3)].
- Apply to taxpayers without an AFS or other financial statement specified by the IRS [IRC Sec. 451(b)(1)(B)(i)].
- Apply to income in connection with a mortgage servicing contract [IRC Sec. 451(b)(1)(B)(ii); ~~Prop.~~ Reg. 1.451-3(b)(3)] (taxpayers will continue to use pre-TCJA law, which recognizes income upon the earlier of when it is earned or received).
- Prevent revenue from being recognized for tax purposes *before* it is reported on an AFS.
- Require accrued market discount under IRC Sec. 1276 to be included in income (Notice 2018-80).

Accrual method expenses are reported in the period to which they apply, without regard for when the expenses are paid. Expenses are deducted or capitalized when (1) the taxpayer becomes liable for the expense, (2) the amount can be determined with reasonable accuracy, and (3) economic performance occurs [Reg. 1.461-1(a)(2)].

Economic performance occurs at the time property or service is provided or used. For example, a calendar-year taxpayer takes delivery of supplies in December 2020, but does not make payment until January 2021. Under the accrual method, since the taxpayer became liable and economic performance (delivery) occurred in 2020, the expense is reported in 2020.

A taxpayer using the accrual method of accounting incurs a liability for services or insurance at the earlier of (1) the occurrence of the event fixing liability or (2) the payment due date (Rev. Rul. 2007-3). An accrual-basis taxpayer can take a deduction (or add a cost to its basis in property) in the year of payment if it reasonably expects the property or services to be provided within 3½ months of payment [Reg. 1.461-4(d)(6)(ii)].

Economic performance typically occurs as services or property are provided to, or ratably as property is used by, the taxpayer unless the recurring item exception applies. Accrual method taxpayers are required to recognize lease liabilities ratably over the lease period unless the liability was immaterial or early expense recognition results in a better matching of expenses and income (Rev. Rul. 2012-1).

Effective for tax years ending on or after July 30, 2015, the IRS has issued guidance for accrual method taxpayers to treat economic performance as occurring ratably on contracts that provide services on a regular basis. Under this safe harbor, a taxpayer can ratably expense the cost of regular and routine services as provided. The guidance defines a *Ratable Service Contract* and provides examples of what will and will not satisfy the definition. Examples of services that may qualify include contracts for regular janitorial and landscape maintenance. Contracts that provide for a single deliverable (for example, an environmental impact study) will not qualify (Rev. Proc. 2015-39).

Hybrid method. Here, two or more accounting methods are combined. The most common hybrid method is used by taxpayers with inventory, accounting for purchases and sales of inventory using the accrual method, and accounting for service income and related expenses using the cash method. The combination of methods must clearly reflect income and be consistently used. For example, if the accrual method is used to report income, it must also be used to report related expenses.

If a combination of methods includes the cash method, the accounting method is treated as the cash method for purposes of limitations on use of the cash method.

Limitations on Use of Cash Method

Post-2017. For tax years beginning in 2018, the TCJA significantly expanded the availability of the cash method by replacing more limited exceptions to the accrual method available under prior law with a $25 million gross receipts test [IRC Sec. 448(c)(1)]. The $25 million ($26 million for 2020) gross receipts test applies regardless of whether the purchase, production, or sale of merchandise is an income-producing factor.

Gross receipts test. A corporation or partnership satisfies the $25 million ($26 million for 2020) gross receipts test for any tax year the taxpayer seeks to use the cash method if average annual gross receipts for the three-year period preceding the current tax year does not exceed $25 million ($26 million for 2020). Taxpayers are no longer required to have satisfied the three-year average test for all prior years as was necessary under prior law.

Other excepted businesses. Both farming businesses and qualified PSCs are eligible to use the cash method without having to satisfy the $25 million ($26 million for 2020) gross receipts test.

1) *Farming businesses* (including the operation of a nursery or sod farm and the raising, harvesting, or growing of trees bearing fruits, nuts, or other crops, or ornamental trees). An evergreen tree more than six years old at the time severed from the roots shall not be treated as an ornamental tree [IRC Sec. 448(d)(1)].
2) *Qualified PSCs* in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, and substantially all of the stock of which (by value) is held by employees, retired employees or their estates [IRC Sec. 448(d)(2)].

Tax shelters, including partnerships and other entities (but not C corporations) where more than 35% of losses are allocated to limited partners or limited entrepreneurs {persons who have an interest in an enterprise other than as a limited partner and do not actively participate in management [IRC Sec. 461(k)(4)]}, are prohibited from using the cash method [IRC Secs. 448(d)(3), 461(i)(3), and 1256(e)(3)].

Note: ~~Prop.~~ Reg. 1.448-2(b)(2)(iii)(B) permits entities to annually elect to determine syndicate status by looking at whether they allocated more than 35% of their losses to limited owners in the prior year. Entities making this election must attach a statement to their timely-filed federal income tax return (including extensions) that this election is made for that tax year. ~~Once made this election may not be revoked earlier than the fifth tax year following the first tax year for which the election was made unless extraordinary circumstances are demonstrated to the satisfaction of the IRS.~~

Gross receipts includes all receipts recognized under the method of accounting used by the taxpayer for that tax year [Temp. Reg. 1.448-1T(f)(2)(iv)]. It includes sales (net of returns and allowances), credit card payments and amounts received from services, bartering, interest, dividends, rents, royalties, and annuities. Failure to include payments reported on Form 1099-K (Payment Card and Third Party Network Transactions) could raise questions with the IRS.

Automatic accounting method change. Taxpayers (other than tax shelters) that meet the $25 million ($26 million for 2020) gross receipts test (*small business taxpayers*) and wish to make any of the following accounting method changes must use the automatic change procedures in Rev. Procs. 2015-13 and 2019-43 (or any successors): (1) from the overall accrual method to the overall cash method; (2) from capitalizing costs under IRC Sec. 263A to no longer capitalizing such costs; (3) from a Section 471 method of accounting for inventory items to (a) treating inventory as non-incidental materials and supplies or (b) conforming to the taxpayer's method of accounting reflected in its applicable financial statements or books and records; and (4) for (a) exempt long-term construction contracts, from the percentage-of-completion method to an exempt contract method or (b) home construction contracts, from capitalizing costs under IRC Sec. 263A to not capitalizing such costs. In addition, the IRS has waived the five-year restriction on eligibility for making automatic changes for a taxpayer's first, second or third year beginning after 2017 (Rev. Proc. 2018-40).

Note: The IRS has issued ~~proposed~~ regulations for TCJA's simplified tax accounting rules for small businesses (TD 9942). The ~~proposed~~ regulations implement statutory changes and provide clarifying definitions. The ~~proposed~~ regulations also provide guidance for small businesses with long-term construction contracts and the requirements for exemption from the percentage-of-completion method and the Section 263A rules. For taxpayers with income from long-term contracts reported under the percentage-of-completion method, guidance is provided for applying the look-back method after the repeal of the corporate alternative minimum tax and the enactment of the base erosion and anti-abuse tax (BEAT).

Accounting Methods for Inventory

Also see *Inventories* on Page L-7.

Under the general rule, taxpayers are required to use the accrual method for purchases and sales of inventory, even if ending inventory is always zero [Reg. 1.446-1(c)(2)(i)]. A taxpayer with inventory may use the overall accrual method or a hybrid method using accrual for purchases and sales of inventory, and cash for other income and expenses.

Beginning in 2018, taxpayers that meet the $25 million ($26 million for 2020) gross receipts test may use an accounting method for inventories that either treats inventories as non-incidental materials and supplies or conforms to the taxpayer's financial accounting treatment of inventories [IRC Sec. 471(c)].

Materials and supplies. Purchases and sales of materials that do not fall under the category of inventory may be accounted for under the cash method. However, a cash basis taxpayer may not deduct the cost of nonincidental materials until they are actually used or consumed, or until the taxpayer pays for the items, whichever is later. See *Costs to Acquire Tangible Property* on Page J-8 and *Materials and supplies* on Page O-3 for more information.

Other Accrual Method Matters

Nonaccrual experience (NAE) method permits accrual method taxpayers to not accrue income that, based on their experience, they do not expect to collect [Reg. 1.448-2(a)].

A taxpayer may compute its uncollectible amount by multiplying the portion of the year-end allowance for doubtful accounts attributable to current year NAE-eligible accounts receivable on its applicable financial statement by 95% (Rev. Proc. 2011-46).

Bonuses to a group of eligible employees are deductible for an accrual method taxpayer who becomes obligated to pay a fixed amount of bonuses at the end of the year in which services were rendered, even though the employer does not know the identity of recipients or the amount of bonus payable to each until after the end of the tax year (Rev. Rul. 2011-29). However, if an employee leaves the company after year end but before bonuses are paid, and the bonus reverts back to the company (instead of being reallocated to other employees), the deduction is allowed only in the year paid (CCA 201246029).

Advance payments for certain services to be performed or goods to be provided in a later tax year must be included in gross income by an accrual method taxpayer in the year of receipt unless the taxpayer elects to defer recognition to the following tax year. However, the one-year deferral is not available for any portion of the advance payment that must be recognized in the year received under the AFS income inclusion rule discussed at *Accrual method income* on Page L-1. The remaining portion of the advance payment is included in gross income in the tax year following the tax year of receipt. This one-year deferral method can be used even if the agreement term extends beyond the end of the following tax year. If the deferral election is made, it is an accounting method that applies to the current and all future years unless the taxpayer gets IRS permission to change it [IRC Sec. 451(c)].

Generally, an advance payment is a payment for goods, services or other such items identified by the IRS if including the payment in the year of receipt is a permissible accounting method for tax and, if the taxpayer has an AFS, is included in income in that AFS in a later year [IRC Sec. 451(c)(4)(A); ~~Prop.~~ Reg. 1.451-8(a)(1)(i)].

Advance payments do not include [IRC Sec. 451(c)(4)(B); ~~Prop.~~ Reg. 1.451-8(a)(1)(ii)]:

1) Rent.
2) Life insurance premiums.
3) Payments with respect to financial instruments.
4) Payments with respect to warranty or guarantee contracts under which a third party is the primary obligor.
5) Payments to certain foreign persons subject to tax under IRC Sec. 871(a) or 881 or withholding under IRC Sec. 1441 or 1442.
6) Payments in property to which IRC Sec. 83 applies.
7) Other payments identified by the IRS.

Regulations for advance payments. Taxpayers with an AFS can use the AFS deferral method if they are able to determine the extent to which advance payments are included in revenue in their AFS in the year received. Under the AFS deferral method, taxpayers must include the advance payment, or any portion of that payment, in the tax year received to the extent it is included in their AFS. The remaining portion of the advance payment must be included in income in the tax year following the year in which payment is received [~~Prop.~~ Reg. 1.451-8(c)].

Taxpayers without an AFS that can determine the extent to which advance payments are earned in the year received can use the non-AFS deferral method. Under this method, the taxpayer includes the advance payment in income for the tax year of receipt to the extent that it is earned in that tax year. The remaining portion of the advance payment is included in income in the following tax year [~~Prop.~~ Reg. 1.451-8(d)(3)].

A payment is earned (for the non-AFS deferral method) when the all-events test described in Reg. 1.451-1(a) is met, regardless of when the taxpayer receives it. Taxpayers who are unable to determine the extent to which a payment is earned in the year received may determine that amount using any of the methods described in ~~Prop.~~ Reg. 1.451-8(d)(3)(ii).

~~Although it will not be effective until it is finalized, taxpayers may rely on Prop. Reg. 1.451-8 for tax years beginning after 2017 provided they (1) apply all applicable rules contained in the proposed regulations, and (2) consistently apply the proposed regulations to all advance payments [Prop. Reg. 1.451-8(f)].~~ Rev. Proc. 2019-43, Sec. 16.12, contains guidance for making an automatic change in the taxpayer's method of accounting for advance payments to apply the rules in ~~Prop.~~ Reg. 1.451-8.

The TCJA added IRC Sec. 451(c) for tax years beginning after 2017 to codify the rules for deferring taxability of advance payments received in connection with services and some nonservices previously provided by Rev. Proc. 2004-34. Recognizing that this approach overrides the deferral method found in current regulations, the IRS has issued final regulations that remove Reg. 1.451-5. In addition, the final regulations remove references to Reg. 1.451-5 that are found in other regulations. The final regulations, which adopt without change regulations proposed in October 2018, apply to tax years ending on or after July 15, 2019 (TD 9870).

Example: Fred gives dance lessons and receives in 2020 an advance payment for a two-year contract for 96 lessons. He provides eight lessons in 2020, 48 in 2021, and 40 in 2022. In his accounting records, he recognizes 1/12 of the payment in 2020, 6/12 in 2021, and 5/12 in 2022. For tax purposes, under IRC Sec. 451(c), Fred must include 1/12 of the payment in gross income in 2020 and the remaining 11/12 of the payment in 2021.

The IRS has modified and clarified the advance payment rules for certain gift cards (Rev. Proc. 2011-18, as modified by Rev. Proc. 2013-29).

Service warranty contracts. Taxpayers selling multi-year service warranty contracts in connection with the sale of motor vehicles or other durable consumer goods that, in turn, immediately pay a third party to insure their risks under the contracts are allowed to use a special method of accounting for the advance payments. Under the service warranty income method, income is recognized over the life of the warranty obligation (Rev. Proc. 97-38).

Loyalty discounts. The liability associated with supermarket fuel rewards discounts unclaimed at year end was deductible under the all events test (see *Choosing an Accounting Method* on Page L-1) since there was both an absolute liability and near certainty the liability would soon be discharged [*Giant Eagle, Inc.,* 117 AFTR 2d 2016-1476 (3rd Cir. 2016), *nonacq.*, AOD 2016-03].

Related Parties—Accrual vs. Cash Basis

An accrual basis taxpayer cannot deduct an expense payable to a cash basis related party until the amount is includable in income of the recipient [IRC Sec. 267(a)(2)]. Once the expense is accrued, the rule still applies even if the parties cease to be related before the amount is includable in the income of the recipient. See also *Related-Party Transactions* on Page O-20.

Installment Sales

An installment sale occurs when property is sold and at least one payment is to be received after the end of the tax year [IRC Sec. 453(b)(1)]. Under the installment method, income is reported as payments are received, and gain is recognized based on the gross profit percentage from the original sale. Use of the installment method is generally required unless the taxpayer elects out. A taxpayer who reports the entire gain in the year of sale on a timely filed return (including extensions) has elected out.

See *Installment Sales* on Page N-18 for using the installment sale method when selling a business.

Long-Term Contracts

A long-term contract is a contract for building, installing, construction, or manufacturing that will not be completed within the tax year entered into. Long-term contracts generally must be accounted for using the percentage-of-completion method (PCM) (IRC Sec. 460).

PCM. The taxpayer reports income based on the percentage of the contract that is completed during the tax year. The percentage is computed by dividing contract costs incurred by total estimated costs. The taxpayer includes a portion of the total contract price in gross income as he incurs allocable contract costs. See Reg. 1.460-5 for more details on allocating costs under this method.

Exemptions:

- *Home construction contract.* Exempt when 80% or more of estimated total contract cost is allocated to construction of dwelling units in buildings containing four or fewer dwelling units [IRC Sec. 460(e)].

  Note: *Residential construction contracts* may use a percentage-of-completion/capitalized cost method. See Regs. 1.460-3(c) and 4(e).

- *Other construction contracts.* Exempt if the work will be completed within two years from the commencement of the contract date and meets the $25 million ($26 million for 2020) gross receipts test for the tax year in which the contract is entered into. See *Gross receipts test* on Page L-2.

Note: Exempt long-term contracts may use the completed contract method—the taxpayer reports all income and expenses from the contract in the year of completion.

Look-back rules. Since the PCM computes yearly income based on estimated costs, when the contract is complete, the taxpayer must look back to compare the estimates with the actual final costs (Reg. 1.460-6). The purpose of the look-back rules is to compute interest on either (1) underpayment of tax (estimated costs exceed actual costs) or (2) overpayment of tax (actual costs exceed estimates), resulting in either an amount owed to the IRS or a refund due the taxpayer. See *Automatic accounting method change* on Page L-2 for ~~proposed~~ regulations on the PCM.

***De minimis* rule (look-back).** If estimated costs reported in a look-back year are within 10% of actual costs (both on a cumulative basis), the taxpayer can elect not to apply the look-back rules [IRC Sec. 460(b)(6)]. The exception still applies if additional costs are incurred after the project is completed.

> **Example:** In the final year of a contract, a taxpayer using the PCM looks back to what income would have been if actual costs had been used:
> Year 1 ..... $20,000 Year 2 ..... $24,000 Year 3 ..... $26,000
> The taxpayer may elect not to apply the look-back rules if cumulative income reported, based on estimates, was:
> Year 1 ..... Between $18,000 and $22,000.
> Year 2 ..... Between $39,600 and $48,400.
> By making the election, the taxpayer does not pay or receive interest on the underpayment or overpayment of tax.

Prepaid Expenses

A prepaid expense is deductible only in the year to which it applies unless it qualifies under the so-called *12-month rule*.

12-month rule. Prepaid expenses are deductible when paid if the rights or benefits to the taxpayer do not extend beyond the earlier of the following [Reg. 1.263(a)-4(f)(1)]:

- 12 months after the right to the benefit begins or
- The end of the tax year after the tax year the payment is made.

> **Example:** On December 1, 2020, ZAP Corp. prepays a $10,000 insurance premium for a property insurance policy with a one-year term beginning February 1, 2021. Because the right or benefit attributable to the $10,000 payment extends beyond the end of the tax year following the tax year in which the payment is made, the 12-month rule does not apply. ZAP must capitalize the $10,000 payment and deduct it over the term of the policy.
>
> *Variation:* Assume the same facts, except that the policy's one-year term begins December 15, 2020. Now, the 12-month rule applies because the right or benefit attributable to the payment neither extends more than 12 months beyond December 15, 2020 (the first date the benefit is realized), nor beyond the end of the tax year following the tax year in which the payment is made. Accordingly, ZAP can deduct the $10,000 when paid.

The IRS gives automatic consent to taxpayers that want to change their accounting method to use the 12-month rule for prepaid expenses. See Rev. Procs. 2006-12 and 2006-37 for guidance. Taxpayers must follow the automatic change procedures of Rev. Proc. 2015-13 (see discussion that follows). Also see *Intangible Assets* on Page O-17 for more information.

Change in Accounting Method

To change an accounting method, a taxpayer generally must receive IRS consent. Under certain circumstances, automatic consent is available. Form 3115 (Application for Change in Accounting Method) is used to request a change in method.

User fees. If the change is not automatic, a user fee of $10,800 applies for all requests received by the IRS after February 1, 2020 (Rev. Proc. 2020-1). Reduced user fees of $7,600 and $2,800 are available for businesses with gross income of less than $1 million or $250,000 respectively. See Rev. Proc. 2020-1, Appendix A, for more information about user fees (the IRS updates and issues a new Rev. Proc. each year). There is no fee for filing Form 3115 if the change in accounting method is eligible for automatic consent.

Note: All user fee payments must be made through **www.pay.gov** (Rev. Proc. 2020-1).

Consent required to change accounting method. Rev. Proc. 2015-13 sets forth procedures for obtaining a nonautomatic change in accounting method.

Automatic consent to change accounting method. Rev. Proc. 2015-13 also sets forth procedures for obtaining automatic consent for a change in accounting method. Highlights of the procedure include:

- Provisions exist for limited relief for late filing of the application on an amended return within six months of the original due date.

3) Redefine how certain types of costs are categorized for purposes of the simplified methods.

In addition, the IRS has provided procedures by which a taxpayer may obtain automatic consent to change to certain accounting methods described in the final regulations (Rev. Proc. 2018-56). The final rules apply to tax years beginning on or after November 20, 2018.

Regulations implement legislative changes to IRC Secs. 263A, 448, 460, and 471 that generally simplify the accounting method rules for small taxpayers. ~~The regulations are proposed to apply to tax years beginning on or after the date they are adopted as final. However, for tax years beginning after 2017, and before adoption as final, taxpayers may rely on the proposed regulations provided they follow all applicable rules for each Code provision they choose to apply (REG-132766-18).~~

~~Prop.~~ Reg. 1.263A-1(j)(2) provides that, in the case of a taxpayer other than a corporation or partnership, the Section 448(c) gross receipts test is applied as if each trade or business of the taxpayer were a corporation or partnership. Except when the Section 448(c)(2) aggregation rules apply:

1) The gross receipts of a taxpayer other than a corporation or partnership take into account the amount of gross receipts derived from all trades or businesses of that taxpayer. Amounts not related to a trade or business of that taxpayer, such as inherently personal amounts of an individual, are generally excluded from gross receipts.
2) Each partner in a partnership includes a share of partnership gross receipts in proportion to that partner's distributive share of items of gross income that were taken into account by the partnership under IRC Sec. 703, and each shareholder in an S corporation includes a pro rata share of the S corporation's gross receipts taken into account by the S corporation under IRC Sec. 1363(b).

Exceptions where UNICAP rules do not apply include [IRC Sec. 263A; Reg. 1.263A-1(b)]:

1) Corporations, partnerships and individuals (but not tax shelters) that meet the $25 million ($26 million for 2020) gross receipts test are all eligible for the Section 263A(i) exemption from the UNICAP rules.
2) Research and experimental expenditures deductible under IRC Sec. 174.
3) Certain intangible drilling, development and other costs of oil and gas or geothermal wells; certain costs of other mineral properties.
4) Property produced under a long-term contract, except for certain home construction contracts described in IRC Sec. 460(e)(1).
5) Timber and certain ornamental trees, including land.
6) Qualified creative expenses incurred by an artist, writer, or photographer.
7) Costs allocable to cushion gas.
8) *De minimis* non-inventory property provided to customers in connection with provision of services.
9) Certain producers who use the simplified production method when total indirect costs are $200,000 or less. See Reg. 1.263A-2(b)(3)(iv) for more information.
10) Loan origination costs.
11) Property produced to use as personal or nonbusiness property not connected with a trade or business conducted for profit.
12) Certain costs to replant plants bearing an edible crop for human consumption that were lost or damaged by reason of freezing temperatures, disease, drought, pests, or casualty [IRC Sec. 263A(d)(2)(A)].

Direct costs include material costs that become an integral part of the asset, material costs that are used in the ordinary course of producing the asset, and the cost of labor (including payroll taxes) that can be identified or associated with the production of the asset [Reg. 1.263A-1(e)(2)].

Indirect costs. All costs other than direct costs that directly benefit or are incurred in production or resale activities. Under UNICAP, an allocable portion of the following indirect costs must be included in the cost of the asset [Reg. 1.263A-1(e)(3)]:

1) Repair and maintenance of equipment or facilities.
2) Utilities relating to equipment or facilities.
3) Rent of equipment, land or facilities.
4) Indirect labor and contract supervisory wages.
5) Indirect materials and supplies.
6) Tools and equipment that are not otherwise capitalized.
7) Quality control and inspection.
8) Taxes (other than state, local, or foreign income taxes) that relate to labor, materials, supplies, equipment, land, or facilities. Does not include taxes that are treated as part of the cost of property.
9) Depreciation, amortization, and cost recovery allowances on equipment and facilities.
10) Depletion (whether or not in excess of cost). This is not capitalized until the property is sold.
11) Direct and indirect costs incurred by any administrative, service or support function, or department, to the extent the costs are allocable to particular activities.
12) Compensation paid to officers attributable to services performed in connection with particular activities (but not including any cost of selling).
13) Insurance on the plant, machinery or equipment, or insurance on a particular activity.
14) Deductible contributions paid to or under a stock bonus, pension, profit-sharing, or annuity plan.
15) Employee benefit expenses, including worker's compensation, payments under IRC Sec. 404A, life and health insurance premiums, and miscellaneous employee benefits.
16) Rework labor, scrap, and spoilage.
17) Bidding costs incurred in solicitation of contracts that are awarded.
18) Engineering and design costs.
19) Storage and warehousing costs, purchasing costs, handling, processing, assembly and repackaging costs, and a part of general and administrative costs.
20) Licensing and franchise costs.
21) Environmental remediation expense (Rev. Rul. 2004-18).

Interest on debt connected with the production of the asset is included in inventory costs. Interest connected with the acquisition and holding for resale of the asset is excluded from the capitalization rules. See *Capitalization of Interest* on Page L-10.

Costs not capitalized [IRC Sec. 263A; Reg. 1.263A-1(e)(3)(iii)]:

1) Marketing, selling, advertising, and distribution costs.
2) Bidding expenses incurred in solicitation of contracts not awarded.
3) General and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular production activity.

Continued on the next page

- Gains from the disposition of a commercial building depreciated under the prescribed accelerated cost recovery system (ACRS) percentages (including an office in the home) are ordinary income to the extent of total depreciation claimed.
- Gains from the disposition of residential rental property depreciated under the prescribed ACRS percentages are ordinary income to the extent of the excess over SL depreciation claimed.
- Depreciation of commercial and residential rental property under modified ACRS (MACRS) is described as only SL depreciation.

For corporations, IRC Sec. 291(a)(1) provides that 20% of the excess (if any) of (1) ordinary income that would have resulted if the property was Section 1245 property over (2) the amount treated as ordinary income under IRC Sec. 1250, is treated as gain that is ordinary income under IRC Sec. 1250.

Involuntary Conversions

An involuntary conversion occurs when property is destroyed, stolen, condemned, or disposed of under the threat of condemnation, and the taxpayer receives other property or money in payment, such as insurance or a condemnation award.

Gain from an involuntary conversion may be postponed to the extent that the taxpayer purchases replacement property that is similar to the old property or related in service or use (or like-kind in the case of condemned real estate). Replacement property held for the same function as the converted property can be excluded from gain recognition [*Gaynor News*, 22 TC 1172 (1954), *acq*. 1955-2 CB 6]. In order to postpone the entire amount of the gain, the cost of replacement property must be at least as much as the amount realized on the conversion. Gain must be recognized, however, to the extent that the taxpayer receives unlike property as reimbursement. The new property's basis equals the adjusted basis of the old property.

Example #1: A retail store is located beside a highway that is to be converted into a wider freeway. Under threat of condemnation, the store sells its property (needed for freeway lanes) to the highway department. Using the cash proceeds from the sale, the store relocates across town. The new store is similar to the old store. The sale of the old store is an involuntary conversion. The gain from the sale is postponed, and the basis of the new store is the basis of the old store plus the cost of sale.

Example #2: An auto repair shop has some tools and equipment stolen. The tools and equipment were expensed in prior years so that their adjusted basis is zero. The auto repair shop received $12,000 in insurance proceeds from the theft. The proceeds were used to purchase new tools and equipment. This qualifies as an involuntary conversion; the insurance reimbursement is not taxable, and the purchase of the new tools and equipment is not deductible. The basis of the new tools and equipment is zero.

IRS Ruling: The IRS ruled that gain realized from insurance proceeds for hurricane damage to an apartment complex could be deferred to the extent that such proceeds were used to repair damaged buildings, clubhouses, and landscaping; demolish destroyed buildings; or reinvest in qualified replacement property. In addition, the IRS allowed the taxpayer to defer gain realized from the sale of what remained of the apartment complex, but only if the insurance proceeds were reinvested in replacement property in a transaction that otherwise qualified under IRC Sec. 1033 (Ltr. Rul. 200743010).

Court Case: A manufacturer processed trees at lumber and paper mills. Before the trees were fully mature and ready for harvest, they were damaged by storms, fire, and insects. Instead of selling the damaged trees as is, the taxpayer processed the trees and sold the products manufactured from the damaged trees. The taxpayer claimed involuntary conversion and deferred the portion of the gain attributable to the difference between the basis in the trees and their FMV prior to salvage of the trees began.

The IRS argued the taxpayer had processed the trees into end products in the ordinary course of business and was not entitled to involuntary conversion treatment. The Court disagreed and allowed the taxpayer to defer a portion of the gain because the conversion was involuntary and the trees were not available for their original intended business use [*Willamette*, 118 TC 126 (2002)].

Replacement period. To postpone the gain, the property must be replaced within a specified period of time [IRC Sec. 1033(a)].

Replacement period begins on the earlier of:
1) Date on which the condemned property was disposed of or
2) Date on which the threat of condemnation began.

Replacement period ends two years after the close of the first tax year in which any part of the gain on the conversion is realized. *Exception:* Three-year replacement period for real property used in a trade or business or for investment.

Property acquired from related parties. Certain taxpayers must recognize gain on involuntary conversions if the replacement property is acquired from a related party, including [IRC Sec. 1033(i)]:
1) C corporations,
2) Partnerships in which C corporations own more than 50% of the capital or profits interest, and
3) Any other taxpayer, including individuals, if the realized gain is greater than $100,000.

Exception: Recognition of gain under these rules will not apply if the related party acquired the replacement property from an unrelated party during the replacement period. For definitions of related parties, see IRC Secs. 267(b) and 707(b)(1).

Electing to defer gain. A taxpayer is not required to defer recognition of gain on an involuntary conversion, but rather is allowed to elect to either defer recognizing the gain or recognize it in the current year. The election to defer the gain from income in the current year is made by excluding the deferred gain from income and attaching a statement to the return reporting all details of the conversion [Reg. 1.1033(a)-2]. Including the gain in income in the year of sale is an election to recognize the gain in that year.

See Tab 9 of the *Depreciation Quickfinder® Handbook* for more information on involuntary conversions.

Casualties

Disaster Relief Alert: Special rules apply to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)* on Page Q-1 and *December 2020 Legislation* on Page Q-1.

For 2018–2025, personal casualty losses in excess of personal casualty gains are deductible only if attributable to a federally declared disaster and are subject to AGI and dollar thresholds. Casualty losses on business property (other than employee property) and income-producing property are not subject to these limits. See Tab 5 in the *1040 Quickfinder® Handbook* for discussion of personal casualty losses and Tab 4 in the *Individuals—Special Tax Situations Quickfinder® Handbook* for an expanded discussion of disaster victims.

Federally declared disaster. A casualty loss occurring in, and attributable to, a federally declared disaster can be deducted in the year the disaster occurred or in the year preceding the loss [IRC Sec. 165(i)]. The election must be made on or before the date that is six months after the original due date for the taxpayer's federal tax return for the disaster year (without extensions). The taxpayer need not request a filing extension for the disaster year to benefit from this due date. The taxpayer makes the election to deduct the loss in the preceding tax year by deducting the loss on an original (if not yet filed) or amended return for the preceding year and attaching a specified election statement to the return. The election can be revoked within 90 days of its due date (Temp. Reg. 1.165-11T; Rev. Proc. 2016-53).

See IRS Pubs. 547 (Casualties, Disasters, and Thefts) and 976 (Disaster Relief) for additional discussion.

For purposes of the involuntary conversion rules, a special allowance applies to property destroyed in a federally declared disaster area [IRC Sec. 1033(h)]. If business or income-producing property is destroyed in such an area, any tangible replacement property acquired for use in a business qualifies as "similar or related in service or use." This relaxed definition for replacement property allows business owners to postpone gain when starting a new

Cost of goods sold. See *Cost of Goods Sold (COGS)* on Page O-15.

Demolition expenses. Costs incurred to demolish a structure are added to basis of the land where the demolished structure was located (IRC Sec. 280B).

Depletion. See Tab J.

Depreciation. See Tab J.

Development costs. Costs of developing a mine or other natural deposit (other than an oil or gas well) may be deducted. The costs must be paid after the discovery of ores or minerals in commercially marketable quantities [IRC Sec. 616(a)]. An election can be made to treat the costs as deferred expenses deducted ratably as the ores/minerals are sold [IRC Sec. 616(b) or to amortize the costs over ten years [IRC Sec. 59(e)].

Disaster losses. For 2018–2025, personal casualty losses are limited to federally declared disaster areas and are subject to AGI and dollar thresholds. Casualty losses on business property (other than employee property) and income-producing property are not subject to these limits. Per IRC Sec. 165(i), any loss occurring in a disaster area and attributable to a federally declared disaster may, at the election of the taxpayer, be taken into account for the tax year immediately preceding the tax year in which the disaster occurred (not just business losses).

~~*See Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)* on Page Q-1.~~

Disaster Relief Alert: Special rules apply to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)* on Page Q-1 and *December 2020 Legislation* on Page Q-1.

Donations of patents, etc. A deduction for a contribution of a patent or certain other items of intellectual property to charity is limited to the lesser of (1) the taxpayer's basis in the property or (2) the FMV. Taxpayers may deduct certain additional amounts in later years, based on a specified percentage of qualified income received by the charitable organization from the contributed property. No deduction is permitted for income received by the charity after the expiration of the legal life of the patent or other intellectual property [IRC Sec. 170(e) and (m)].

Education expenses. An employer can deduct the following employee education expenses:

- *Educational Assistance Program.* Up to $5,250 of qualified educational assistance can be excluded from an employee's income (IRC Sec. 127). **COVID-19 Tax Alert:** The CARES Act expands education expenses for an EAP to include student loan repayments of interest and principal for 2020–2025. See Tab K for more information about educational assistance programs.
- *Working Condition Fringe Benefit* [IRC Sec. 132(d)]. Employer-provided education is excludable from an employee's income if the expense would have been deductible as a business expense if paid out of the employee's pocket. An individual is generally not allowed to deduct education expenses if (1) the education is required to meet minimum requirements of the individual's employment or trade, or (2) the education will qualify the individual for a new trade or business. See *Work-Related Education Costs* in Tab 5 of the *1040 Quickfinder® Handbook* for more information about deducting education expenses for individuals.

Employee awards. See *Awards and bonuses* on Page O-1.

Employee benefit programs. See Tab K.

Entertainment. Before 2018, the expense of providing entertainment to a client, customer, or employee could qualify as an ordinary and necessary business expense provided it directly related to or was associated with the active conduct of the trade or business. Entertainment activities included the cost of meals (food, beverage, tax, tip).

The TCJA provides that no deduction is allowed for any entertainment expenses paid or incurred after 2017, except for certain meal expenses associated with operating a trade or business. See *Meals* on Page O-3.

Entertainment expenses included in W-2 wages. Entertainment expenses are completely nondeductible [unless one of the exceptions in IRC Sec. 274(e) applies]. IRC Sec. 274(e) was not changed by the TCJA. This includes expenses for goods, services, and facilities that are treated as compensation to an employee on the employer's income tax return and as wages to the employee for withholding purposes. When an employer adds the personal value of a benefit to a *specified individual's* taxable W-2 wages, the employer's deduction is limited to the lesser of the actual cost of the benefit or the amount included in the employee's taxable wages. This rule applies to expenses for activities generally considered to be entertainment, amusement, or recreation and facilities used in connection with such activities, such as a company airplane. *Specified individuals* generally include officers, directors, and 10% or greater owners [IRC Sec. 274(a) and (e)(2)(B)].

Environmental clean-up costs. Rev. Rul. 94-38 held that costs incurred to construct groundwater treatment facilities were capital expenses. Other costs incurred to clean up land and to treat groundwater contaminated with hazardous waste resulting from business operations were deductible as business expenses. Otherwise deductible costs incurred by a manufacturing operation must be included in inventory under the uniform capitalization rules of IRC Sec. 263A (Rev. Rul. 2004-18).

Taxpayers must capitalize amounts paid to ameliorate (make better or more tolerable) a material condition or defect that existed prior to a taxpayer's acquisition of property, whether or not the taxpayer was aware of the defect at the time of acquisition [Reg. 1.263(a)-3(j)]. Therefore, if a taxpayer purchases land contaminated prior to acquisition, the clean-up cost is capitalized.

The IRS has privately applied rules similar to those for soil remediation costs to a taxpayer removing mold from a building. A deduction was allowed for the cost of removing mold from a nursing home where the facility was not contaminated at acquisition and the mold removal did not prolong the building's life or increase its value (Ltr. Rul. 200607003).

Environmental remediation costs incurred to clean up land contaminated with a taxpayer's hazardous waste during operation of the taxpayer's manufacturing activities are allocable to the inventory produced under IRC Sec. 263A during the year costs are incurred (Rev. Rul. 2005-42).

Fines. See *Penalties and Fines* on Page O-20.

Franchise. See *Intangible Assets* on Page O-17.

Fringe benefits. See Tab K.

Gifts. See *Awards and bonuses* on Page O-1.

Goodwill. See *Intangible Assets* on Page O-17.

Impact fees on real estate development. Impact fees are one-time charges imposed by a state or local government for offsite capital improvements necessitated by a new or expanded development. The IRS has ruled that impact fees are capital expenses that are added to the basis of buildings. This allows developers to depreciate impact fees over the life of constructed buildings, rather than adding the fees to the basis of nondepreciable land. Impact fees may also be considered for purposes of computing the low-income housing credit (Rev. Rul. 2002-9).

Impairment losses. See *Impairment Losses* on Page O-16.

Improvements and repairs. Taxpayers may deduct amounts paid for repairs or maintenance of tangible property provided the amounts are not otherwise required to be capitalized (Reg. 1.162-4).

Insurance. See *Insurance* on Page O-17.

Intangible assets. See *Intangible Assets* on Page O-17.

maintaining employee morale, avoiding wrongful termination suits, etc.). If the employee can choose to receive cash or taxable benefits in place of the services, the value of the services is included in the employee's income (Rev. Rul. 92-69).

Paycheck Protection Program (PPP). The COVID-related Tax Relief Act of 2020 (COVIDTRA) allows, to taxpayers with forgiven PPP loans, deductions for otherwise deductible expenses paid with PPP loan proceeds, and tax basis and other attributes of the borrower's assets will not be reduced as a result of loan forgiveness (Sec. 276 of COVIDTRA). A taxpayer may receive debt forgiveness of a covered loan for payments made during the 24-week (or if elected, eight-week) covered period of (1) payroll costs, (2) interest on a covered mortgage obligation, (3) covered rent, and (4) covered utilities [subject to certain limitations addressed in Sec. 1106(d) of the CARES Act]. The income associated with the forgiveness is excluded from gross income under Sec. 1106(i) of the CARES Act. **Note:** The Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act, enacted December 27, 2020 as part of the Consolidated Appropriations Act, 2021, added additional covered expenses, provided for a second round of PPP loans, and made several other changes to the PPP program. See the *Handbook Updates* section of the Quickfinder website (**tax.thomsonreuters.com/quickfinder**) for tables summarizing key provisions of the December 2020 legislation.

Several Small Business Administration (SBA) ~~released~~ interim final rules on calculating loan forgiveness amounts and other aspects of the PPP, along with numerous other PPP resources, are available at **https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses**.

Payroll. See *Salaries and Wages* on Page O-21 and *Taxes* on Page O-22. See Tab I and Tab K for more information.

Penalties and fines. See *Penalties and Fines* on Page O-20.

Personal expenses. In general, personal expenses are not deductible [IRC Sec. 262(a)]. If an expense relates to an item that is used for both personal and business purposes, only the business portion may be deducted.

Political and lobbying expenses. Amounts paid to influence legislative matters or to participate in political campaigns generally are not deductible [IRC Sec. 162(e)]. Dues paid to a tax-exempt organization are not deductible to the extent the amounts are used by the organization for nondeductible lobbying activities. Paying for advertising in convention programs or admission to dinners or inaugural events is considered an indirect political contribution and is not deductible if any of the proceeds are for the benefit of a party or candidate.

A *de minimis* exception states that in-house expenses connected with lobbying are deductible, but only if the total of such expenses do not exceed $2,000 for the tax year [IRC Sec. 162(e)(4)(B)]. A professional lobbyist is allowed to deduct business expenses in connection with lobbying.

Reimbursed employee expenses. See *Accountable plan* on Page O-1.

Rent. See *Lease and Rental Expenses* on Page O-19.

Repairs. See *Improvements and repairs* on Page O-2.

Research and development costs. See *Research and Development Costs* on Page O-21.

Restaurant or tavern smallwares (Rev. Proc. 2002-12, as modified by Rev. Proc. 2019-43). Costs of replacing smallwares such as glassware, dinnerware, pots and pans, tabletop items, kitchen utensils, and food storage supplies are deducted in the year they are available for use at a taxpayer's restaurant. An automatic change in accounting method is available subject to limitations set forth in the revenue procedure.

Note: The deduction is for replacement items only. Costs of opening a restaurant with an inclusive package of smallwares purchased as part of a business acquisition must be deducted and/or amortized or capitalized as start-up costs.

Retirement plans. See Tab K.

Rotable, temporary, and standby emergency spare parts. Rotable spare parts are materials and supplies that are acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are materials and supplies that are used temporarily until a new or repaired part can be installed, at which time they are removed and stored for later (emergency or temporary) installation [Reg. 1.162-3(c)(2)]. Standby emergency spare parts are also treated as materials and supplies [Reg. 1.162-3(c)(3)]. The costs are generally deducted when the parts are disposed of [Reg. 1.162-3(a)(3)]. Alternatively, taxpayers can elect to capitalize and depreciate the costs [Reg. 1.162-3(d)] or, if eligible, deduct the costs under the *de minimis* safe harbor [Reg. 1.162-3(f)]. (See *Capital Improvements vs. Deductible Repairs* on Page J-8 for more information.) An optional method of accounting for rotable or temporary spare parts is also available—see Reg. 1.162-3(e).

Start-up costs. See *Organizational and Start-Up Costs* on Page M-6.

Taxes. See *Taxes* on Page O-22.

Tools. The cost of tools with a useful life of less than one year is generally deductible when purchased, unless the *Uniform Capitalization Rules* on Page L-8 apply. Tools with a useful life of more than one year are depreciated. Tab J covers depreciation.

Trademark and trade names. See *Intangible Assets* on Page O-17.

Travel. Costs for transportation, lodging, and meals are generally deductible if the expenses are reasonable and necessary, and if the trip is primarily for business. See *Lodging* on Page O-3 and *Meals* on Page O-3. See Tab 9 in the *1040 Quickfinder® Handbook* for more information.

Truck and trailer tires. Under the original tire capitalization method (OTCM), the cost of original tires is depreciated as part of the vehicle and the cost of replacement tires is deducted as a current expense. A taxpayer must use the OTCM consistently for all its vehicles. (Rev. Proc. 2002-27)

Wages. See *Salaries and Wages* on Page O-21.

Qualified Business Income (QBI) Deduction

IRC Sec. 199A

The TCJA added IRC Sec. 199A, which applies to tax years 2018–2025. Under this new provision, individuals, estates and trusts may deduct up to 20% of their QBI from sole proprietorships (including farms) and pass-through entities.

Observation: Section 199A is intended to provide tax relief to businesses not benefitting from the reduction in the top corporate rate from 35% to 21%. The rules are complex and subject to phase-outs and limits. In conjunction with the enactment of Section 199A, former Section 199, which provided a 9% deduction for qualified production activities income, was repealed.

Understanding the mechanics of the QBI deduction is essential to effective planning to maximize its tax benefit. See *Qualified Business Income (QBI) Deduction* on Page B-8, as it relates partnerships and partners; *Qualified Business Income (QBI) Deduction* on Page D-1, as it relates to S corporations and shareholders; *Qualified Business Income (QBI) Deduction* on Page F-4 for more detailed coverage of the deduction; and *Qualified Business Income (QBI) Deduction* on Page G-8, as it relates to estates and trusts.

Qualified Opportunity Zones

To encourage economic growth and investments in distressed areas, Congress often uses tax legislation to spur the growth. The TCJA created qualified opportunity zones (QO Zones). These are certain low-income communities that meet the requirements of IRC Sec. 1400Z-1. Investing in QO Zones can result in three major tax breaks (IRC Sec. 1400Z-2):

- Temporary deferral of capital gains reinvested in a qualified opportunity fund (QO Fund),

- The "building" of basis in deferred gain (10% or 15%, based on holding period), and
- Permanent exclusion of post-acquisition capital gains from the sale or exchange of an investment in a QO Fund held for at least 10 years.

Taxpayers continue to be allowed to recognize losses associated with investments in QO Funds.

Designation of QO Zones. A QO Zone is a population census tract that is a low-income community. In addition, the IRS must certify and designate the community as a QO Zone [IRC Sec. 1400Z-1(a)]. The term *low-income community* is borrowed from the Section 45D new markets tax credit [IRC Sec. 1400Z-1(c)(1)]. It includes any population census tract with a poverty rate of at least 20%. It also includes a tract whose median family income does not exceed 80% of statewide median family income. For tracts located within a metropolitan area, the standard is 80% of the greater of:
- Statewide median family income or
- The metropolitan area median family income.

The IRS has published a complete list of all population census tracts that the Dept. of Treasury has designated as QO Zones (see Notices 2019-42 and 2018-40).

Definition of a QO Fund. A QO Fund is any investment vehicle that:

1) Is organized as a corporation or partnership for investing in QO zone property and
2) Holds at least 90% of its assets in QO Zone property [IRC Sec. 1400Z-2(d)].

The 90% test looks to the average percentage of QO Zone property held by the fund on the last day of the first half of the tax year and the last day of the tax year. Note that a QO Fund cannot be organized for the purpose of investing in other QO Funds.

Caution: A QO Fund that fails the 90% test is subject to a penalty for each month of noncompliance [IRC Sec. 1400Z-2(f)]. The penalty amount is calculated under the following formula:

(90% of aggregate assets − aggregate amount of QO zone property) × Section 6621(a)(2) underpayment rate for the month

No penalty is imposed if the failure is due to reasonable cause [IRC Sec. 1400Z-2(f)(3)].

Form 8996 (Qualified Opportunity Fund) is filed annually by corporations or partnerships that are organized and operated as a QO Fund.

The IRS has released final regulations on investing in QO Zones. The final rules retain the general approach of regulations proposed on October 28, 2018 and May 1, 2019 but introduce certain modifications. Among other things, the final regulations:

1) Provide additional guidance on the election to temporarily defer the inclusion of certain eligible gain;
2) Address the taxpayer's ability to increase the basis of a qualifying investment to fair market value once held for at least 10 years;
3) Provide a list of income inclusion events and how to compute the income inclusion amount at the time of the event;
4) Clarify how an entity becomes a QO Fund or QO Zone business; and
5) Provide additional guidance on the QO Zone business property rules (TD 9889 and News Release IR-2019-212).

COVID-19 Tax Alert: The IRS has provided tax relief to ~~Qualified~~ QO Funds and their investors in response to the ongoing COVID-19 pandemic. Specifically, if a taxpayer's 180th day to invest in a QO Fund falls on or after April 1, 2020 and before March 31, 2021, the taxpayer ~~now~~ has until March 31, 2021 to invest eligible gain in a QO Fund. Also, the period between April 1, 2020 and March 31, 2021 is suspended for purposes of the 30-month period during which property may be substantially improved. The IRS also announced that a QO Fund's failure to hold at least 90% of its assets in QO Zone property on any semi-annual testing date from April 1, 2020 through June 30, 2021 is due to reasonable cause under IRC Sec. 1400Z-2(f)(3), and such failure does not prevent qualification of an entity as a QO Fund or an investment in a QO Fund from being a qualifying investment (Notice 2021-10).

Tax Credits

Unlike deductions—which reduce a taxpayer's tax liability by the marginal tax rate times the deduction amount (cents on the dollar)—tax credits reduce the tax liability on a dollar for dollar basis.

See the table *Selected General Business Tax Credits* on Page O-6 for more information on the component credits of the general business credit.

General Business Credit

A taxpayer must file Form 3800 (General Business Credit) to claim any of the general business component credits.

Compute each component credit separately on its applicable form. After each component credit is separately computed on its applicable form, it is then carried to Form 3800, where the component credits are separately listed and then combined into one general business credit (GBC). The combined credit is subject to a limitation based on tax liability. Follow the line-by-line steps of Part II of Form 3800 to figure the limitation. Attach to the return Form 3800 and the separate forms for each credit claimed.

Exception: Taxpayers whose only source of credits listed on Form 3800, Part III, is from pass-through entities may not be required to complete and file separate credit forms to claim the general business credit—see the Form 3800 instructions. If a credit is being reported from a pass-through entity, that entity's employer identification number must be entered in Part III.

Form 3800, Part III includes several check boxes for the specific categories of GBC being reported. A taxpayer must complete a separate Part III for each box checked, and an additional consolidated Part III if certain conditions are met. See the Form 3800 instructions for details.

Carryback/carryforward of unused credits. The passive activity limit and carryover amounts for all GBCs are also reported on Form 3800. The general business credit is limited to net income tax reduced by the greater of [IRC Sec. 38(c)(1)]:

- Tentative minimum tax or
- 25% of the amount by which the net regular tax liability exceeds $25,000.

If the full general business credit may not be claimed because of the limitation, unused credits are carried back one year and forward 20 years (IRC Sec. 39). However, no part of any unused current year business credit attributable to a component credit may be carried back to tax years before the first tax year that the component credit was allowable.

Unused credits. Credits as defined in IRC Sec. 196(c) that remain unused after the 20-year carryforward period may be taken as a deduction in the first tax year following the expiration of the 20-year period. Unused credits may also be taken as a deduction if a taxpayer dies or goes out of business. See the instructions for Form 3800 for more information about deducting carryovers.

Selected General Business Tax Credits[1]

Credit Name	IRC Sec.	For	Rate	Tax Forms
Employment Credits				
Differential Wage Payment	45P	Small business employers paying differential wages to qualified employees that are active duty uniformed service members.	20% of eligible differential wage payments; $20,000 maximum wages/year/employee.	8932
Disabled Access	44	Expenses to make business accessible to/usable by disabled.	50%; $5,000 maximum credit.	8826
Employer-Paid FICA on Tips	45B	Amount paid on tips (not service charges) above minimum wage.	100% of eligible amounts.	8846
Employer-Provided Child Care	45F	Employers who provide child care and related services to employees.	25% of qualified child care facility plus 10% of resource and referral costs.	8882
Empowerment Zone Employment	1396	Wages paid to employees working in selected geographic areas.	20% of wages up to $15,000.	8844
Family and Medical Leave	45S	Eligible employers that pay wages to qualifying employees while they are on family and medical leave.	12.5% of wages paid to employees on leave, increased (but not above 25%) by .25 % pts. for each % pt. by which payment exceeds 50%.	8994
Indian Employment	45A	Wages and health insurance costs paid to members of an Indian tribe or spouse for services performed on a reservation.	20% of increase over amount paid in 1993.	8845
Small Employer Automatic Enrollment	45T	Costs of new retirement plans that include automatic enrollment. Also available to employers that convert an existing plan to automatic enrollment.	$500 per year for three years	8881
Small Employer Pension Plan Start-Up Costs	45E	Credit for start-up costs of new employer retirement plans. Employer cannot have more than 100 employees.	50% of eligible costs up to a maximum credit of the greater of (1) $500 or (2) the lesser of (a) $250 per eligible employee or (b) $5,000, for first 3 years of plan.	8881
Small Employer Health Insurance Premiums	45R	Qualified small employers that pay at least 50% of a qualified health arrangement for their employees.	Up to 50% (35% for tax-exempt organizations) of the lesser of: (1) the amount contributed or (2) the small business benchmark premium.	8941 990-T
Work Opportunity	51	Effective for work begun by certain targeted groups through 2025.	Rates vary for certain targeted groups.	5884 8850
Other Credits				
Biodiesel and Renewable Diesel Fuels	40A	Use in the production of biodiesel mixture; use of biodiesel in a trade or business or sale at retail; production of qualified agri-biodiesel. For biodiesel mixture and biodiesel components, $1 rate applies if agri-biodiesel or renewable diesel (may include certain aviation fuel) is used.	Biodiesel mixture: $1 per gallon used. Biodiesel: $1 per gallon used or sold at retail. Agri-biodiesel: 10¢ for each gallon produced.	8864
Biofuel Producer	40(b)(6)	Producers of second generation biofuel.	Generally, $1.01 for each gallon produced.	6478
Distilled Spirits	5011	Wholesalers and warehousers of distilled spirits.	19.065¢/case of distilled spirits purchased or stored.	8906
Energy Credits	Var.	See *Selected Energy Tax Incentives for Businesses* on Page O-9.	Varies	Var.
Investment Credit:				
• Rehabilitation Property	47	• Certified historic structures.	• 20%, taken ratably over five years.	3468
• Energy Credit	48	• Equipment that uses solar energy to generate electricity, heat or cool a structure (or provide hot water for use in), provide solar process heat or illuminate the inside of a structure using fiber-optic distributed sunlight. Also, equipment (1) used to produce, distribute or use energy derived from a geothermal deposit; (2) that is a qualified fuel cell or microturbine, combined heat and power system or qualified small wind energy property; or (3) that uses the ground or ground water as a thermal energy source to heat or cool a structure.	• 10%; 30% for solar energy property and property using fiber-optic distributed sunlight, and qualified fuel cell, or small wind energy property. **Note:** The 30% rate is reduced to 26% for property that begins construction in 2020, and to 22% if construction begins in 2021.	
• Qualifying Advanced Coal	48A	• Investment in qualifying advanced coal project.	• 15%, 20% or 30% of qualified investment (QI).	
• Qualifying Gasification	48B	• Investment in qualifying gasification project.	• 20% or 30% of QI.	
• Qualifying Advanced Energy	48C	• Investment in qualifying advanced energy project.	• 30% of QI.	
Low-Income Housing	42	Owners of residential rental buildings providing qualified low-income housing.	70% (or 30%) of qualified building basis over 10 years.	8586 8609-A
New Markets	45D	Investment in community development entities.	5% – 6% per year over seven years.	8874
Orphan Drug	45C	Expenses in testing certain drugs for rare diseases or conditions.	25% of qualified clinical testing costs.	8820
Research Activities	41	Business research and experimental expenditures.	20% of expenses over base amount.	6765
Qualified Opportunity Zones and Qualified Opportunity Funds	1400Z-1- and 1400Z-2	Investment in low-income communities as designated as a QO Zone by the Dept. of Treasury.	Temporary deferral of gain from the sale of the property and permanent exclusion of post-acquisition capital gains on disposition when held for 10 years.	8996

[1] See the current version of Form 3800, the other referenced forms and their instructions for details of these credits.

Qualified health insurance arrangement is an arrangement under which an employer pays premiums for each employee enrolled in health insurance coverage offered by the employer. The contribution must be an amount equal to a uniform percentage (at least 50%) of the premium cost of the qualified health plan.

For employers offering one plan and whose health insurer uses composite billing, the uniformity requirement is met if the employer either (1) pays the same percentage (not less than 50%) or (2) pays the same dollar amount (not less than 50% of the self-only premium) for each employee.

Example: Max offers one health plan to his employees. The employee's cost is $5,000 per year for self-only coverage and $10,000 per year for family coverage. Max can meet the uniformity requirement by paying at least 50% of each employee's cost ($2,500 for self-only and $5,000 for family) or by paying at least $2,500 (50% of self-only coverage) per employee, regardless of which coverage was elected.

In addition to major medical coverage, premiums for more limited coverage, such as the following, are counted (Notice 2010-44):

- Limited scope dental or vision.
- Long-term care, nursing home care, home health care, community-based care, or any combination thereof.
- Coverage only for a specified disease or illness
- Hospital indemnity or other fixed indemnity insurance.
- Medicare supplemental health insurance.

Owners and their related parties. Self-employed individuals (general partners and sole proprietors), >2% S corporation shareholders and >5% owners of other businesses, as well as their spouses, children, grandchildren, siblings, parents, grandparents, aunts, uncles, nieces, nephews, and in-laws are not treated as employees for these definitions. So, their wages and hours worked are not counted in determining the number of FTE employees and average annual wages, and premiums paid for their health insurance coverage don't qualify for the credit. Also, a member of the individual's household who is not related but qualifies as a dependent is not an employee.

Credit Phase-Out

The amount of the credit is reduced in the following situations:

1) *More than 10 FTE employees.* The reduction is the otherwise applicable credit multiplied by the number of FTE employees in excess of 10, and divided by 15.
2) *Average annual wages exceed $25,000.* The reduction is the otherwise applicable credit multiplied by the amount by which average annual wages exceed $25,000 and divided by $25,000.

For an employer with more than 10 FTEs and average annual wages exceeding $25,000, the credit is reduced (not below zero) by the sum of the two reductions.

Note: The credit phase-out is adjusted for inflation. For 2020, the credit begins to phase out when wages exceed $27,600 and is fully phased out when they reach $55,200 (Rev. Proc. 2019-44). But, since average annual wages for computing the credit are rounded down to the nearest thousand, the phase-out amounts are also rounded.

Example: For 2020, James, a qualified employer, had 12 FTE employees and paid them average annual wages of $30,000 (rounded down to the nearest thousand). He paid $96,000 in health care premiums for those employees. The premiums paid were less than the average premium for the small group market in James's state. James's credit is calculated as follows:

Credit amount before any reduction	50% × $96,000	$ 48,000
Reduction for number of FTE employees > 10	$48,000 × 2/15	(6,400)
Reduction for average annual wages > $27,600	$48,000 × $2,400/$27,600	(4,174)
2020 small employer health insurance credit		$ 37,426

CARES Act and FFCRA Tax Credits

In response to the novel coronavirus (COVID-19), Congress enacted the Coronavirus Aid, Relief, and Economic Security (CARES) Act, and the Families First Coronavirus Response Act (FFCRA). Both pieces of legislation provide aid to small businesses through the issuance of new tax credits. Many businesses impacted by COVID-19 will qualify for two new employer tax credits (1) employee retention credit and (2) credit for qualified sick and family leave wages.

Employee Retention Credit

A refundable payroll tax credit is available for 50% of wages paid by eligible employers to certain employees during the COVID-19 crisis. The credit is available to (1) employers, including nonprofits, whose operations were fully or partially suspended due to a COVID-19-related shut-down order or (2) employers whose gross receipts declined by more than 50% when compared to the same quarter in the prior year.

The credit is based on qualified wages paid to employees. For employers with an average number of full-time employees during 2019 greater than 100, qualified wages are wages paid to employees when they are not providing services due to the COVID-19-related circumstances described earlier. For eligible employers with an average number of full-time employees during 2019 of 100 or less, all employee wages qualify for the credit, whether the employer is open for business or subject to a shut-down order. However, wages do not include those taken into account for purposes of the payroll credits for required paid sick leave or required paid family leave under the FFCRA. In addition, no credit is available with respect to an employee for any period for which the employer is allowed a work opportunity credit under IRC Sec. 51 with respect to that employee.

The refundable credit is capped at $5,000 per employee and applies against certain employment taxes on wages paid to all employees. The credit applies to the first $10,000 of compensation, including health benefits, paid to an eligible employee after March 12, 2020 and before July 1, 2021.

Law Change Alert: Beginning on January 1, 2021, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 extends and expands certain provisions, including increasing the ERC rate from 50% to 70% and the limit on per-employee creditable wages from $10,000 for the year to $10,000 for each quarter. See the *Handbook Updates* section of the Quickfinder website (**tax.thomsonreuters.com/quickfinder**) for tables summarizing key provisions of the December 2020 legislation.

Note: The credit is subject to the aggregation rules (single employer rules) of IRC Secs. 52 and 414.

The Secretary of the Treasury is granted authority to advance payments to eligible employers and to waive applicable penalties for employers that do not deposit applicable payroll taxes in anticipation of receiving the credit. The credit is not available to employers receiving Paycheck Protection Program loans (CARES Act Sec. 2301).

Note: In Notice 2020-22, the IRS provided relief from the Section 6656 penalty for failure to timely deposit employment taxes to the extent the amounts not deposited are equal to or less than the amount of the employee retention credit. This relief applies to qualified retention wages paid March 13, 2020 through December 31, 2020.

Payroll Tax Credits for Employers

The FFCRA provides refundable credits against an employer's Section 3111(a) tax (the 6.2% portion of the FICA tax) or Section 3221(a) railroad retirement tax to cover wages required to be paid to employees while they are taking paid leave under the Emergency Paid Sick Leave Act (EPSLA) (Division E of the FFCRA) and Emergency Family and Medical Leave Expansion Act (EFMLEA) (Division C of the FFCRA).

Under the EPSLA (sick leave) credit, an employer is allowed a credit equal to 100% of sick leave wages paid for the quarter, subject to limits based on the circumstance of the leave. The credit is limited to $511 per day ($5,110 in total) for sick leave paid for an employee who is unable to work because he is (1) subject to a federal, state, or local quarantine or isolation order related to COVID-19; (2) advised by a health care provider to self-quarantine due to coronavirus concerns; or (3) experiencing coronavirus symptoms and seeking a medical diagnosis. The credit is limited to $200 per day ($2,000 in total) if the sick leave is for an employee who is caring for an individual described in item 1 or 2, caring for a son or daughter whose school or place of care is closed or child care provider is unavailable, or because the employee is experiencing a "substantially similar condition" specified by the government. The aggregate number of days taken into account for any calendar quarter can't exceed the excess of 10 days over the aggregate number of days taken into account for all preceding calendar quarters.

Under the EFMLEA (family leave) credit, also referred to as the *child care leave credit*, an employer is allowed a credit equal to 100% of qualified family leave wages paid for the quarter, limited to $200 per day with a maximum of $10,000 per eligible employee.

The credit can be claimed for up to 10 weeks of an employee's qualifying family leave.

The amounts of the EPSLA and EFMLEA credits are increased by the portion of the employer's qualified health plan expenses that are properly allocable to qualified sick leave wages or qualified family leave wages. *Qualified health plan* expenses are amounts paid or incurred by the employer to provide and maintain a group health plan [as defined in IRC Sec. 5000(b)(1)], but only to the extent that such amounts are excluded from the gross income of employees by reason of IRC Sec. 106(a).

The EPSLA and EFMLEA credits for employers also are increased by the amount of the tax imposed by IRC Sec. 3111(b) (the 1.45% hospital insurance portion of FICA) on qualified sick leave wages, or qualified family leave wages, for which an EPSLA or EFMLEA credit is allowed.

The credits are refundable to the extent they exceed the employer's Section 3111(a) or 3221(a) payroll taxes. An employer may not claim a credit under Section 45S (for certain paid family and medical leave) for any qualified sick leave wages or qualified family leave wages required to be paid under the EPSLA or EFMLEA provisions. The credits originally applied to wages paid for the period beginning on April 1, 2020 and ending on December 31, 2020 (Notice 2020-21). The COVID-related Tax Relief Act of 2020 Sec. 286 extends the credits for employers who provide paid leave through March 31, 2021. While employers are not mandated to provide paid sick or family COVID-19 related leave in 2021, those who do may claim the tax credit through March 31, 2021.

Minimum Tax Credit for Corporations

The corporate alternative minimum tax (AMT) was repealed as part of the TCJA, but outstanding AMT credits could be claimed, subject to certain limits for tax years prior to 2021, at which time any remaining AMT credit could be claimed as fully refundable.

The CARES Act allows corporations to claim 100% of AMT credits in 2019 as fully refundable and provides an election to accelerate claims to 2018, with eligibility for accelerated refunds. Thus, corporations can claim a refund now and obtain additional cash flow during the COVID-19 emergency (CARES Act Sec. 2305).

Selected Energy Tax Incentives for Businesses

Alternative Motor Vehicle Credit

See also Form 8910; IRC Sec. 30B

For vehicles purchased after 2011, the credit is available only for qualified fuel cell motor vehicles.

Qualified fuel cell vehicle credit. Qualified fuel cell motor vehicles include, for example, vehicles that run on hydrogen power cells. Only new vehicles placed in service after 2005 and purchased before 2022 qualify for the credit.

The IRS will certify the credit amount for qualifying vehicles. Taxpayers can rely on this certification (Notice 2008-33).

Reporting. Form 8910 (Alternative Motor Vehicle Credit) is used to claim the alternative motor vehicle credit. The business/investment-use percentage of the credit is then transferred to Form 3800.

The personal-use portion of the credit is transferred to the "Nonrefundable Credits" line 6 of Schedule 3, Form 1040 (check box c and write "8910" in the space next to that box). Any part of the personal-use portion of the credit that can't be used in the current year is lost. It cannot be carried over to other years.

Recapture. The IRS has been instructed to issue regulations on the rules for recapturing the credits for vehicles that cease to qualify for the credits [IRC Sec. 30B(h)(8)], except that no recapture will be required if the vehicle ceases to qualify because it is converted to a qualified plug-in electric drive motor vehicle. As of the date of this publication, no regulations have been issued.

Vehicle Refueling Property Credit

See also Form 8911; IRC Sec. 30C

Taxpayers may claim a 30% credit for the cost of installing clean-fuel vehicle refueling property to be used in a trade or business or installed at the taxpayer's principal residence. The credit generally applies to property placed in service after 2005 and before 2022.

The maximum allowable credit is:

- $30,000 for business property.
- $1,000 for property installed at a principal residence.

Qualified alternative fuel vehicle refueling (QAFVR) property is any property, not including a building and its structural components, whose original use begins with the taxpayer, that is depreciable (not required for the $1,000 credit) and that:

1) Stores or dispenses a clean-burning fuel into the fuel tank of a vehicle propelled by that fuel, but only if the storage or dispensing of the fuel is at the point where the fuel is delivered into the fuel tank of the vehicle or
2) Recharges vehicles propelled by electricity, but only if the property is located at the point where the vehicles are recharged.

Clean-burning fuels include:

- Any fuel at least 85% of which consists of one or a mixture of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen.
- Any fuel that is a mixture of diesel fuel and biodiesel determined without regard to any use of kerosene and containing at least 20% biodiesel.
- Electricity.

The tax basis of QAFVR property is reduced by the portion of the property's cost allowed as a credit. Notice 2007-43 provides interim guidance on the credit pending issuance of regulations.

Plug-In Electric Drive Motor Vehicle Credit

See also Form 8936; IRC Sec. 30D

Taxpayers can claim a credit for each new qualifying vehicle purchased for use or for lease, but not for resale. The credit amount ranges from $2,500 to $7,500. The portion of the credit attributable to the vehicle's business-use percentage is treated as part of the taxpayer's general business credit. The remainder is a nonrefundable personal credit that can offset both regular tax and AMT (IRC Sec. 30D).

Qualifying vehicles. These are new four-wheeled plug-in electric vehicles manufactured primarily for use on public streets, roads, and highways that meet certain technical requirements.

However, the following do not qualify:

1) Vehicles manufactured primarily for off-road use (such as golf carts).
2) Vehicles weighing 14,000 pounds or more.
3) Low-speed vehicles (four-wheeled vehicles that can obtain a speed of 20 but not more than 25 miles per hour and a gross vehicle weight rating of less than 3,000 pounds).

An Index to Manufacturers of qualified vehicles can be found at **www.irs.gov** by searching for "Plug-in electric drive motor vehicle."

Manufacturer's certification. The IRS will acknowledge a manufacturer's (or in the case of a foreign vehicle manufacturer, its domestic distributor's) certifications that a vehicle meets the standards to qualify for the credit. Taxpayers may rely on such a certification (Notice 2009-89).

The credit begins to phase out for a manufacturer's vehicles when at least 200,000 qualifying vehicles manufactured by that manufacturer have been sold for use in the U.S. (determined cumulatively for sales after 2009). For General Motors, LLC and Tesla, Inc. the phaseout period begins in 2019. For the latest on the phase out amounts, see the IRS website at **www.irs.gov/businesses/irc-30d-new-qualified-plug-in-electric-drive-motor-vehicle-credit**.

Note: A vehicle is considered acquired on the date when title to that vehicle passes under state law (Notice 2009-89).

Two-Wheeled Electric Vehicles

See also Form 8936; IRC Sec. 30D(g)

A credit for purchasing qualified two-wheeled plug-in electric vehicles is available for vehicles purchased in 2015–2021. Among other criteria, the vehicle must be (1) capable of achieving a speed of 45 miles per hour or greater and (2) manufactured for use on public roads. The credit equals 10% of the vehicle's cost (limited to $2,500) [IRC Sec. 30D(g)].

Recapture. The IRS has been instructed to issue regulations on the rules for recapturing the credits for plug-in vehicles that cease to qualify for the credits [IRC Sec. 30D(f)(5)]. As of the date of this publication, no regulations have been issued.

Energy Efficient Home Builders Credit

See also Form 8908; IRC Sec. 45L

Contractors (including producers of manufactured homes) that build new energy-efficient homes in the U.S. are eligible for a credit of $2,000 per dwelling unit (IRC Sec. 45L). The credit is reported on Form 8908 (Energy Efficient Home Credit). Partnerships and S corporations transfer the amount to Schedule K. All others carry it to Form 3800 (General Business Credit).

- To qualify, the dwelling unit must be certified to have annual energy consumption for heating and cooling that is at least 50% less than comparable units and meet certain other requirements.
- The credit can also apply to a substantial reconstruction and rehabilitation of an existing dwelling unit.
- A manufactured home that meets a 30% reduced energy consumption standard can generate a $1,000 credit.
- These credits only apply to homes sold by contractors for use as personal residences.
- The contractor's tax basis in the home is reduced by the amount of the credit.
- Construction must be substantially completed after August 8, 2005, and the home must be purchased after 2005 and before 2022.

Certification. The IRS issued guidance on the certification process that builders must complete to qualify for the credit. The notices also provide a public list of software programs that may be used in calculating energy consumption for obtaining a certification. See Notice 2008-35 for standard homes rules. Notice 2008-36 covers manufactured homes.

Energy-Efficient Commercial Building Deduction

IRC Sec. 179D allows businesses to deduct, rather than capitalize and depreciate, all or part of the cost of energy efficient commercial building property. The deduction is allowed for new and existing buildings but only for qualifying property placed in service in 2006 or later. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 makes this provision permanent for property placed in service after December 31, 2020.

Qualifying property. Energy efficient commercial building property is depreciable property that is:

- Installed on or in a building located in the U.S. that is not a (1) single-family house, (2) multi-family structure of three stories or fewer above grade, (3) mobile home, or (4) manufactured house.
- Part of the (1) interior lighting system, (2) heating, cooling, ventilation, and hot water systems or (3) building envelope. Building envelope includes insulation materials primarily designed to reduce heat loss or gain, exterior windows, skylights, exterior doors, and some metal roofs [IRC Sec. 25C(c)(2)].
- Certified that it will reduce or is part of a plan to reduce the overall energy costs of these systems by 50% or more.

Deduction limits. There are several deduction limits to consider:

- *Qualifying property.* For any one building, the total deduction for property meeting the 50% or more energy reduction requirement is limited to $1.80 times the building square footage.
- *Partially qualifying property.* A summary of energy savings percentages necessary to qualify for a partial deduction (60¢ times building square footage) is available in Notice 2012-26.

Certification. Before claiming the deduction, the property must be certified as meeting the requirements by an unrelated qualified and licensed engineer or contractor. Taxpayers must retain these certifications in their tax records.

Software programs. The Department of Energy maintains a public list of software that may be used to calculate energy and power consumption and costs as part of the certification process. The list appears at **http://energy.gov/eere/buildings/qualified-software-calculating-commercial-building-tax-deductions.**

Net Income per Books vs. Taxable Income

A comparison between GAAP and tax accounting rules

Net income per books is not the same as taxable income. Thus, certain nontaxable income and nondeductible expenses for tax purposes are included as income and expenses for book purposes. For example, assume a business pays $200 in interest expense related to tax-exempt municipal bond interest income. For tax and AMT purposes, the $200 is nondeductible. However, for book

Tax Planning for the Small Business

Tab P Topics

Basics of Tax Planning

The following tax planning ideas are general in nature and are intended to provide possible federal tax savings strategies for small business owners. There are many other factors that should be considered before using any of these ideas.

Tax Rates

Individuals

Tax rates. The following seven tax brackets apply for years beginning in 2018–2025: 10%, 12%, 22%, 24%, 32%, 35% and 37% (for 2020, the top tax rate applies to individuals with taxable income greater than $622,050 for MFJ, $518,400 for Single or HOH, and $311,025 for MFS).

Alternative minimum tax (AMT). For years beginning in 2020 the following AMT exemptions apply: $113,400 for MFJ, $72,900 for Single or HOH, and $56,700 for MFS. The exemptions are reduced by 25% of alternative minimum taxable income (AMTI) over $1,036,800 for MFJ and $518,400 for Single, HOH, or MFS.

Note: For years 2019–2025 these amounts are inflation indexed.

Corporations

Tax rates. The corporate income tax rate is a flat 21%. The flat 21% rate also applies to personal service corporations (PSCs).

AMT. The corporate AMT was repealed as part of the TCJA, but outstanding AMT credits could be claimed, subject to certain limits for tax years prior to 2021, at which time any remaining AMT credit could be claimed as fully refundable. The CARES Act allows corporations to claim 100% of AMT credits in 2019 as fully refundable and provides an election to accelerate claims to 2018, with eligibility for accelerated refunds (CARES Act Sec. 2305).

Paycheck Protection Program (PPP) Loan Forgiveness

The CARES Act created the PPP to help small businesses (including sole proprietors, independent contractors, and eligible self-employed individuals) negatively impacted by the COVID-19 pandemic. The extended deadline for applying for the 1st round of loans was August 8, 2020. The full principal amount of the loan, plus any accrued interest, may be forgiven if certain criteria are met. Amounts that are not forgiven will be subject to a two-year note if the loan was issued prior to June 5, 2020, and a five-year note if the loan was issued after June 5, 2020, with a 1% interest rate. Taking the appropriate steps to ensure maximum PPP loan forgiveness should be a priority.

Tax treatment. The forgiven portion of a PPP loan is excluded from gross income. The COVID-related Tax Relief Act of 2020 (COVIDTRA) allows, to taxpayers with forgiven PPP loans, deductions for otherwise deductible expenses paid with PPP loan proceeds, and tax basis and other attributes of the borrower's assets will not be reduced as a result of loan forgiveness (Sec. 276 of COVIDTRA).

~~**Caution:** There are still many unknowns regarding the forgiveness provisions of the PPP. Although the Small Business Administration (SBA) has released some guidance, more is expected. Also, as with the PPP application process, lenders have their own interpretation of the loan forgiveness computation. Watch for future guidance.~~

Best Practices

Here are five best practices to help meet the requirements for total loan forgiveness.

Diligently track how the funds are used. Loan forgiveness requires the funds be used on forgivable expenses. These include business (1) payroll costs, (2) interest payments on mortgages, (3) rent or lease payments on non-capital leases, and (4) utility payments.

Note: The Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act, enacted December 27, 2020 as part of the Consolidated Appropriations Act, 2021, added additional covered expenses, provided for a second round of PPP loans, and made several other changes to the PPP program. See the *Handbook Updates* section of the Quickfinder website (**tax.thomsonreuters.com/quickfinder**) for tables summarizing key provisions of the December 2020 legislation.

At least 60% of the loan proceeds must be used for payroll (for example, salary, wages, and commission payments

up to a $100,000 limit per employee or self-employed individual), group health care coverage, retirement plan contributions, and payment of state and local taxes assessed on employee compensation. Payroll costs are calculated on a gross basis without regard to (that is, not including subtractions or additions based on) federal taxes imposed or withheld, such as the employee's and employer's share of FICA and income taxes required to be withheld from employees. Thus, payroll costs are not reduced by taxes imposed on an employee and required to be withheld by the employer, but payroll costs do not include the employer's share of payroll tax. The SBA has released much interim guidance on PPP loans available at **https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses**.

Note: Payroll cost for self-employed individuals with no employees is the 2019 net profit amount on line 31 of Schedule C (limited to $100,000). For taxpayers self-employed in 2020 but not in 2019 and for calculating the payroll costs for Form 1065 entity owners, see **www.sba.gov/sites/default/files/2020-06/How-to-Calculate-Loan-Amounts-508_1.pdf**.

Caution: PPP funds used for unauthorized purposes are required to be repaid (and subject to penalty if the misuse was intentional).

Carefully track employee headcount and salary. PPP loans require employers to maintain certain employee headcount and compensation levels to obtain full forgiveness. The forgivable amount may be reduced if an employer reduces the average number of its full-time equivalent employees, or reduces the salary (or hourly wage) of certain employees by more than 25%. Several exceptions and safe harbors have been provided to offer relief to employers.

Keep good records. Businesses will need sufficient records to prove the PPP funds were used for forgivable purposes. Create a spreadsheet of all forgivable expenses as incurred. Maintain a special folder (electronic or otherwise) that includes all supporting documentation. This includes the following items:

1) FTE employee headcount calculations.
2) Payroll tax filings (both federal and state).
3) Mortgage documents, leases, and utility bills.
4) Cancelled checks and payment receipts. Bank statements for the separate account used to pay forgivable expenses. If a separate bank account was not used, include copies of other bank statements with forgivable expenses highlighted.
5) Documentation supporting employee job offers and refusals, voluntary resignations, written requests by any employee for a reduction in work schedule, or other documentation supporting an employer's use of a safe harbor or exception.

Understand the forgiveness application process. Be sure to understand the bank's procedures for determining loan forgiveness. An authorized representative of the business must certify that (1) the documentation presented is true and correct and (2) the amount for which forgiveness is requested was used to retain employees, pay interest on a covered mortgage obligation, pay a covered rent obligation, or pay covered utilities.

Prepare for future obligations. Any unforgiven portion of the loan will be subject to a two-year or five-year note, as applicable, with a 1% interest rate. Fortunately, no payments will be due for the first ten months (although interest will continue to accrue). In addition, no collateral or personal guarantee is required, and there are no prepayment penalties.

Accounting Method Changes

Change to Cash Method of Accounting

The cash method of accounting was greatly expanded by the TCJA to apply to businesses (other than tax shelters) with up to $25 million ($26 million for 2020) in gross receipts. In addition, the exemption from the requirement to maintain inventories and to apply the uniform capitalization (UNICAP) rules has been expanded to $25 million ($26 million for 2020) in gross receipts. Regulations issued in January 2021 implement the TCJA changes to IRC Secs. 263A, 448, 460, and 471 (TD 9942). ~~They are proposed to apply to tax years beginning on or after the date adopted as final. However, for tax years beginning after 2017, and before the regulations are adopted as final, taxpayers may rely on the proposed regulations provided they follow all applicable rules for each Code provision they choose to apply.~~

Caution: Tax shelters, including partnerships and other entities (but not C corporations) where more than 35% of losses are allocated to limited partners or limited entrepreneurs (persons who have an interest in an enterprise other than as a limited partner and do not actively participate in management), are prohibited from using the cash method [IRC Sec. 448(a)(3)]. See *Tax shelters* on Page B-5 and *Syndicates* on Page B-5 for additional discussion.

Problem. Prior to the enactment of the TCJA, the cash method was available to (1) taxpayers with average annual gross receipts of $1 million or less; (2) C corporations and partnerships with C corporation partners with $5 million or less in average annual gross receipts; and (3) individuals, S corporations, and individually owned partnerships engaged in service activities when average annual gross receipts were $10 million or less.

The cash method provides several advantages. For example, under the cash method:

1) Cash basis taxpayers don't report accounts receivable as revenue until constructively received [Reg. 1.451-1(a)];
2) Expenses are deducted in the tax year actually paid [Reg. 1.461-1(a)(1)];
3) Near the end of a tax year, cash method taxpayers can defer the receipt of income and accelerate the payment of expenses to minimize taxable income for that year; and
4) When the taxpayer wants to report more taxable income for the year (for example, to use an expiring net operating loss), income can be accelerated and deductions deferred.

Solution. The cash method of accounting under IRC Sec. 448(c) is available to taxpayers (other than tax shelters) that satisfy a $25 million ($26 million for 2020) gross receipts test, regardless of whether the purchase, production or sale of merchandise is an income-producing factor. In addition, such taxpayers are not required to maintain inventories under IRC Sec. 471 or apply the Section 263A UNICAP rules. Instead, taxpayers may treat inventories as nonincidental materials and supplies or conform to their financial accounting treatment of inventories.

The gross receipts test is based on the three-tax-year period before the testing year; however, it doesn't have to be met for all prior tax years. If a taxpayer hasn't been in existence for three years, the test period includes the number of years the taxpayer has existed. Finally, gross receipts for short tax years must be annualized [IRC Sec. 448(c)(3)].

Small Contractor Exemption from Percentage of Completion Method (PCM)

The small contractor exemption from the PCM has been greatly expanded by the TCJA to apply to contractors with up to $25 million ($26 million for 2020) in gross receipts.

Problem. Prior to enactment of the TCJA, income from small construction contracts didn't have to be computed using the PCM. However, this exception applied only if all of the following conditions were met:

1) The contract was a construction contract.
2) At the time the contract was entered into, the taxpayer expected the project to be completed within two years.
3) The taxpayer's average annual gross receipts for the three tax years preceding the year the contract was entered into didn't exceed $10 million.

Example: An employer subject to employment taxes of 7.65% FICA and 2.35% other (unemployment tax, workers' compensation, etc.), for a total of 10% of wages provides the following fringes to an employee with a federal marginal tax rate of 24%, state rate of 8%, and FICA rate of 7.65%, for a total tax rate of 39.65%, yielding the indicated tax savings.

Benefit Provided	*Savings:*		
	Employee	Employer	Combined
$5,000 Dependent Care Assistance	$ 1,982	$ 500	$ 2,482
$2,000 *De Minimis* Fringe Benefits	793	200	993
$6,000 Lodging (required and on the business premise)	2,379	600	2,979
$5,250 Education Assistance[1]	2,081	525	2,606
$1,000 On-Premises Athletic Facilities	397	100	497

[1] **COVID-19 Tax Alert:** Educational assistance may include employer-provided student loan repayments (principal or interest) made on behalf of the employee from March 28, 2020 through December 31, 2025. See *Educational Assistance* on Page K-11.

Home Office for the Small Business

Problem. Dealing with home office expenses where the corporate office is in the employee's principal residence.

Applicable rules:

1) An employee cannot deduct home office expenses for the business use of the home if rent is paid by the employer [IRC Sec. 280A(c)(6)].
2) This rule does not prevent the deduction of mortgage interest and real estate taxes on Schedule A [IRC Sec. 280A(b)].
3) The employer may deduct rent paid to an employee for use of the employee's home even though the employee is not allowed corresponding deductions [IRC Sec. 162(a)(3)].
4) Unreimbursed employee business expense deductions are disallowed for tax years 2018–2025 [IRC Sec. 67(g)].

Solution. Have the employer reimburse the employee for expenses directly related to the home office (repairs and supplies) and allocated expenses (utilities and insurance). The employee is not reimbursed for depreciation, interest, or taxes. The arrangement will qualify as a Section 132(a)(3) *working condition fringe* if [Reg. 1.132-5(a)(1)(v)]:

1) The payments are for expenditures that would be deductible as business expenses by the employee if he paid them,
2) The employee verifies to the employer that the payments were actually used for such expenses and
3) Any amounts not used are returned to the employer.

In this solution, the reimbursements are tax free to the employee as a working condition fringe. This solution does not involve renting part of the employee's home to the employer. As stated earlier, an employee cannot deduct home office expenses if the business use of the home is attributable to rent paid by the employer. This solution is a way for a taxpayer to recoup some business expenses while avoiding the rental limitation.

Example: Reggie is the sole shareholder of an S corporation that operates clothing stores. He works full-time in the business. The stores have no office space, so Reggie handles all of the administrative work from his home office, which occupies 10% of his principal residence. He incurs the following home office expenses in the current year: utilities $1,200, insurance $400, general maintenance $800, and office supplies $600. In January, the corporation sets up a plan that reimburses Reggie for all of the direct expenses ($600) and 10% of the indirect expenses ($240), but excluding depreciation, mortgage interest, and real estate taxes. In December, Reggie receives a check for $840. Since the expenses would have qualified as a business deduction if incurred by Reggie as a non-employee, and he substantiates the expenses to his employer, the reimbursements qualify as a working condition fringe not taxable to Reggie. This is not a rental arrangement subject to the disqualifying language of IRC Sec. 280A(c)(6).

Hobby Losses

Problem. The IRS may challenge the profit motive of a business that generates losses year after year. If successfully challenged, the IRS will deny the deduction of the losses against a taxpayer's other income.

Applicable rules. Net losses sustained in an activity classified as a hobby are not deductible (IRC Sec. 183).

An activity is considered a for-profit business (not a hobby) if gross income exceeds deductions for at least three out of five consecutive years (at least two out of seven years for horse breeding, training, showing, or racing). If a business is not profitable in at least three out of five years, or profits are small in the three profit years and losses are large in the two loss years, the taxpayer must prove the activity is a for-profit business under the facts and circumstances test to avoid the hobby loss disallowance rules.

Solution. Business owners must be able to substantiate the profit motive of their business to be able to deduct losses.

Establishing a profit motive. Although the activity must be engaged in for profit, the expectation of profit does not necessarily have to be reasonable. It may be sufficient that a small chance of making a large profit exists. For example, a taxpayer may have a profit motive for investing in a risky venture (such as wildcat oil well drilling or providing capital to start-up businesses). The circumstances should indicate that the taxpayer entered into, or continued, the activity with the honest objective of making a profit [Reg. 1.183-2(a)].

Whether an activity is a for-profit business is determined under a facts and circumstances test. The following items are relevant factors [Reg. 1.183-2(b)]:

1) The manner in which the taxpayer carries on the activity.
2) The expertise of taxpayer or advisors.
3) Time and effort spent by taxpayer in carrying on the activity.
4) The expectation that assets used may appreciate in value.
5) Taxpayer's success in other similar or dissimilar activities.
6) Taxpayer's history of income/loss with respect to the activity.
7) Amount of occasional profits, if any.
8) Taxpayer's financial status.
9) Elements of personal pleasure or recreation.

Note: These factors are not an exclusive list. Factors should be considered as a whole to determine if a profit motive exists.

Planning ideas to avoid hobby loss disallowance. A sole proprietor's behavior is often the determining factor in whether an activity is categorized as a for-profit business or as a hobby. To preserve for-profit status, the sole proprietor should conduct the activity in a businesslike manner. The following suggestions can help preserve business losses on the tax return.

- Keep thorough and businesslike books.
- Use a separate business checking account.
- Record both business and personal use of assets (such as a charter boat or photography equipment) in a log book.
- Use separate credit cards for business and personal purchases.
- Research market/technology trends used in similar businesses.
- Consult with reputable advisors in the field.

Continued on the next page

What's New

Tab Q Topics

Inflation-Adjusted Amounts

For a summary of inflation-adjusted amounts for 2020 (plus 2021 and 2019 and prior years), see the *Business Quick Facts Data Sheet* on Page A-1.

Tax Legislation~~—December 2019~~

December 2020 Legislation

Consolidated Appropriations Act (CAA), 2021. The CAA, 2021, which includes new relief payments to individuals, another round of Paycheck Protection Program (PPP) funding, changes to the deductibility of expenses for PPP recipients, and numerous tax extenders, was signed into law on December 27, 2020. Tax and economic relief provisions are included in some of the acts that make up the CAA, 2021—COVID-related Tax Relief Act of 2020 (COVIDTRA); Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act (Economic Aid Act); Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA); and Continued Assistance for Unemployed Workers Act of 2020.

Quickfinder tax act summaries. See the *Handbook Updates* section of the Quickfinder website (**tax.thomsonreuters.com/quickfinder**) for tables summarizing key provisions of the December 2020 legislation.

Setting Every Community Up for Retirement Enhancement (SECURE) Act

The Further Consolidated Appropriations Act, 2020 (Public Law 116-94, enacted on December 20, 2019) includes the SECURE Act. The SECURE Act expands opportunities for individuals to increase their retirement savings, increases small business access to retirement plans, and makes administrative simplifications to the retirement system. The SECURE Act is widely considered the most significant retirement legislation since the Pension Protection Act of 2006.

See the table *Setting Every Community Up for Retirement Enhancement (SECURE) Act Summary of Major Provisions* on Page Q-6 for a summary of the SECURE Act provisions.

Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act)

The Further Consolidated Appropriations Act, 2020 (Public Law 116-94, enacted on December 20, 2019) includes the Disaster Act. The Disaster Act retroactively extends certain expired provisions, generally through 2020. This means that taxpayers can apply many of these provisions to 2019 and later and already-filed 2018 tax returns. The Disaster Act also provides relief for taxpayers affected by qualified disasters occurring from January 1, 2018 through January 19, 2020. In addition, the Disaster Act includes other provisions not related to expired provisions or disasters.

See the table *Taxpayer Certainty and Disaster Tax Relief Act of 2019 Retroactive Extension of Provisions That Had Expired* on Page Q-10 for a summary of the extended provisions.

See the table *Taxpayer Certainty and Disaster Tax Relief Act of 2019 Disaster Tax Relief and Other Provisions* on Page Q-13 for a summary of disaster relief and other provisions.

Tax Legislation—COVID-19 Relief

To help taxpayers deal with the impact of the coronavirus pandemic, and to stimulate the U.S. economy, the federal government has provided a host of tax and employee benefit relief provisions. Some are by way of legislation, while others are administrative.

COVID-19 Tax Alert: The IRS has created a "Coronavirus Tax Relief" website. According to the agency, the site focuses on steps to help taxpayers, businesses, and others affected by the virus. The IRS will update its Coronavirus Tax Relief website as new information is available and it can be accessed at **www.irs.gov/coronavirus**.

In addition to the COVID-19 legislation addressed in this section and in the impacted topics throughout this *Handbook*, the IRS has issued and will continue to issue guidance to clarify and implement provisions related to this federally declared disaster. Due to the time sensitivity of that guidance, it will not be focused on in this *Handbook*. Tax professionals can refer to **www.irs.gov/newsroom** for current releases.

Families First Coronavirus Response Act (FFCRA)—Selected Provisions

On March 18, 2020, President Trump signed into law the FFCRA (Public Law 116-127), which is intended to ease the economic consequences stemming from the coronavirus pandemic by providing, among other things, (1) family and medical leave, and sick leave, to employees and (2) tax credits to employers that pay for the leave. The FFCRA also affects employer-sponsored health plans.

Family leave for employees. The FFCRA includes the Emergency Family and Medical Leave Expansion Act (EFMLEA) (Division C of the FFCRA), which requires employers with fewer than 500 employees to provide both paid and unpaid public health emergency leave to certain employees from April 1, 2020 through December 31, 2020. The emergency leave generally is available when an employee who has been employed for at least 30 calendar days (an *eligible employee*) is unable to work or telework due to a need for leave to care for a son or daughter under age 18. The need for leave must arise because an elementary or secondary school or place of care has been closed, or the son's or daughter's regularly compensated childcare provider is unavailable, due to an emergency with respect to the coronavirus that is declared by a federal, state, or local authority.

The first 10 days of leave may be unpaid, but an employee may elect to substitute vacation, personal, medical, or sick leave for the unpaid leave. After the first 10 days, the employer must provide up to an additional 10 weeks of paid expanded family and medical leave. The required paid leave is calculated based on an amount not less than two-thirds of an employee's regular rate of pay and the number of hours the employee would otherwise be normally scheduled to work, but not in excess of $200 per day and $10,000 in the aggregate. Certain special rules apply, such as when calculating required paid leave for an employee whose schedule varies from week to week. Also, if the leave is foreseeable, an employee must provide the employer with notice of leave as is practicable.

The Secretary of Labor is authorized to issue regulations that—

- Exclude certain health care providers and emergency responders from the definition of *eligible employee*, and
- Exempt small businesses with fewer than 50 employees from the leave provision mandate if it would jeopardize the viability of the business as a going concern.