

BUSINESS TAX UPDATE



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By Arthur Werner, Esq.

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2023 BUSINESS FEDERAL TAX UPDATE



Today's Instructor

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Art received his B.S. in Accounting and his M.S. in Taxation from Widener University. He holds a J.D. in Law from the Delaware Law School.

Art lectures extensively in the areas of Tax Planning and Compliance as well as Estate and Financial Planning, Financial Planning to CPAs, EAs, and other tax professionals, and has presented well in excess of 2500 eight-hour seminars over the past twenty-five years as well as numerous webinars and video presentations. Mr. Werner has been rated as having the highest speaker knowledge in his home state of Pennsylvania by the Pennsylvania Institute of Certified Public Accountants, was awarded the AICPA Outstanding Discussion Leader Award in the State of Nevada, the Florida Institute of CPAs Outstanding Discussion Leader Award, and the South Carolina Association of CPAs Outstanding Discussion Leader Award.



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Misc. Business Issues

Reporting Cash Transactions

- **Why?** – FinCEN's effort to combat money laundering, tax evasion, terrorist financing and drug dealings.
- **Who Must Report** – Any business transaction receiving cash (or equivalent) within a 12-month period of:
 - A single lump sum over \$10,000, or
 - Two or more related transactions (those occurring within a 24-hour period) in excess of \$10,000.
- **Form Due Date:** Within 15 days after the cash was received.
 - If the 15th day falls on a Saturday, Sunday or holiday, the next business day.
- **Penalty** – Minimum penalty for intentionally filing an incorrect or incomplete 8300 is \$25,000.

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Reporting Cash Transactions (cont.)

- **Mandatory E-File**
 - Effective for Form 8300 filed after 2023.
 - Beginning with calendar year 2024, businesses must e-file all Forms 8300 (and certain other types of information returns required to be filed in a given calendar year) if they're required to file at least 10 information returns other than Form 8300.
 - Can be e-filed on the FinCEN website or to IRS.
 - Form 8508 Waiver is available for undue hardship.
 - Again, the form is due 15 days after transaction.
 - Late penalty is \$310 per form (\$60 if only 30 days late).

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Expenses for a Previously Failed Business

- Expenses from a prior failed or closed Schedule C business can be deducted in a future year when paid.
- As per Rev Ruling 67-12, expenses incurred in prior years and paid in the current year by a cash-basis individual can be deducted even though the trade or business has been discontinued.
- The expenses must be deducted on a Schedule C.
 - Unfortunately, this can create a poor audit profile.
- Some practitioners incorrectly attempt to hide these expenses on other forms.
 - This runs afoul of Cir 230 §10.51(4) (providing false or misleading information).
- Voluntary payments of another's business expenses, where there is no legal obligation to pay them, are not deductible.
 - This is true even though the payments are made to preserve the individual's reputation, credit or professional standing.

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Employing a Child

- The income tax advantages include:
 - Reduces SE and income taxes of the parents (business owners).
 - If unincorporated business, wages for child under age 18 not subject to FICA.
 - A salary is earned income, not subject to the "Kiddie Tax".
 - The child's EI is offset by the standard deduction, \$13,850 for 2023.
 - The child could make a traditional IRA contribution up to \$6,500.
 - Thus earn \$20,350 tax free.
 - Or for long-term benefits contribute to a Roth IRA.
 - If child balks, perhaps parents or grandparents could gift the child the IRA contribution.

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Charity of Business Expense

- Generally, cannot deduct a charitable contribution on Schedule C.
- However, transfers to a charity that are directly related to a taxpayer's business and made with a "reasonable expectation of financial return commensurate with" the amount transferred may be deductible as business expenses.
- Of course, no business expense deduction is allowed for the transfer if *any* part of it is deductible as a charitable contribution. (Reg §1.162-15(a)(2))

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Business Expense – “Lavish or Extravagant

- The term lavish or extravagant is frequently used in the tax code.
- Nowhere in the Code are the terms lavish or extravagant defined in a measurable way.
 - For example, in relation to business meals, IRC §274(k)(1)(A) says “lavish or extravagant under the circumstances”.
 - So, it boils down to a facts and circumstances determination.

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Business Expense – Is Claiming Optional?

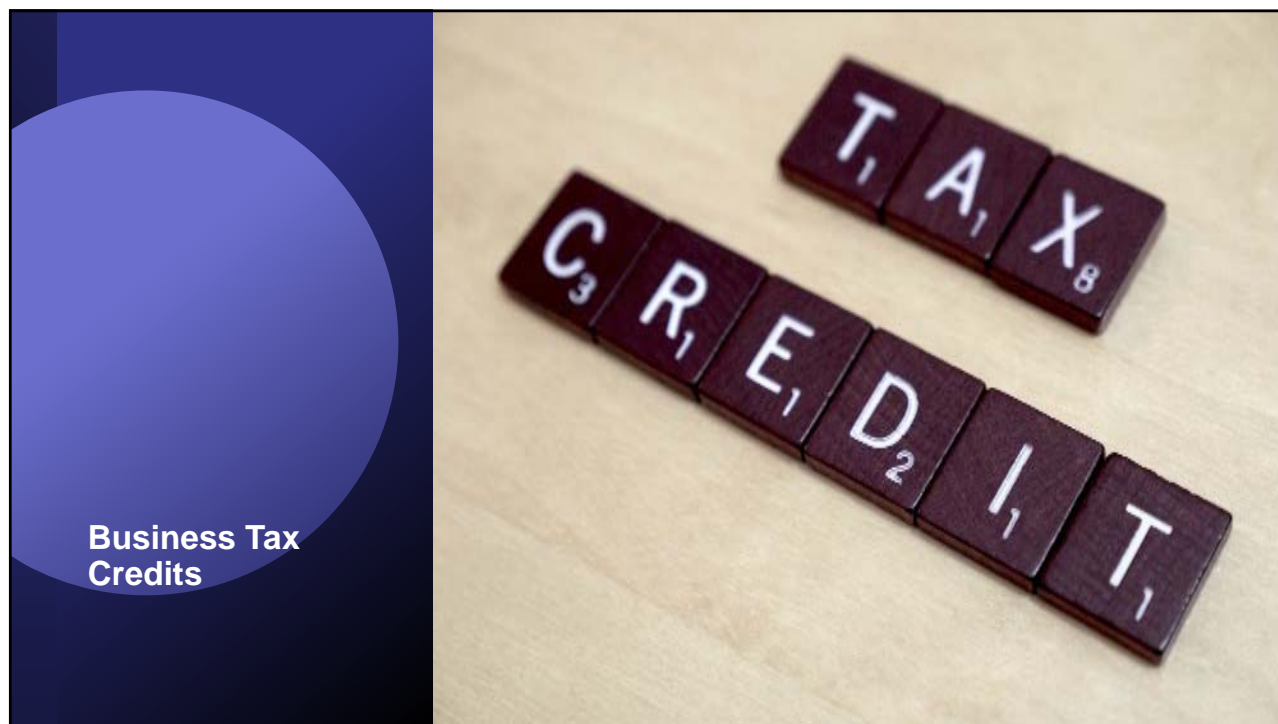
- Some might adjust to:
 - Boost their SE tax for the purpose of increasing their SS Benefits.
 - Others might want to establish earned income to maximize EITC.
 - This is what unethical preparers and scammers frequently do.
- **Short Answer Is NO!**
 - IRC §1402(a) defines net earnings from self-employment as “the gross income, less the deductions allowed by this subtitle.”
 - Gross income from a trade or business does not itself constitute net earnings from self-employment; allowable deductions must be taken for expenses in order to arrive at net SE earnings.
 - Since net SE earnings are earned income for EITC purposes the rule that claiming allowable deductions is mandatory applies to EITC.
 - Deliberately not claiming expenses to increase the amount of EITC would be fraud. (Chief Counsel Advice 200022051)

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Buying or Selling a Business

- An often forgotten, but very important IRS form is the 8594.
 - Both purchaser and seller of a group of assets must file Form 8594.
 - \$310 penalty (\$60 if corrected within 30 days and \$120 if corrected by August 1st)
 - The form allocates assets by the “residual method”, Class I through VII.
 - The purchase price is reduced successively by the assets in classes through VI based on their fair market value.
 - The excess (residual) is goodwill and going concern value.

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General Business Credit

- **General Business Credit** - Certain business incentive credits are combined into one “general business credit” for purposes of determining each credit’s allowance limitation for the tax year.
- **Limitation** - Generally only allowed against income tax.
- **AMT**- Certain credits offset AMT.
- **Carryback** - Carried back one year.
- **Carryover** – Carried forward for twenty years.
- **Credits** - Over 40 different credits make up the general business credit.
 - For small businesses, the general business credit is made up of the 20-some credits.

Pension Start-Up Credit

- Nonrefundable income tax credit for the administrative and retirement education expenses.
- For small businesses that adopt a new plan, including:
 - 401(k) plans,
 - SIMPLE plans, or
 - Simplified employee pension ("SEP") plans).
- In addition to claiming the credit for the expenses for the year in which the plan becomes effective, the credit may also be claimed for the plan-related administrative and retirement-education expenses in the following two years.
- Applicable Years: First credit year and each of the two tax years immediately following the first credit year.
- Credit equals the greater of \$500 or the lesser of:
 - \$250 multiplied by the number of non-highly compensated employees eligible to participate, or
 - \$5,000.

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Automatic Enrollment Credit

- **Effective** – 2020 and later years
- **Credit** - \$500 per year for first 3 years.
- **Applicable** - Starting the first year the employer's qualified retirement plan includes an eligible automatic contribution feature. Applies to converted existing plans and new plans.
- **Eligible Employer**
 - 100 or fewer employees who received compensation in excess of \$5,000.
- **Pension Start-Up Credit** – The auto-enrollment credit can only be claimed by employers that also qualify for the pension start-up credit.
- Is a **General Business Credit** (carry back 1 year, forward 20).
- **Eligible Plans** – Defined benefit and defined contribution plans, 401(k), SIMPLE and SEP plans.

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Automatic Enrollment Credit (cont.)

- **Mandatory Automatic Enrollment**

- Effective Date: Plan years beginning after December 31, 2024
- Requires new 401(k) and 403(b) plans to automatically enroll participants upon becoming eligible (employees may opt out).
 - The initial auto-enrollment contribution rate is least 3% but not more than 10%.
 - Each year thereafter is increased by one percentage point until it reaches at least 10%, but not more than 15%.
- All 401(k) and 403(b) plans in existence before the enactment date of SECURE 2.0 Act (12/29/2022) are grandfathered (i.e., not required to have automatic enrollment).
- The following employers are exempt from the mandatory enrollment, including:
 - Small businesses with 10 or fewer employees.
 - SIMPLE Plans (within the meaning of section 401(k)(11)).
 - Employers that have been in business for less than 3 years.
 - Church Plans.
 - Government Plans.

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Work Opportunity Credit

- **Employer's Credit** – 25% to 40% of first-year wages, generally up to \$6,000.
- **Sunset** – Employee must begin work before Jan 1, 2026.
- **Max Credit** – Generally \$2,400 (.4 x \$6,000) per employee.
 - For target groups with higher eligible wage limit, credit is higher.
- **Credit Percentage**:
 - Employee working a minimum of 400 hours first year: 40%
 - Employee working 120 to 399 hours first year: 25%
- **Certification** – To be eligible to claim a WOTC, an employer files Form 8850 with the State Workforce Agency (SWA) no later than the 28th day after the potentially eligible employee begins work.
 - Vets get fast track certification.

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Work Opportunity Credit (cont.)

- **No credit** allowed for an employee who is related to employer, or to owners of employer or a dependent of the employer.
- **Other credits** - Claiming the WOTC may also impact the availability of certain other employment-related tax credits.
- **Prior Employees** - Employment of prior employees or replacements for employees on strike or locked out and employees who are receiving federally funded on-the-job-training do not qualify.
- **General Business Credit** – Credit is part of the General Business Credit.
- **Tax-Exempt Employers** –
 - Qualifies for hiring veterans.
 - Credit allowed against the employer's share of Social Security taxes.
 - Credit reduced: 26% instead of 40% and 16.25% instead of 25%.

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Credit for Commercial Clean Vehicles

- **§38 Business Credit**
 - New Sec 45W
 - Available after 2022
- Credit is the lesser of:
 - 15% of the vehicle's basis (30% for vehicles **not** powered by a gasoline or diesel engine) or
 - The "incremental cost" of the vehicle over the cost of a comparable vehicle powered solely by a gasoline or diesel engine.
- Maximum Credit:
 - \$7,500 for vehicles with gross vehicle weight ratings of less than 14,000 pounds, or
 - \$40,000 for heavier vehicles.

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Credit for Commercial Clean Vehicles - Qualified Vehicles

- Acquired for use or lease by the taxpayer, and not for resale;
 - Manufactured for use on public streets, roads, and highways, or
 - Mobile machinery as defined in IRC §4053(8).
- With a battery capacity of not less than 15 kilowatt hours (7 kilowatt hours for vehicles weighing less than 14,000 pounds);
- Charged by an external electricity source;
- Qualified commercial fuel cell vehicles are also eligible for the credit;
- Must be depreciable property;
- Made by qualified manufacturers, who have written agreements with and provide periodic reports to the Treasury.

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Credit for Commercial Clean Vehicles – Mobile Machinery

- Mobile Machinery is any vehicle which consists of a chassis:
 - That has permanently mounted machinery or equipment to perform construction, manufacturing, processing, farming, mining, drilling, timbering, or similar operation if its operation is unrelated to transportation on or off the public highways, and
 - That has been specially designed to serve only as a mobile carriage and mount (and a power source, where applicable), and
 - Which cannot transport any load other than that machinery or equipment it was designed for.

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Credit for Commercial Clean Vehicles – Other Issues

- Special rules apply to vehicles placed in service by tax-exempt entities.
- A vehicle identification number (VIN) is required on returns claiming the credit.
- Basis must be reduced by the amount of the credit.
- Property used outside of the U.S. is not qualified
- Credit recapture rules shall be specified by IRS regulations
- Vehicle will not be qualified for the credit unless in compliance with the Clean Air Act.

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Research Credit

- The IRC §41 credit is generally based upon increases in research activities and expenditures. Its purpose is to reward businesses that pursue innovation by continually increasing investment.
 - Even so, the simplified method allows taxpayers to claim the research credits even if research costs remain the same or even decline when compared with prior years.
- **Credit Methods** - There are two methods of determining the credit.
 - Regular (equals 20% of qualified research expenditures over a 1984–1988 base amount or another method for companies that started up subsequently), and
 - Simplified Method (used by most small businesses and which equals 14% of qualified research expenses over 50% of the average annual qualified research expenses in the three immediately preceding tax years.)

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Research Credit – Small Business Payroll Election

- A qualified small business may elect to apply a portion of its research credit against the employer's share of the employees' FICA withholding requirement (the 6.2 percent payroll tax).
 - A qualified small business is one with less than \$5,000,000 in gross receipts for the year the credit is being claimed and no gross receipts for any taxable year before the 5-taxable-year period ending with the taxable year
- The Inflation Reduction Act of 2022 increases the limitation on the ability of small businesses to claim the research credit against payroll taxes from \$250,000 to \$500,000 after December 2022.

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Research Credit – Amortization of Expenses

- As of the 2022 tax year, in lieu of the credit, amounts paid or incurred for specified research expenditures must be amortized ratably over five years (or 15 years for foreign expenditures).
- With the amortization period beginning in the mid-point of the tax year in which the expenditures were paid or incurred.
 - Previously taxpayers could immediately expense these costs or elect a 60-month amortization period.
- For post-2021 expenditures, even if the related property is disposed of, retired, or abandoned during the amortization period, the taxpayer must continue amortizing the expenses until the end of the amortization period.

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Research Credit – Qualified Research

- Qualified research means research which is undertaken for the purpose of discovering information which is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and relates to:
 - A new or improved function,
 - Performance, or
 - Reliability or quality.
- Certain purposes that are not qualified include style, taste, cosmetic, or seasonal design factors.
- The definition is relatively broad and encompasses such activities as:
 - Developing new or improved products, processes or formulas;
 - Developing prototypes or models; Developing or applying for patents;
 - Certification testing; Developing new technology;
 - Environmental testing; Developing or improving software technologies;
 - Building or improving manufacturing facilities; and Streamlining internal processes.

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Paid Family and Medical Leave Credit

- The credit is 12.5% of the amount of wages.
- Where the wages are at least 50% of normal.
- For a maximum of 12 weeks per year.
- The credit % is increased by 0.25% for each percentage point above 50% paid to the employee.

EXAMPLE PAY-CREDIT PERCENTAGES	
Percent of Normal Pay	Credit Percentage
50	12.50
60	15.00 (12.5 + (.25 x 10))
70	17.50 (12.5 + (.25 x 20))
80	20.00 (12.5 + (.25 x 30))
90	22.50 (12.5 + (.25 x 40))
100	25.00 (12.5 + (.25 x 50))

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Paid Family and Medical Leave Credit (cont.)

- A “Qualifying Employer” must have a written policy.
- The policy at a minimum must provide:
 - 2 weeks of coverage to full time employees
 - Pro-rated amount for part-time employees.
 - Paid leave wages are at least 50% of normal
 - Full time employee is 30 hours or more per week.
- A “Qualifying Employee”:
 - Must have been an employee for a year or more.
 - For the preceding year had compensation not in excess of an amount equal to 60% of the “highly compensated employee” threshold.
- The highly compensated amount for 2023 is \$150,000 (up from \$135,000 in 2022)
 - Thus, a qualifying employee for 2023 would be one earning less than \$90,000 (.60 x \$150,000).

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Paid Family and Medical Leave Credit – Other Issues

- The credit is a general business credit.
- The employer cannot double dip. Must choose between a deduction for the employee’s wages or claim the tax credit.
- Wages used to figure the COVID-19 employee retention credit (ERC) cannot also be used to figure the PMFL credit.
- If a 2021 or 2022 Form 941 is amended to claim the ERC, the business return must be amended for the leave credit.
- The credit is claimed on Form 8994. Practitioners should carefully review the 8994 instructions for additional details.

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Disabled Access Credit

- The credit is 50% of eligible expenses in excess of \$250.
- The credit is capped at \$5,000.
- The Credit is nonrefundable.
- No Double Dipping - To the extent of the credit, the eligible access expenditures may not be claimed as a deduction in figuring taxable income, capitalized, or used in figuring any other credit.
- An eligible small business is one that had:
 - Gross receipts for the prior year of not more than \$1 million, OR
 - No more than 30 full-time employees in the prior year.

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Disabled Access Credit (cont.)

- For purposes of the definition:
 - Gross receipts are reduced by returns and allowances.
 - An employee is considered full time if employed at least 30 hours per week for 20 or more calendar weeks in the tax year, and
 - All members of the same controlled group and all persons under common control generally are one person.

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Disabled Access Credit – Eligible Access Expenditures

- Remove barriers preventing a business from being accessible by individuals with disabilities.
 - **Caution:** Does not include costs that are incurred with any facility first placed in service after Nov. 5, 1990.
- Provide interpreters or audio materials for hearing-impaired;
- Provide qualified readers, taped texts, and other methods of making visual materials available to individuals with visual impairments; or
- To acquire or modify equipment or devices for individuals with disabilities.

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Entity Issue

- **C Corporation** – Health insurance for all employees is fully deductible by the entity **SUBJECT TO** Affordable Care Act limitations.
- **All Other Entities**
 - **For non-owner employees:** Health insurance is fully deductible by the entity **SUBJECT TO** Affordable Care Act rules.
 - **For owners:** See upcoming slides

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Above-the-Line Deduction

- An above-the-line health insurance deduction for the cost of health insurance is allowed for self-employed, partners and more-than-2%-shareholders of an S corporation.
- **Application** - Applies to coverage for taxpayer, spouse, dependent, and child (even if not a dependent) who has not attained the age of 27 as of the end of the year.
- **Subsidized** - No deduction for any month during which the self-employed individual is eligible to participate in a “**subsidized**” health plan maintained by an employer of the taxpayer, the taxpayer's spouse, or any dependent, or any child of the taxpayer who hasn't attained age 27 as of the end of the tax year.
 - The term subsidized means 50% or more is paid by an employer and is applied separately to each type of insurance.
 - This rule is applied separately to (1) plans that provide coverage for qualified long-term care services or are qualified long-term care insurance contracts and (2) plans which don't include such coverage and aren't such contracts (IRC §162(l)(2)(B)).
 - Thus, an individual eligible for employer-subsidized health insurance may still be able to deduct long-term care insurance premiums, so long as he isn't eligible for employer-subsidized long-term care insurance.

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Above-the-Line Deduction (cont.)

- **Income Limit** – Limited to net SE income (wages for S-corp. shareholders).
 - Where the limit applies any excess can be claimed on Schedule A if itemizing.

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Self-Employed

- The deduction cannot exceed the individual's net earnings from self-employment derived from the trade or business.
- Net earnings is the net profit from Schedule C or Schedule F reduced by:
 - The 50% of SE tax deduction (1040 Schedule 1, line 14)
 - Contributions to the taxpayer's qualified retirement plan, SEP or SIMPLE plan (1040 Schedule 1, line 15)
- The health care policy can be either in the name of the business or in the name of the taxpayer.

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Partner in a Partnership

- Applies if taxpayer is a partner with **net earnings from self-employment** for the year reported on Schedule K-1, box 14, code A.
- The policy can be in the name of the partnership or in the name of the partner.
 - **If the partnership pays the premiums**, the premium amounts must be reported on Schedule K-1, Form 1065, as guaranteed payments included in the partner's gross income.
 - **If a taxpayer/partner pays the premiums**, and the policy is in the taxpayer/partner's name, the partnership must reimburse the taxpayer and the premium amounts will be included in gross income as guaranteed payments on Schedule K-1.
 - Otherwise, the insurance plan won't be considered established under the business.

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Partner in a Partnership

- Applies if taxpayer is a partner with **net earnings from self-employment** for the year reported on Schedule K-1, box 14, code A.
- The policy can be in the name of the partnership or in the name of the partner.
 - **If the partnership pays the premiums**, the premium amounts must be reported on Schedule K-1, Form 1065, as guaranteed payments included in the partner's gross income.
 - **If a taxpayer/partner pays the premiums**, and the policy is in the taxpayer/partner's name, the partnership must reimburse the taxpayer and the premium amounts will be included in gross income as guaranteed payments on Schedule K-1.
 - Otherwise, the insurance plan won't be considered established under the business.

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Shareholder of an S-Corporation

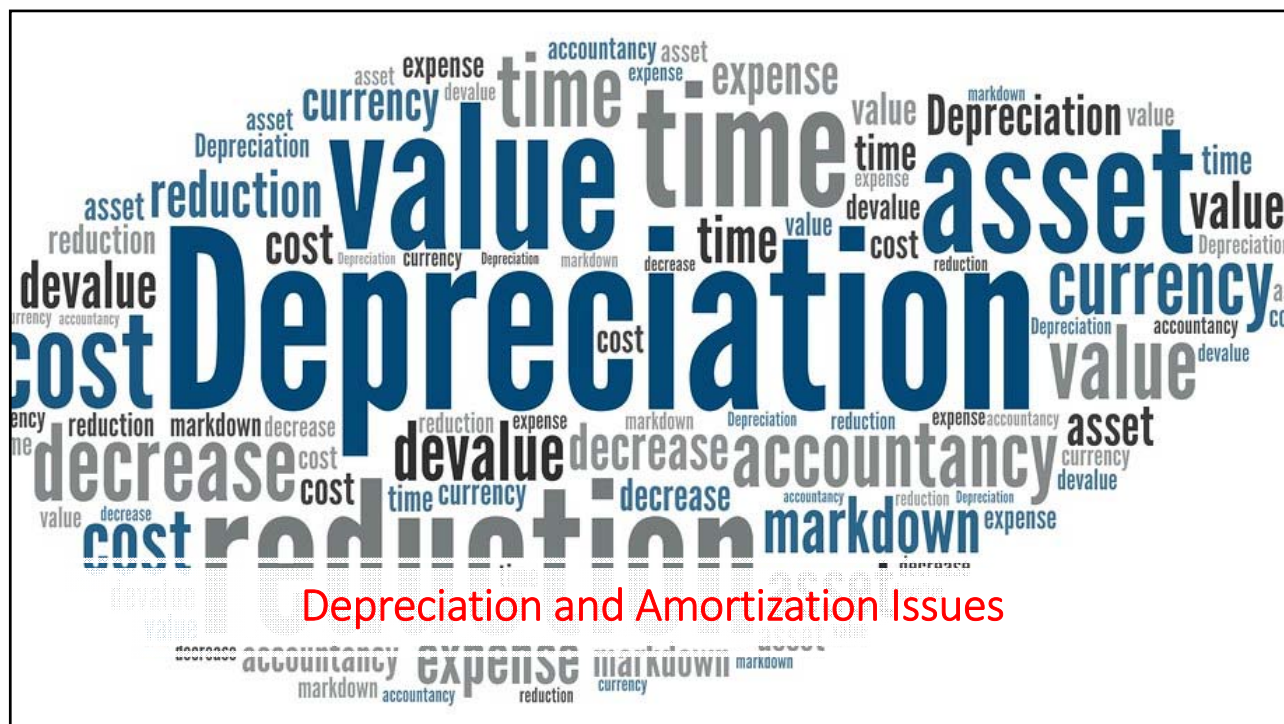
- Must be a more-than-2% S corporation shareholder,
- **Earned Income** - The shareholder's wages (i.e., the Medicare wages from box 5 of Form W-2) from the S corporation are treated as his earned income,
- **Premiums** - The premiums paid or reimbursed by the S corporation are shown as wages on Form W-2.
- **Policy** - The policy can be either in the name of the S corporation or in the name of the shareholder.
 - **If the S corporation pays the premiums**, the premium amounts are included on Form W-2 as wages.
 - **If the shareholder pays the premiums**, and the policy is in the shareholder's name, the S corporation must reimburse the shareholder and report the premium amounts on the W-2 as wages.
 - Otherwise, the insurance plan won't be considered established under the business.

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Types of Insurance Deductible at the Business Level

- Long-term care insurance premiums (up to the age-based max)
- ACA marketplace premiums net of the APTC
- Payback of any portion of the APTC in the year of the APTC
- Employee costs for employer group coverage
- Medicare parts B, C and D premiums
- Medicare supplemental plan premiums
- Dental insurance premiums
- Vision insurance premiums
- Lost or damaged contact lens premiums
- Travel Medical Insurance

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MACRS Life

- **Green Energy Property** – After December 31, 2024, MACRS 5-year life will include certain green energy property: qualified facilities, qualified property, and energy storage technology as added by the Inflation Reduction Act of 2022.
- **Artificial Grass** – Falls under landscaping (15 Year).
 - Plus, manufacturers indicate the useful life to be 14-15 years.

Bonus Depreciating Sunsetting

- 100% After September 27, 2017, and through 2022.
- **80% After Dec. 31, 2022, and before Jan. 1, 2024**
- **60% After Dec. 31, 2023, and before Jan. 1, 2025**
- 40% After Dec. 31, 2024, and before Jan. 1, 2026
- 20% After Dec. 31, 2025, and before Jan. 1, 2027
- Sunsets after 2026.

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Bonus Depreciating Sunsetting (cont.)

- Bonus Depreciation phaseout begins in 2023 (see prior slide)
- Replacement Options
 - IRC §179
 - Recapture Issue
 - Capitalization & Repair Regs
 - De Minimis Safe Harbor
 - Per Building Safe Harbor
- Nothing in Inflation Reduction Act that changes the phaseout timing

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Bonus Depreciation – The “Rules”

- Allowed for both new and used property.
- Applies to:
 - Tangible assets (except structures) with a MACRS life of 20 years or less;
 - Qualified film, TV, live theatrical productions;
 - Certain fruit and nut trees grafted or planted after 9/27/2017; and
 - Qualified improvement property.
 - TCJA created qualified improvement property by combining:
 - Qualified leasehold improvement property,
 - Qualified restaurant property, and
 - Qualified retail improvement property
- **Note:** Qualified improvement property qualifies for either Bonus or §179 or a combination of both.

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Revoking Bonus Depreciation

- Claiming bonus depreciation is automatic.
 - However, a taxpayer can elect out of bonus depreciation.
 - Generally, taxpayers have until 6 months after the original due date of the tax return to elect to revoke bonus depreciation.
 - Not a per-property election - revocation applies to all property in the class.
 - To make the revocation all taxpayers whose tax liability would be affected by the election must file an amended tax return for the year in question within the time limits
- Considerations:
 - Bonus depreciation can produce a loss and losses can create an NOL which, if incurred in 2021, will carry forward.
 - The §179 deduction is limited to the amount of taxable income from any of a taxpayer's active trades or businesses (so can't go into loss territory) and there are recapture issues

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IRC §179 Deduction

- **Annual Deduction Limit:** For 2023, it is \$1,160,000
- **Investment Limit for 2023** - \$2,890,000 (annual deduction limit is reduced \$1 for every \$1 the total cost of qualifying property placed in service in any given year exceeds the investment limit).
- **Taxable Income Limit** - The amount of deduction is limited to the amount of taxable income from any of a taxpayer's active trades or businesses. Taxable income, for this purpose, is computed **without** regard to:
 - The cost of any qualified expense property;
 - The above-the-line deduction for a portion of SE tax;
 - Any net operating loss carryback or carryforward; and
 - Any deductions suspended under the passive activity rules.

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IRC §179 Deduction (cont.)

- **Carryover** – Amounts that can't be deducted because of the taxable income limit may be carried over to the next year and added to the cost of qualifying property in that year.
 - Apply carryover amounts on a FIFO basis.
 - Carryover subject to the taxable income limit and dollar limit for carryover year.
 - No carryover for amounts lost due to investment limit or the maximum deduction limit.
- **Recapture** - If property is removed from business service (or not used more than 50% for business) at any time before the end of its recovery life, recapture is necessary.
 - Add back the excess of the §179 amount over the MACRS deduction that would have been allowed.
 - Recapture entered on Form 4797, Part IV, then reported as income where it was originally claimed.

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Bonus Depreciation, or IRC §179 Deduction?

- When deciding whether to use bonus depreciation or 179 consider:
 - **Recapture:** §179 is subject to recapture, but bonus is not.
 - **SUVs:** §179 is limited to \$28,900 in 2023 (up from \$27,000 in 2022).
 - No limit for bonus.
 - **Income Limit:** §179 deduction limited to taxable income from all trades and businesses of the taxpayer (and spouse).
 - Bonus is not.
- However, §179 can be used on a property-by-property basis while bonus applies to all assets of a property class if claimed for any asset of that class – can't pick and choose.

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IRC §179 – Residential Rentals

- §179 generally applies to §1245 (personal tangible property),
- §179 property specifically states that buildings and their structural components do not qualify.
- There are exceptions for property used in an active trade or business:
 - Qualified leasehold improvements,
 - Qualified Restaurant property,
 - Qualified retail improvements,
 - Off-the-shelf software, and
 - Heating and air conditioning systems.
- However, don't overlook expensing opportunities in the cap and repair regs. expensed under routine maintenance for buildings, repairs undertaken contemporaneously with improvements, or the per-building safe harbor for qualifying small taxpayers.

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IRC §197 – Intangibles

- There is different tax treatment for intangibles that are acquired as opposed to being self-created.
- **Acquired Intangibles** – Amortized over 15 years.
- **Acquired DURING the business**
 - Goodwill, going concern, workforce and Information in place and know-how, customer and supplier-based intangibles,
 - Government licenses and permits. These include:
 - Liquor License
 - Taxi-cab Medallion (or license)
 - Franchises, trademarks, and trade names,
 - Insurance policy expirations, and
 - Bank deposit base

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IRC §197 – Intangibles (cont.)

- **Acquired as Part of the BUSINESS ACQUISITION**
 - Covenants not to compete,
 - Computer software,
 - Films,
 - Sound recordings,
 - Video tapes and books,
 - Copyrights and patents,
 - Rights to receive tangible property or services,
 - Interest in patents and copyrights,
 - Mtg servicing rights secured by residential real property, and
 - Contract rights good for less than 15 years or fixed in amount.

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Introduction to the CTA

- As part of the Defense Authorization Act for Fiscal Year 2021 enacted on January 1, 2021, the Corporate Transparency Act (CTA) established a new directive for the Financial Crimes Enforcement Network (FinCEN) to develop standardized reporting, maintenance, and disclosure of beneficial ownership information.
- The purpose of the Act is to strengthen existing mechanisms that protect U.S. national security and guard against money laundering, sanction-evasion maneuvers, terrorism financing, and other forms of illicit finance.

What Companies Must Comply?

- **Reporting Companies Include:**

- Domestic Corporations (Both C & S).
- Domestic Limited Liability Companies.
- Other Domestic Entities Created by State or Tribal Filings.
 - Would generally include limited partnerships and family limited partnerships.
 - Perhaps even general partnerships depending upon state/tribal law, plus ???
- Foreign Corporations, LLCs, or other foreign entities AND which are registered to do business in a U.S. State or Indian Tribe.

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When is Reporting Required?

- FinCEN will begin accepting reports on January 1, 2024.
- Companies Created or Registered before January 1, 2024
 - Will have until January 1, 2025, to file its initial beneficial ownership information report.
- Companies Created or Registered after January 1, 2024
 - Will have 30 days to file its initial beneficial ownership information report. This 30-day deadline runs from the time the company receives actual notice that its creation or registration is effective, or after a secretary of state or similar office first provides public notice of its creation or registration, whichever is earlier.

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How is Reporting Required?

- It is done electronically through a secure filing system available via FinCEN's website.
- There will be no fee for submitting beneficial ownership information reports to FinCEN.
- Reporting companies must report changes in beneficial ownership information within 30 days of any such changes.
- The Act exempts 23 types of entities from the reporting requirement.

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Who is a Beneficial Owner?

- In general, a beneficial owner is any individual:
 - Who directly or indirectly exercises “substantial control” over the reporting company, or
 - Who directly or indirectly owns or controls 25% or more of the “ownership interests” of the reporting company.
- “Substantial control” over a reporting company depends on the power they may exercise over a reporting company.
- “Ownership interests” generally refer to arrangements that establish ownership rights in the reporting company, including simple shares of stock as well as more complex instruments.

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What does the Company need to report?

- . Its legal name.
- . Any trade names, DBA, or “trading as” (ta) names.
- . The current street address if in the U.S
- . When principal place of business is outside the U.S. the current address from which the company conducts business in the United States.
- . Its jurisdiction of formation or registration; and
- . Its Taxpayer Identification Number.
 - A reporting company will also have to indicate whether it is filing an initial report, a correction of a prior report, or an update to a prior report.

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What Beneficial Owner information is needed?

- . The individual's name, date of birth, and address.
- . A unique identifying number from an acceptable identification document; and
- . The name of the state or jurisdiction that issued the identification document.
- . **Address:** Reporting company must report the residential street address. Except in the case of legal counsel, the business address.

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Acceptable Identification Documents

- A Non-expired U.S. state driver license.
- A non-expired identification document issued by a U.S. state or local government, or Indian Tribe.
- A non-expired passport issued by the U.S. government.
- If the individual does not have any of the above, the reporting company may provide the identifying number from a non-expired passport issued by a foreign government.
- In addition, the reporting company must submit an image of the identification document associated with the unique identifying number reported to FinCEN.

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Failure to Report

- To encourage compliance, and to discourage mishandling of sensitive personal data, the CTA includes penalties.
 - Mandatory \$500/day while a violation continues for willfully failing to report or willfully providing false information plus,
 - A civil fine of up to \$10,000 and up to 2 years in prison,
- Unauthorized disclosure or use of beneficial ownership data:
 - Criminal fine of up to \$250,000 or 5 years in prison or both, **or**
 - Up to \$500,000 and 10 years in prison, if the conduct occurred as part of other financial wrongdoing.

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Self-Employment Tax

WHO IS SUBJECT TO SE TAX?

- **Miscellaneous Income From an Occasional Act or Transaction** – Income from an occasional act or transaction, absent proof of efforts to continue those acts or transactions on a regular basis, isn't income from self-employment subject to the SE tax.
- **Notary** – **NO** - But need proof income is just from notary services.
- **Non-Resident Aliens** - **NO**
- **Fiduciaries:**
 - Professional fiduciaries – **YES**
 - Nonprofessional fiduciaries managing an estate with a trade or business – **YES**
 - Nonprofessional fiduciaries - **NO**
- **Probate Court Commissions** – Generally **NO** but see text.



Self-Employment Tax

WHO IS SUBJECT TO SE TAX? - Continued

- **Limited Partners – NO**
 - Generally, a partner is treated as a limited partner unless:
 - Has personal liability as a partner for debts of the partnership or claims against it,
 - Has authority to contract on the partnership's behalf, or
 - Participates more than 500 hours during the tax year.
 - If the partnership is a service partnership, anyone who provides more than de minimis amount of service isn't a limited partner.
- **Newspaper Vendors** under the age of 18 – **NO**
- **Conservation Reserve Program Payments** – if receiving SS retirement or disability payments - **NO**
- **Corporate Director Fees** – **YES**



Self-Employment Tax

WHO IS SUBJECT TO SE TAX? - Continued

- **S-Corporation Taxable Income – NO** – But don't overlook reasonable compensation (wages) requirements.
- **Partners – Trade or Business** – distributive share of the partnership's income and guaranteed payments – **YES**
- **Religious Exemptions** - Ministers, Christian Science practitioners, and members of religious orders who haven't taken a vow of poverty - generally **YES**.
- **Insurance Agent Termination Payments** – Generally **NO**.
- **Agricultural Co-op Payments to Retired Farmers** – **MAYBE**
- **Rents Paid in Crop Shares** – **NO** unless the landowner materially participates



Self-Employment Tax

WHO IS SUBJECT TO SE TAX? - Continued

- **Real Property** – Residential & Commercial, generally **NO**, except...
 - Hotel, Motel, etc., that provides substantial services - **YES**
 - Short-term Rentals reported on Schedule C – Discussed in Lesson 1.
- **Fishing Crew Member** – Compensation based on sales - **YES**
- **Statutory Employee** – Income is from a W-2 – **NO**
- **Taxpayer's Child under 18** – **NO** if employed in parent's unincorporated business. Otherwise **YES**.



Employee vs. Independent Contractor

EMPLOYEE OR INDEPENDENT CONTRACTOR

- **At Stake Monetarily Is:**
 - The government's ability to collect employment taxes,
 - The worker's ability to deduct business expenses,
 - Which retirement plans the worker will be eligible for...
 - Employer's retirement plan or
 - Self-employed retirement plan.
- **Employer Issues:**
 - May not be able to withstand the "economic strain" of additional employment taxes, retirement plan contributions, etc.
 - A worker who was misclassified as an independent contractor could also put the business's retirement and benefit plans in jeopardy for failing to cover all employees.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

STATE LAW PRIMARILY RULES

- The IRS provides a 20-Factor Test for determining if an individual is an employee or independent contractor.
- States are almost always the first to enforce employment laws and they enforce state law not federal.
- This almost renders federal law mute.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

STATE LAW

- **ABC Test** – Adopted by many states

(A) That the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact;

(B) That the worker performs work that is outside the usual course of the hiring entity's business; **and**

(C) That the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

"A" follows the federal direction and control criteria, but "B" and "C" apply criteria not specifically included in the federal definition.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

STATE LAW PRIMARILY RULES (CONT.)

- However federal law does provide a process where either an individual or an employer can request a determination when status is in doubt.
 - SS-8 – may be used by either the employer or the employee to request an IRS determination.
 - Filed separately, not with the tax return.
 - IRS will not issue determinations on proposed or hypothetical situations.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

AVOIDING EMPLOYER'S SHARE OF PAYROLL TAXES

- Form 8919 – Used by an employee to avoid having to pay SE tax on the 1099-NEC income when...
 - Already has been determined to be an employee, or
 - When the worker has filed an SS-8 and has not received a response from the IRS.
- Form 8919 (Uncollected Social Security and Medicare Tax on Wages), only requires payment of what would have been withheld if the worker were treated as an employee. By using Form 8919, the employee's Social Security and Medicare taxes will be credited to the employee's Social Security record.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

AVOIDING EMPLOYER'S SHARE OF PAYROLL TAXES (CONT.)

- Form 8919 requires the employee to check one of these boxes:
 - **Code A.** Filed Form SS-8 and received a determination as an employee.
 - **Code C.** I received other correspondence from the IRS that states I am an employee.
 - **Code G.** I filed Form SS-8 with the IRS and have not received a reply.
 - **Code H.** Received a W-2 and 1099-NEC and/or 1099-MISC from the firm for the same tax year.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

AVOIDING EMPLOYER'S SHARE OF PAYROLL TAXES (CONT.)

- **Code G** - If used:
 - Employee or the firm may be contacted for additional information.
 - No guarantee that the IRS will agree with the worker's opinion.
 - If the IRS disagrees, the worker may be billed for the additional tax, penalties, and interest.
 - If IRS determination is for multiple years – file amended open years.
- **Code H** – If used:
 - Do not file form SS-8

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

THE 20-FACTOR EMPLOYEE TEST

1. **Instructions:** Worker who must comply with instructions about when, where and how to work indicates employee status.
2. **Training:** Training given the worker by the employer usually shows employee status.
3. **Integration:** Services integrated into the business tends to mean worker is an employee.
4. **Services Rendered Personally:** A business requiring the worker to personally perform the services is showing control.
5. **Hiring Assistants:** If a worker hires, pays and supervises assistants to complete a contract that requires the worker to supply materials and labor and be responsible for the result, then the worker is independent.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

THE 20-FACTOR EMPLOYEE TEST – Continued

6. **Continuing Relationship:** work is performed at frequently recurring (although irregular) intervals demonstrates employee status.
7. **Set Hours of Work:** employees normally have set hours, independents set their own.
8. **Full-time Work:** Independents work when and for whom they choose. Employees' options are set by employer.
9. **Work Done on Premises:** Performed on employer's premises often indicates control. Control may even be present when a worker performs services in his/her own office(s) if it is the employer's option.
10. **Order of Sequence Set:** When the employer sets the order of an employee's duties, it shows control by the employer.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

THE 20-FACTOR EMPLOYEE TEST – Continued

11. **Reports:** If a worker must submit reports (oral or written) to the employer to account for his/her actions, control is also shown.
12. **Payments:** Employee status is shown if a worker is paid by the hour, week, etc.
13. **Payments of Expenses:** If the employer pays business or travel expenses of the worker, indicates employee.
14. **Tools and Materials:** An employer furnishing all the tools and materials to do the job usually indicates employee.
15. **Significant Investment:** An independent has significant investment in facilities or equipment.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

THE 20-FACTOR EMPLOYEE TEST – Continued

- 16. Profit or Loss:** An independent contractor can realize a profit or loss as a result of services performed. An employee has no such risk.
- 17. Working For More than One Business at a Time:** Independent status is indicated.
- 18. Offers Services to the General Public:** A worker who regularly and consistently makes his/her services available to the general public, is an independent contractor.
- 19. Right to Fire:** An independent contractor can't be fired if the specifications of a contract are met. An employee can be fired.
- 20. Right to Quit:** An employee can quit a job at any time without incurring liability whereas an independent is responsible to meet the terms of a contract

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

OTHER ISSUES

- **Home Workers** – A home worker is a person who:
 - Performs work per specifications provided by the person for whom the work is performed;
 - Works on materials or goods furnished by that person; and
 - Must return the finished product to that person or to someone designated by that person.
- **Home Workers are Statutory Employees**
 - Receives a W-2
 - Can deduct expenses above-the-line

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

OTHER ISSUES (CONT.)

- **Statutory Independent Contractors**

- Qualified Real Estate Agent - licensed real estate salesperson. Substantially all income earned is directly related to sales not hours worked. Must be a written contract between the agent and the principal that provides the agent won't be treated as an employee.
- Direct sellers are those in the business of selling consumer products to buyers at other than a permanent retail establishment. The sales must be made on a buy-sell basis, deposit-commission basis, or similar arrangement. Must be on a commission basis, not according to hours worked and there should be a written contract stating nonemployee status for tax purposes.

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EMPLOYEE OR INDEPENDENT CONTRACTOR (CONT.)

OTHER ISSUES – Continued

- **Section 530 Relief**

- Allows employers to treat certain employees as independent contractors, sometimes even when the employer has classified workers as independents in error.
- Gives relief from employment taxes to an employer who treats a worker as an independent (has never treated the worker as an employee) and has consistently filed all Federal returns (including 1099s) required AND has a "reasonable basis" for not treating the worker as an employee.

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Business Use of Home

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BIUBUSINESS USE OF HOME

Applies to Self-Employed Individuals Only (2018-2025)

- **Qualifications:** Used **exclusively** on a **regular basis** AND one of the following must apply:
 - Storing inventory for a wholesale or retail business for which the taxpayer's home is the only fixed location of the business.
 - Used as a licensed day care center.
 - A separate structure (caution – home sale gain exclusion will not apply to the separate structure).
 - Where the taxpayer meets with customers, patients, or clients.
 - The principal place of business.

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BUSINESS USE OF HOME

GROSS INCOME LIMIT

- **Deduction Limited** - To the gross income from the business.
- **Always Deductible** – Business portion of:
 - Home mortgage interest (no equity interest)
 - Property taxes, but see SALT limit later
 - Disaster losses
- **Gross Income** – Definition is a little odd... and is defined as total income from the business less:
 - The business portion of mortgage interest, taxes, casualties, plus
 - The business expenses relating to the business (e.g., supplies, advertising, etc.), but not to the use of the home

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BUSINESS USE OF HOME

OTHER ISSUES

- **Never Included in Carryover** – Since they are always deductible currently, whether or not a home office is claimed, the following are not included in home office carryover:
 - Home mortgage interest.
 - Property taxes.
 - Disaster losses.
- **Carryover** – Cannot be used on a different business.
- **Business closes** – Carryover not used on final year is lost.
- **Depreciation** – Is last item to be deducted; thus, any amount not used is not subject to recapture (basis reduction).

NOTE: The home office deduction, bonus depreciation, and Sec 179 all reduce a business's net income (QBI) and thus reduce the Sec 199A 20% pass-through deduction.

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BUSINESS USE OF HOME

DAY CARE CENTER Not subject to the exclusive use requirement provided the operator of a day care center or a family or group day care home with respect to state law:

- Has applied for a license, certification, registration or approval (and not been rejected), or
 - Has been granted a license, certification, registration or approval (and it has not been revoked), or
 - Is exempt from having a license, certification, registration or approval.
- Business usage is determined by space use and time used:

Example – Edna uses her living room, kitchen, and bathroom (1,400 square feet) ten hours a day, five days a week to provide licensed day care services. Her home is 2,400 square feet. Her business use is:

$$\frac{1,400}{2,400} \times \frac{10}{24} \times \frac{5}{7} = .1736 \text{ or } 17.36\%$$

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BUSINESS USE OF HOME

SIMPLIFIED HOME OFFICE DEDUCTION

- **Maximum Sq Ft Used in Calculation:** 300 Square Feet.
- **Amount Per Sq. Foot:** \$5.00 – Thus maximum deduction is \$1,500.
- **Deduction** is prorated by the month. Month = 15 days or more.
- **Form 8829** – Not required; enter directly on Schedule C.
- **Gross Income Test** – Applies
- **Depreciation** – None allowed including Sec 179 and bonus. Deemed amount is zero.
- **Additional Expenses** – Utilities, insurance, & maintenance not allowed.
- **Home Office Carryover**
 - Unused simplified method: deduction cannot be carried over.
 - Carryover from the regular method cannot be used in a year the simplified method is used.

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Businesses (SSTBs):

Trades or businesses that only qualify for the 20% pass-through deduction if the owner's taxable income is less than certain threshold amounts.



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SECTION 199A DEDUCTION

- **199A Deduction** – Is a 1040 below-the-line deduction equal to 20% of the QBI from a qualified trade or business.
- **Qualified Business Income (QBI)** – is generally the net profit from a Schedule C, E or F, a 1065 K-1, an 1120S K-1, a 1041 K-1, REITS (dividends) and pass-through income from publicly traded partnerships (PTP).
- **Taxable Income** – The deduction is limited to the taxpayer's 1040 taxable income (not to be confused with a business entity's net profit).
- **Business Categories** – There are two categories of business when computing the 199A deduction:
 - **Specified Service Trades or Businesses (SSTB)** – Which are basically those businesses providing personal services, and
 - **Qualified Trades or Businesses (QTB)** – All other trades or businesses.

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SECTION 199A DEDUCTION (CONT.)

- **Limitations** – There is a major distinction between QTBs and SSTBs when computing the 199A deduction.
- **SSTB** – The deduction phases out for taxpayers with 1040 taxable incomes above a threshold.
- **QTB** – The deduction is subject to the threshold except instead of phasing out, the “wage limitation” phases-in. The wage limitation will be explained later.
- The table below shows the threshold amounts and caps. The cap is where the phaseout for an SSTB ends and for QTB where the wage limitation is fully phased in.

Filing Status	Threshold (taxable income)				Delta	Cap			
	2020	2021	2022	2023		2020	2021	2022	2023
Married Joint	326,600	329,800	340,100	364,200	100,000	426,600	429,800	440,100	464,200
Single & HH	163,300	164,900	170,050	182,100	50,000	213,300	214,900	220,050	232,100
Married Separate	163,300	164,925	170,050	182,100	50,000	213,300	214,925	220,050	232,100

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SECTION 199A DEDUCTION (CONT.)

- The table below shows the 199A computation relationship between:
 - Filing status
 - The taxpayer’s 1040 taxable income, and
 - The type of trade or business.

Example: The taxpayer is filing a joint return and has a taxable income of \$400,000. If the TP is an SSTB then the deduction is phased out. If a QTB, the wage limitation is being phased in.

Taxpayer's Filing Status	1040 Taxable Income (2022) (Before the 199A deduction)		
	Less Than \$340,100	Between \$340,100 and \$440,100	Greater than \$440,100
Married Filing a Joint Return	Less Than \$340,100	Between \$340,100 and \$440,100	Greater than \$440,100
Married Filing Separate	Less Than \$170,050	Between \$170,050 and \$220,050	Greater than \$220,050
Other filing Statuses	Less Than \$170,050	Between \$170,050 and \$220,050	Greater than \$220,050
Type of Business	The 199A Deduction*		
	20% of QBI	Deduction is phased out	No deduction allowed
Specified Service Trade or Business (SSTB)	20% of QBI	Deduction is phased out	No deduction allowed
Qualified Trade or Business	20% of QBI	Wage limitation phased in	Deduction is the lesser of 20% of QBI or the wage limitation

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SECTION 199A DEDUCTION (CONT.)

- **SSTB Phaseout** – The phase out for SSTBs is not a simple ratable phaseout. Instead it takes into consideration wages paid by the business entity and assets owned by the business entity.
- **What is an SSTB?** - Specified service businesses include trades or businesses involving the performance of services in the fields of:
 - health, law, accounting, consulting,
 - actuarial science,
 - performing arts, athletics,
 - financial services,
 - brokerage services (not RE or investment brokers) or
 - Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

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Health

- **Included Are:**
 - Physicians, pharmacists, nurses, veterinarians, physical therapists, psychologists and other similar healthcare professionals.
- **Not Included Are:**
 - Health clubs or spas that provide physical exercise, payment processing, or research, testing and manufacture and sales of pharmaceuticals or medical devices.

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Law

- **Included Are:**

- Lawyers, paralegals, legal arbitrators, mediators and similar professionals.

- **Not Included Are:**

- Those where the services are not unique to the field of law such as services of printers, delivery services or stenography services.

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Accounting

- **Included Are:**

- Accountants, EAs, return preparers, financial auditors, CPAs.
- Accounting includes tax return and bookkeeping services, even though such services may not require the same education, training, or mastery of accounting principles as a CPA.

- **Not Included Are:**

- Payment processing or billing analysis

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Actuarial Services

- **Included Are:**
 - Actuaries and similar professionals
- **Not Included Are:**
 - Those who are not engaged in analyzing or assessing the financial risks or uncertainty of events, such as: analysts, economists, mathematicians and statisticians.

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Performing Arts

- **Included Are:**
 - Actors, singers, musicians, entertainers, directors, or similar professionals.
- **Not Included Are:**
 - Those whose skills are not unique to the creation of performing arts, including the maintenance or operation of equipment or facilities. Does not include services of broadcasters or distributors of video or audio of performances.

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Athletics

- **Included Are:**

- Participants such as athletes, coaches and team managers.

- **Not Included Are:**

- Services such as maintenance or operation of equipment or facilities used in athletic events or the services of those who broadcast or distribute video or audio of the sporting event.

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Consulting

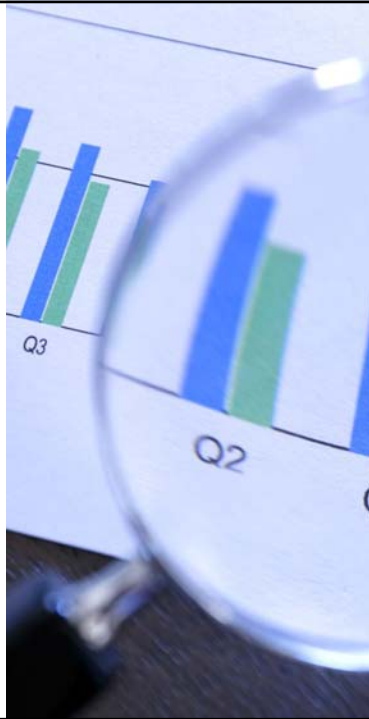
- **Included Are:**

- Providing professional advice and counsel to clients to assist the client in achieving goals and solving problems. Definitely includes lobbyists.

- **Not Included Are:**

- Counseling services provided in conjunction with the sale of goods. The preamble to the regs. also references the \$25 M & 10% rules we discuss later as might apply to this situation.

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Financial Services

- **Included Are:**

- Financial advisors, investment bankers, wealth management, retirement planning, valuations, services related to mergers and acquisitions, dispositions, reorganizations, issuance of securities, etc. Also arranging lending transactions.

- **Not Included Are:**

- Taking deposits or making loans.

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Brokerage Services

- **Included Are:**

- Services provided by stock brokers and similar professions

- **Not Included Are:**

- Real estate agents or brokers or insurance agents or brokers (final Regulation 1.199A-5(b)(2)(x)).

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Reputation & Skill

- **Narrow Definition:**
 - Endorsements
 - Licensing one's image, likeness, name, signature, voice, trademark, or other symbols of identity.
 - Appearance fees
 - Appearances by reality performers on TV, social media, or other forums
 - TV, radio and other media hosts
 - Video game players.

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SECTION 199A DEDUCTION (CONT.)

QUALIFIED BUSINESS INCOME (QBI)

- Net amount of Profit or Loss from a qualified U.S. business including:
 - Ordinary gain attributable to sale of a partnership interest.
 - Income from changes in accounting methods.
- Reduced by the following adjustments to income:
 - One half of SE tax,
 - SE health insurance, and
 - Retirement plan contributions (but not Traditional IRAs).

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SECTION 199A DEDUCTION (CONT.)

QUALIFIED BUSINESS INCOME (QBI)

- **QBI Does Not Include:**
 - ST or LT capital gain or loss
 - Dividends
 - Interest income not allocable to the business
 - Commodity transactions
 - Foreign currency transactions
 - Annuity income not associated with trade or business
 - Reasonable compensation
 - Guaranteed payments to partners for services
 - Payments to partners for use of capital

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SECTION 199A DEDUCTION (CONT.)

- **\$25 Million Rule** – A trade or business is not an SSTB if, determined before aggregation, if it has gross receipts of:
 - \$25 million or less (in a taxable year) **and** less than 10% of the gross receipts are attributable to the services of an SSTB, **or**
 - More than \$25 million - For trades or businesses with gross receipts greater than \$25 million **and** less than 5% of the gross receipts are attributable to the services of a SSTB.
- **Determining Wages** – For purposes of the wage limitation, the IRS provides 3 methods:
 - Unmodified Box Method
 - Modified Box 1 Method
 - Tracking Wages Method

If a payroll company is being used, no doubt they will provide this information.

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SECTION 199A DEDUCTION (CONT.)

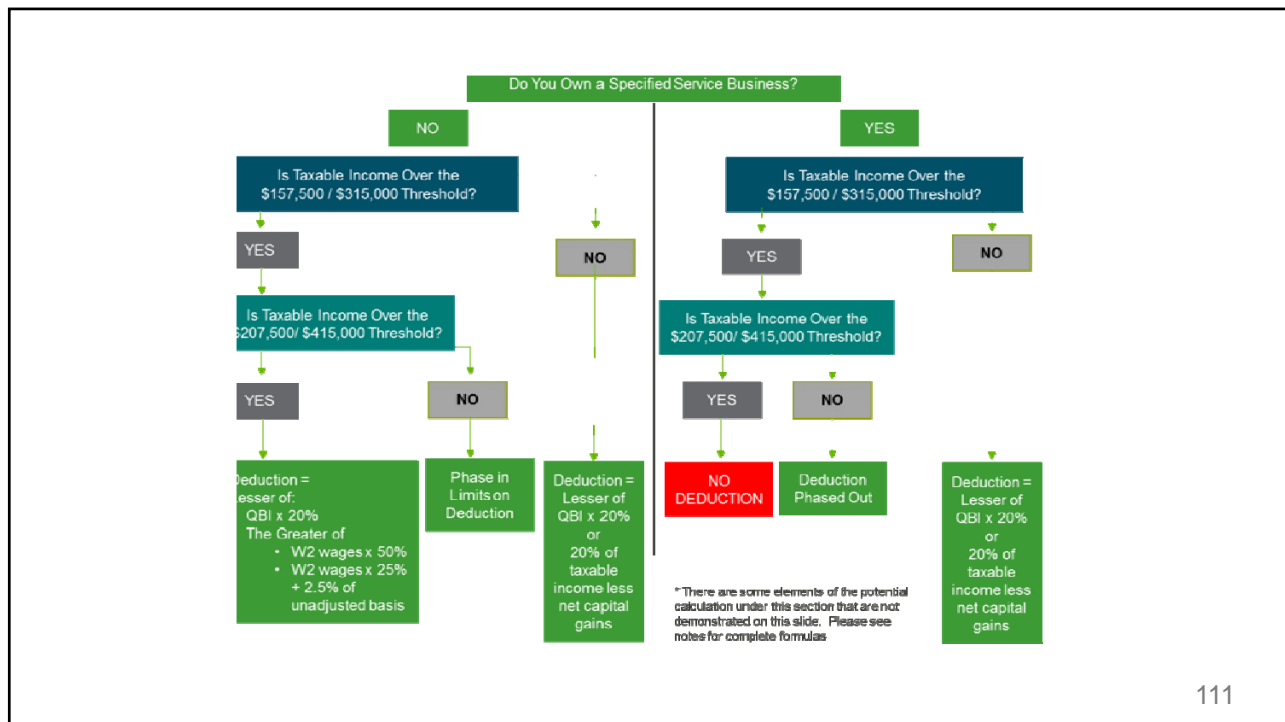
- **Qualified Property** – Includes tangible depreciable property that is:
 - Held by the business activity at year's end.
 - Available for use at year's end.
 - Used at any point during the year.
 - Used in the production of QBI.
 - Has been held for less than 10 years or its recovery period, whichever is longer.
- **Basis** – Is generally cost or other depreciable basis on the date placed in service without any subsequent adjustments.
- **Not Included in Qualified Property**
 - Generally, property acquired within the last 60 days of the year and disposed of within 120 days without being used for at least 45 days prior to disposition.
 - The portion of property also used for personal purposes.

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SECTION 199A DEDUCTION (CONT.)

- **Wage Limitation** – Now that wages and the qualified property have been determined, the wage limitation can be determined.
 - The wage limitation is the **greater** of:
 - 50% of the W-2 wages that the business paid, or
 - 25% of the W-2 wages paid by the business plus 2.5% of the unadjusted basis of the business's qualified property.

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Capitalization and Repair Regulations

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CAP & REPAIR REGULATIONS

BACKGROUND

- **Effective:** These regulations became effective for tax years beginning on or after January 1, 2014, but optionally allowed taxpayers to retroactively apply the regulations to tax years beginning on or after January 1, 2012.
- **Simplified Filing for Small Businesses** - Rev. Proc. 2015-20 provided simplified filing for small businesses and allowed them to apply the regulations prospectively but giving up retroactive audit protection and the ability to make retroactive adjustments based on the new regulations.
- **Application** - The regulations are a set of rules that apply in different circumstances and include a number of safe harbors.

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CAP & REPAIR REGULATIONS (CONT.)

UNIT OF PROPERTY (UOP)

The term UOP is throughout the cap and repair regulations and an understanding of its meaning is necessary to understand the application of the regulations.

- **Assets Other Than Buildings**
 - Consists of all the components that are functionally interdependent (where one requires the other)
- **Buildings** - In general, each building and its structural components are one UOP - "the building." Amounts are treated as paid for an improvement to a building, and thus capitalized, if they improve:
 - The **building structure** or
 - Any designated **building system**.

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CAP & REPAIR REGULATIONS (CONT.)

MATERIALS & SUPPLIES

- **Expensed When Used or Consumed.** They include:
 - Components to repair or improve
 - Fuel, lubricants, etc., consumed in 12 mo.
 - A UOP with a useful life of 12 mo. or less
 - A UOP costing \$200 or less
 - Property meeting the de minimis rule
 - Property identified by IRS guidance

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CAP & REPAIR REGULATIONS (CONT.)

DE MINIMIS SAFE HARBOR

- The de minimis safe harbor rule allows businesses to expense rather than capitalize the purchase of certain tangible property and applies differently to large businesses and small businesses.
 - **Large Businesses** – Are ones with “applicable financial statements” (audited financial statements, SEC filings or other government non-tax financial report filing duty).
 - **Small Businesses** – Are those without “applicable financial statements”.
- **Safe Harbor Amounts** – As specified in a firm’s accounting policies before beginning of tax year.
 - Large Business \$0 to \$5,000
 - Small Business \$0 to \$2,500

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CAP & REPAIR REGULATIONS (CONT.)

SAFE HARBOR ROUTINE MAINTENANCE

- Expenses needed to keep a UOP in operating condition.
- Expensed when performed.
- Maintenance a taxpayer expects to perform more than once:
 - During the class life of the UOP **or**,
 - During a 10-year period for buildings

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CAP & REPAIR REGULATIONS (CONT.)

IMPROVEMENT TO TANGIBLE PROPERTY

Generally, a taxpayer who owns a unit of property must capitalize the amounts paid to improve the UOP that results:

- In a betterment to the UOP,
 - Restores the UOP, or
 - Adapts the UOP to a new or different use.
- **Betterment costs** - which must be capitalized, consist of amounts paid:
 - To improve, perfect, upgrade, enhance a material condition or defect that:
 - Either existed before the taxpayer acquired the UOP **or**
 - Arose during its production,
 - Whether the taxpayer was aware of the condition or defect when it was acquired or produced.

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CAP & REPAIR REGULATIONS (CONT.)

PER BUILDING SAFE HARBOR (Small Taxpayers)

- Applies to TP with \$10M or less average gross receipts in prior 3 years
- Can elect to currently deduct improvements made to a building with an unadjusted basis of \$1 million or less.
- Improvements include repairs, maintenance, and similar activities.
- Per building limit is lesser of:
 - \$10,000 or
 - 2% of the unadjusted basis.

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CAP & REPAIR REGULATIONS (CONT.)

PARTIAL DISPOSITION ELECTION

- **Election** - Taxpayer can elect to report gain or loss on a partially replaced or retired property.
 - Must capitalize the replacement.
 - Must be in asset classes 00.11- 00.4
 - Does not apply to betterments or adaptations to a new or different use.
- **Decision** - Which provides your client with the best tax benefit?
 - Make the election and show a loss for the retired asset, and capitalize the replacement, **or**
 - Expense the replacement (if qualified) and continue to depreciate the retired asset.

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CAP & REPAIR REGULATIONS (CONT.)

PARTIAL DISPOSITION ELECTION (CONT.)

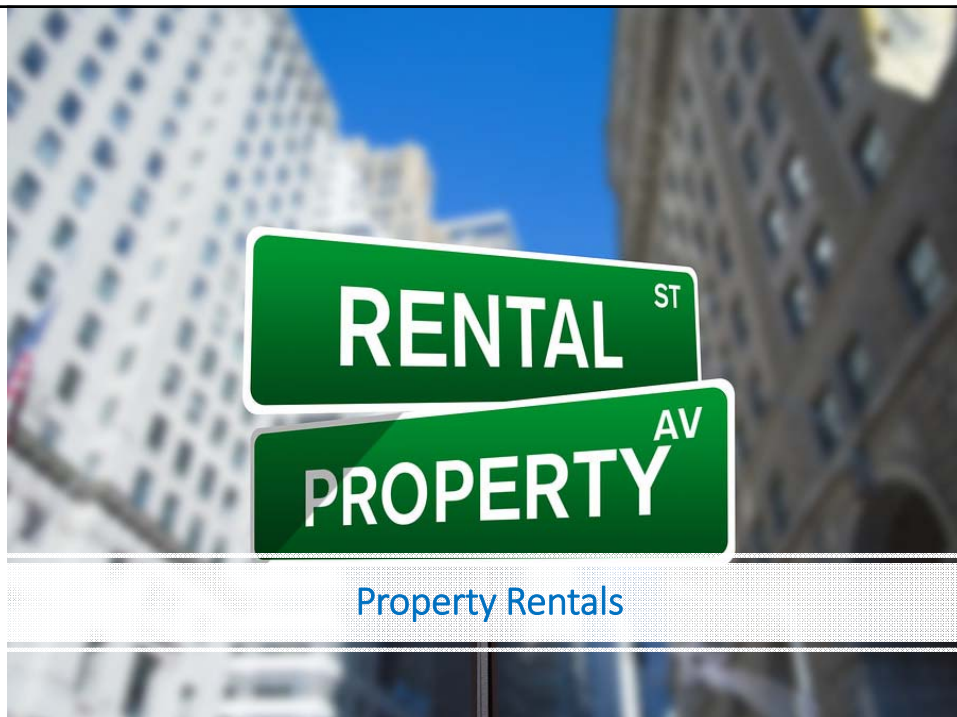
- **Example**

- Roof – Consists of two parts

- **Structure** – Underlying plywood – replacing would be betterment
- **Membrane** – Shingles, tar paper, etc. – replacing just the membrane would NOT be a betterment

- **Additional Problem** – Separating the retired partial asset's adjusted basis from the total property basis

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PERSONAL PROPERTY RENTALS

PERSONAL PROPERTY RENTALS

- **If a Trade or Business**
 - Reported on Schedule C (unless a partnership or corp.)
 - Subject to SE Tax
- **If NOT a Trade or Business**
 - Carefully analyze the circumstance to ensure it is not a trade or business; then if not a trade or business...
 - Enter the income on 1040 Sch 1 line 8(k) ("other" income)
 - Enter the expenses on 1040 Sch 1 line 24(b)

Note: the 1040 Schedule 1 line number references are from the greatly expanded version for 2022.

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Note: the 1040 Schedule 1 line number references are from the greatly expanded version for 2022.

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REAL PROPERTY RENTALS

PASSIVE ACTIVITY

- **Passive Activity** – Is any trade or business activity in which the taxpayer “DOES NOT MATERIALLY PARTICIPATE” in actual operations of the activity on a “regular, continuous, and substantial basis”.
- **Limited Partnership Interest** – is presumed passive (unless certain material participation standards are met).
- **Active Participation** – Participates in management decisions. Generally, must have 10% or more of ownership. Does not apply to limited partners.
- **Special Rental Real Estate Rule** – Passive losses are generally NOT deductible against non-passive income, except for the special rental real estate rule:
 - \$25,000 special loss allowance
 - Must show active participation
 - Allowance ratably phases out for AGI \$100K to \$150K

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REAL PROPERTY RENTALS (CONT.)

MATERIAL PARTICIPATION – Not subject to Passive Rules

- **Time Tests**. A taxpayer is a material participant if the taxpayer:
 - Participates **500 hours** or more during the tax year;
 - Provides **substantially all the participation** in the activity;
 - Spends more than **100 hours** on the activity **and nobody spends more** time than this on the activity; **or**
 - SPENDS AGGREGATE TIME over 500 hours on all “significant participation activities” (SPA's). A SPA is an activity in which the taxpayer spends over 100 hours during the year but cannot meet one of the three other time tests.
- **Prior participation tests** - A taxpayer may be a material participant based on prior participation rather than time. The taxpayer may meet either of these criteria:
 - Participate in the activity “materially” in any 5 of the last 10 tax years; or
 - Taxpayer is in a personal service business and was a material participant in any 3 previous tax years.

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REAL PROPERTY RENTALS (CONT.)

FORMER PASSIVE ACTIVITIES

- **Release of Suspended Passive Losses** – There are 3 events that trigger the release of suspended passive losses.
 - **Income from the same activity.** When an activity produces net income, this will trigger use of former unused losses from the same activity.
 - **Income from another passive activity.** Form 8582 handles this automatically. Any excess net income from passive activities triggers the allowance of suspended losses from all other passives.
 - **Disposition of the activity.** If the activity is disposed of in a fully taxable transaction, all suspended losses from that activity will be triggered.
- **Actual Event** – Rental home (improvements) destroyed in a wildfire. Remaining passive losses not released until the land was sold.

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REAL PROPERTY RENTALS (CONT.)

RENTED TO RELATIVE

- **Rented at Fair Rental Value** – Treat as a normal rental under the passive activity rules.
- **Rented at Less Than Fair Rental Value (FRV):**
 - When a home is rented at less than the FRV, it is treated as being used personally.
 - Since all the rental days (at a bargain rate to a relative) are treated as personal days, the rental portion is zero.
 - So, none of the expenses are deductible, other than property taxes and mortgage interest (if it qualifies as a second home) on Schedule A.
 - Although unlikely, there could be gift tax issues if the difference between the FRV and the actual rent exceeds \$15,000 for the year.

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EXCESS BUSINESS LOSSES

- **TCJA** – Imposed a limitation on business losses:
 - In excess of \$540,000* for MFJ taxpayers and \$270,000* for all other taxpayers, and
 - The unallowed loss is treated as an NOL carryover.

*2022 inflation-adjusted amounts
- **CARES Act** – The CARES Act retroactively turned off the excess active business loss limitation rule for years 2018, 2019 and 2020.
 - **Limitation Resumes** – Beginning after December 31, 2020, the loss limitation will again apply.

Bottom Line – This limitation is back!

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EXCESS BUSINESS LOSSES (CONT.)

EXAMPLE:

- A single taxpayer, in 2022, has...
 - Business deductions of \$500,000.
 - Gross income from the business is \$200,000.
 - The deductible loss would have been \$300,000 under prior law, provided the business was not a passive activity.
- For 2022 the excess business loss under TCJA is:
\$30,000 ($\$500,000 - (\$200,000 + \$270,000)$).
- Thus:
 - The taxpayer's deductible business loss for 2022 is \$270,000
 - The excess of \$30,000 is treated as an NOL carry forward.

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Equity Financing



Disallowance of Business Interest

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DISALLOWANCE OF BUSINESS INTEREST

SMALL BUSINESS EXEMPTION

- An exemption from the business interest limitation rules applies to taxpayers (other than tax shelters) with average gross receipts for the three prior years of \$27 million (2022 limit) or less.
- This amount is inflation-adjusted.

Example:

2019 gross receipts = \$28 million

2020 gross receipts = \$30 million

2021 gross receipts = \$15 million

Average = \$24.33 million...Less than \$27M so the limitation does not apply for the 2022 tax year.

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DISALLOWANCE OF BUSINESS INTEREST (CONT.)

- **PER TCJA** – Regardless of business form the interest expense is limited to the sum of:
 - The taxpayer's business interest income for the tax year;
 - 30% of the taxpayer's adjusted taxable income (ATI) for the tax year; and
 - The taxpayer's floor plan financing interest (certain interest paid by vehicle dealers) for the tax year.
 - Exception for small businesses with average gross receipts for the three prior years of \$27 million (2022) or less

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DISALLOWANCE OF BUSINESS INTEREST

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Average = \$24.33 million...Less than \$27M so the limitation does not apply for the 2022 tax year.

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DISALLOWANCE OF BUSINESS INTEREST (CONT.)

ADJUSTED TAXABLE INCOME (ATI)

- Determined without regard to:
 - Depreciation, amortization or depletion deductions
 - Business interest income or expenses
 - NOL deduction
 - Section 199A deduction
 - Income, gain, deduction or loss not allocated to the trade or business

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DISALLOWANCE OF BUSINESS INTEREST (CONT.)

REAL ESTATE ACTIVITIES

- Not subject to the interest limitation unless:
 - The rental activity is a trade or business, **and**
 - The small business exception does not apply.
- Form 8990 must be filed to deduct interest unless one of the following exceptions applies.
 - Small business exception,
 - Providing services as an employee,
 - Electing real property trade or business (next slide)
 - Electing farming business (next slide), or
 - Certain utility businesses.

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DISALLOWANCE OF BUSINESS INTEREST (CONT.)

REAL PROPERTY TRADES OR BUSINESS ELECTION

- A real property trade or business can elect out of the interest limitation by using the alternative depreciation system (ADS) to depreciate the real property used in the trade or business.

ELECTING FARM BUSINESS

- Farming businesses and specified agricultural or horticultural cooperatives can elect out of this provision if they use ADS to depreciate any property used in the farming business with a recovery period of ten years or more.

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