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2021 Federal Business Tax Update

Presented by:
Michael J. Reilly, CPA/ABV, CVA, CFF, CDA – Managing Partner

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2021 Federal Business Tax Update

Michael J. Reilly, CPA/ABV, CVA, CFF, CDA
Managing Partner
mreilly@dmcpas.com

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Pass-Through Entity Tax (PTET)

Pass-Through Entity Tax

Overview of the State and Local Income Tax (SALT) Cap

- Tax Cuts and Jobs Act (TCJA) limited the amount of SALT that could be included as a federal itemized deduction to **$10,000 for individuals**.
- This provision severely impacted individuals from high-SALT states, including NYS, since for all practical purposes, the SALT federal tax deduction was substantially minimized or eliminated for most individuals.

IRS Notice 2020-75

- On November 9, 2020, the IRS issued Notice 2020-75 which opened the door for a SALT workaround.
- This notice provides Pass-Through Entities (PTEs), such as partnerships and S corporations, a federal tax deduction in computing the PTE's non-separately stated taxable income for amounts paid by the PTE for SALT that are imposed on the taxable income of the PTE passed through to its owners.

Pass-Through Entity Tax

New York State Guidance

- On August 25th, NYS issued guidance on this favorable tax election in the form of a Technical Service Memorandum – TSB-M-21(1)C.
- Under TSB-M-21(1)C, **a PTE can elect to pay a portion of the PTE owners' NYS estimated taxes that are attributable to such owners' share of the PTE's taxable income.**
- The PTE takes a federal tax deduction for such taxes which essentially passes through to the owners of the PTE.
- The PTE owners end up getting a federal tax deduction for the NYS taxes which they would not otherwise get if such NYS taxes were not paid by the PTE.
- **The owners** of the PTE not only get their share of the **tax deduction** but can claim their share of the NYS taxes paid by the PTE as **a credit** against their NYS taxes.
- **Eligible PTEs include** only partnerships, S corporations and multi-member limited liability companies that have elected to be taxed as partnerships or S corporations.
- **For 2021**, the NYS PTET election was required to be **made by 10/15/21**.
- **For 2022**, the NYS PTET election is required to be **made by 3/15/22**.

Employee Retention Credit (ERC)

Employee Retention Credit

Overview

- The Employee Retention Credit (ERC) is a fully refundable tax credit for eligible employers based upon eligibility and payment of qualified wages and health plan expenses.
- The ERC applies to qualified expenses paid after 3/12/20 and **was set to expire on 12/31/21.**
  - **However, the recently House passed Infrastructure Investment and Jobs Act changed it to end on 9/30/21**.

Eligible Employer

- An eligible employer is any employer carrying on a “trade or business” during the ERC period (3/12/20 – 9/30/21), that either:
  - <u>**Fully or partially suspend operations**</u> during any calendar quarter in 2020 or 2021 due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19; or
  - <u>**Experience a “significant decline in gross receipts”**</u> during the calendar quarter.

Employee Retention Credit

CARES Act (3/27/20)

- **Wages Covered:** Wages paid from 3/13/20 – 12/31/20.
- **Credit Amount**: 50% of qualified wages.
- **Wage Cap**: $10,000 per employee for all quarters.
- **Maximum Credit**: $5,000 per employee for 2020.
- **Gross Receipts Eligibility Test:** 50% decline in calendar quarter gross receipts when compared to same quarter in 2019.
- **PPP Loan Recipients:** Not eligible for ERC.

Employee Retention Credit

Consolidated Appropriations Act (12/27/20) and American Rescue Plan Act (3/11/21)

- **Wages Covered:** Wages paid from **1/1/21 – 12/31/21 (now ends 9/30/21).**
- **Credit Amount**: 70% of qualified wages.
- **Wage Cap:** $10,000 per employee per applicable quarter.
- **Maximum Credit:** $7,000 per employee per quarter up to $21,000 per employee for 2021.
- **Gross Receipts Eligibility Test:** 20% decline in calendar quarter or prior calendar quarter gross receipts when compared to same quarter in 2019.
- **PPP Loan Recipients:** Eligible for ERC **(retroactive to 3/13/20)** but only with respect to wages not used for PPP loan forgiveness.

Paycheck Protection Program

PPP Loan Forgiveness Issues

How Using PPP Loan Funds Affects Tax Credits.

- Taxpayers need to be aware how the use of the **PPP loan funds affects the payroll tax credits** enacted as part of the COVID-19 relief effort.

- These Payroll Tax Credits based on wages paid are the:
  - Employee Retention Credit, and
  - Credits for emergency paid sick leave and expanded family leave.

- While the COVID-19 payroll tax credits can be taken even if the employer has taken out a PPP loan, **the same wages cannot be counted both** as qualified payroll expenses for PPP loan forgiveness and as qualifying wages for the payroll tax credits.

PPP Loan Forgiveness Issues

Deductibility of PPP Loan Expenses and Impact on Basis

- When the PPP was first created, the CARES Act specified that no part of a forgiven PPP loan is included in taxable income.

- While that was certainly welcome news, on April 30, 2020, the **IRS** released **Notice 2020-32**, which said that **no deduction is allowed for any expense** if paying that expense resulted in PPP loan forgiveness.

- That guidance became moot on 12/27/2020, when Congress enacted the Consolidated Appropriations Act of 2021 (CAA), which says that **no deduction or tax basis increase will be denied**, and no tax attribute will be reduced, due to the tax-free income realized when a PPP loan is forgiven.

- The CCA also expanded the list of expenses that qualified for PPP loan forgiveness.

PPP Loan Forgiveness Issues

S Corporation Shareholders Still Looking for Guidance

- Since the CAA clarified that the proceeds of a **forgiven PPP loan are treated as tax-exempt income** under *IRC Sec. 1366*, S corporation **shareholders increase their stock basis** by their share of the forgiven PPP loan.

- However, the **timing of the basis increase isn't clear**.

- Generally, borrowing funds from a third party doesn't create stock or debt basis for S corporation shareholders.

- For PPP loans taken out in one year and forgiven in the next, **if the stock basis increase doesn't occur until the PPP loan is forgiven, deductions for expenses paid in the earlier year may be delayed**.
  - The AICPA has asked the IRS to clarify that the stock basis increase for tax-exempt PPP loan forgiveness income occurs when the borrower pays or incurs the expenses that trigger the forgiveness, to prevent the mismatch above.
  - It also asked the IRS to **treat expenses** paid with PPP loans **as decreases to the Other Adjustments Account (OAA),** rather than to the Accumulated Adjustment Account (AAA).
  - Otherwise, it appears that the tax-exempt income increases the OOA while the corresponding expense decreases the AAA, which **can affect how distributions are taxed**.
  - So far, no guidance has been issued.

PPP Loan Forgiveness Issues

Planning for PPP Loan Forgiveness Due to the Double-Dipping Rule

- Generally, taxpayers should use PPP funds to pay **<u>nonpayroll</u>** qualifying expenses (to the extent possible) **<u>to maximize their qualified wages available for the payroll tax credits</u>**.
- The first step is to **<u>identify and document all the qualified nonpayroll costs</u>** paid or incurred during the covered period and include them (up to the 40%-of-total limit) in their PPP forgiveness application.
- After the maximum possible nonpayroll costs are included in the PPP forgiveness application, **<u>then payroll costs are applied</u>**.
    - Any compensation for which a COVID-19 payroll tax credit was claimed cannot be included in the forgiveness application.
- If an employer reports wage expenses as qualified expenses on the forgiveness application and the **<u>loan is not forgiven, the wages can be used for the ERC.</u>**

PPP Loan Forgiveness Issues

Documentation Should Be In Order

- On April 28, 2020, then-Treasury Secretary Steven Mnuchin announced that every company that received a **PPP loan of $2,000,000 or more would be audited** to ensure that loans met the eligibility requirements and were used for intended purposes.
  - Such companies were required to **complete a loan necessity questionnaire** with its PPP Loan forgiveness application.

- Although there is a safe harbor for companies that received less than $2,000,000 in PPP loans, **every company was required to certify, in a good-faith statement, that the loan was necessary to support its ongoing operations**.

- Mnuchin warned that the **SBA would likely perform spot checks**.
  - So, in addition to documenting that the PPP loan proceeds were used to pay covered expenses, taxpayers should also document that the loan was needed to support ongoing operations.

PPP Loan Forgiveness Issues

- While each taxpayer's situation is unique, some of the following could **help support the need-based assertion**:
  - Financial statements showing a significant decline in revenue from the prior period.
  - Any orders issued by a governmental authority to shut down or significantly restrict customer access.
  - Documentation of supply chain failures or the closure of a major customers.

- The PPP loan forgiveness program requires borrowers to retain supporting wage reports and records demonstrating compliance **for six years after the loan is forgiven**.

- In addition to an audit by the SBA, **taxpayers should be prepared to document to the IRS**, if they are selected for a payroll tax audit, that the wages for which payroll tax credits were claimed were not also included as qualified expenses for PPP loan forgiveness.

PPP Loan Data

- **Total PPP Loan Volume:** $793 billion
- **Applications for Forgiveness**: $628 billion
- **Amounts Forgiven**: $610 billion (77%)
- **Applications Not Received:** $165 billion.

Unforgiven Portion of PPP Loan Terms

The terms and interest rate of the unforgiven portion of the loan is as follows:

- **The interest rate will be 1%.**
- The **maturity of the loan** is 2 years for loans made prior to June 5, 2020 and 5 years for loans made on and after June 5, 2020.
    - Loans with a maturity of 2 years **can be extended to 5 years with the agreement of the lender**.
- **Payments are deferred** until a determination of the amount of forgiveness is made by the SBA.
    - Payments are **deferred for 10 months** after the end of the covered period.
    - For forgiveness applications approved after the 10-month period, **the borrower will have to seek reimbursement for the payments made from the SBA, not the lender**.
- Interest will accrue on the loan beginning with disbursement.

Infrastructure Investment and Jobs Act (H.R. 3684)

Infrastructure Investment and Jobs Act (H.R. 3684)

- Passed by the Senate on 8/10/21; Votes 69-30.
- Passed by the House on 11/5/21; Votes 228-206; Ready for President to sign.
- $1.2 Trillion Bipartisan Bill; 2,702 pages.
- **Breakdown of Spending**: New Spending: $550 billion; $650 billion of additional funding normally allocated each year for highway and other infrastructure projects.
    - **New Spending Breakdown (in billions):** Roads and Bridges - $110; Passenger and Freight Rail - $66; Modernizing the Electric Grid - $65; Internet Broadband Access - $65; Water and Wastewater - $55; Cybersecurity and Climate Change - $47; Public Transit - $39; Airports - $25; Environment Cleanup - $21; Ports - $17; Safety - $11; Western Water Infrastructure - $8; Electric Vehicle Charging Stations - $7.5; and Electric School Buses - $7.5.

Build Back Better Act Proposal (H.R. 5376)

Build Back Better Act

- **$1.75 Trillion Spending Bill – Original Version was $3.5 Trillion**
- **Effective Date:** For most provisions it would be for tax years beginning after December 31, 2021.
- **Spending Breakdown:**
  - **$555 billion in tax credits and investments for climate change**. This includes tax credits for consumers to buy green technology like solar panels, which is meant to increase domestic green energy supply chains. This will also include establishing a civilian climate corps to conserve public land and increase community resiliency.
  - **$400 billion to fund child care and universal pre-K.**
  - **$260 billion for Affordable Care Act subsidies.** Half of this money will go to reduce general healthcare coverage costs. However, the other half will be set aside specifically for subsidies to low-income people in the states that don't offer expanded Medicaid, to allow the same access to healthcare.
  - **$200 billion to continue an increased child tax credit** to be extended through 2022 (it currently ends this year).

Build Back Better Act

- **Spending Breakdown (cont.):**
  - **$200 billion to an earned income tax credit**, meant to help low-wage, childless workers.
  - **$150 billion to increase and renovate existing affordable housing** in both urban and rural areas.
  - **$150 billion to improve Medicaid coverage** for home health care services.
  - **$100 billion to reform the immigration system** and reduce backlogs.
  - **$40 billion toward educational initiatives.** These will include increased Pell grants to make college more affordable, increased access for Dreamers, and investing in universities and colleges serving underrepresented communities like HBCUs. This money will also invest in workforce development.
  - **$35 billion to increase Medicaid hearing services coverage.**

Build Back Better Act

- **Enhances IRS Tax Enforcement**
  - Increase staff by 87,000.
  - Focus on taxpayers with incomes over $400,000.
  - Assumes increased audits will result in increased revenue.
  - Projected to generate $120 billion in revenue.
  - Estimated cost - $45 billion.

Build Back Better Act

Revenue and Cost Estimates

- Per the Joint Committee on Taxation (JCT), over the next 10 years:
  - Federal revenues would increase by $1.5 trillion.
    - $460 billion increase in corporate taxes.
    - $530 billion increase in individual and estate taxes.
    - $120 billion from additional IRS tax enforcement.
    - $250 billion from drug pricing provisions.
    - $150 billion from other revenue raisers.
  - This revenue would be reduced by $500 billion in expanded tax credits.
  - As a result, net revenues would increase by $1 trillion.
- Several Democrats have stated that they will not vote on the Bill until it is scored by the Congressional Budget Office (CBO).

Build Back Better Act - Individual Provisions

- **Certain Comprehensive Paid Leave Benefits Excluded from Gross Income.**
  - The proposal provides that any amount that a taxpayer receives as part of the newly created comprehensive paid leave provided under the Social Security Act is not included in the taxpayer's gross income. Effective as of the date of enactment.
- **Modification of Limitation on Deduction for State and local taxes, etc.**
  - The proposal **increases the SALT deduction cap from $10,000 to $80,000** ($40,000 in the case of an estate, trust, or married individual filing a separate return) through 2030, reverting back to $10,000 in 2031.
  - This section is effective for **tax years beginning after December 31, 2020**.
- **Surcharge on High Income Individuals, Estates, and Trusts**.
  - This provision imposes a tax equal to the sum of **5% of a taxpayer's modified adjusted gross income (MAGI) that exceeds $10,000,000** ($5,000,000 for a married individual filing separately) **plus 3%** of the taxpayer's MAGI income that **exceeds $25,000,000** ($12,500,000 for a married individual filing separately). MAGI is AGI less investment interest.

Build Back Better Act - Business Provisions

Business Tax Provisions Removed from Original Version

- **Corporate Tax Rate Increase**
  - Return to a progressive corporate income tax rate structure.
    - $0 - $400,000 = 18%
    - $400,001 - $5,000,000 = 21%
    - > $5,000,000 = 26.5%

- **Limit on Qualified Business Income Deduction (QBID) under IRC Section 199A**
  - Limit the maximum value of the Section 199A passthrough deduction to **$500,000 for joint filers and $400,000 for single filers**, $250,000 MFS, $10,000 trusts.

Build Back Better Act - Business Provisions

- **Applies NIIT to Trade or Business Income of Certain High-Income Individuals.**
  - Expands the NIIT to cover **active business income** derived in the ordinary course of a trade or business **for taxpayers with greater than $400,000 in taxable income** (single filer) or **$500,000 (joint filer),** as well as for trusts and estates.
    - The provision clarifies that this tax is not assessed on wages on which FICA is already imposed.
- **Limits Excess Business Losses of Noncorporate Taxpayers.**
  - Amends Code Sec. 461(l) to permanently disallow excess business losses (i.e., net business deductions that exceed business income **above the $250,000 (single) and $500,000 (married) thresholds)** for noncorporate taxpayers for tax years beyond 2025.
    - The provision allows taxpayers whose losses are disallowed to carry those losses forward to the next tax year.
    - This section applies to **tax years beginning after December 31, 2020**.

Build Back Better Act - Business Provisions

- **Corporate Alternative Minimum Tax**.
  - The corporate alternative minimum tax (AMT) proposal imposes a **15% minimum tax on corporations** with adjusted financial statement income **(AFSI) in excess of $1 billion.**
  - An applicable corporation's minimum tax is equal to the **amount by which the tentative minimum tax exceeds the corporation's regular tax** for the year.
  - **Tentative minimum tax is determined by applying a 15% tax rate to the AFSI** of the corporation for the tax year (after accounting for the AMT foreign tax credit and the financial statement net operating losses).
  - For these purposes, AFSI is the net income or loss of the taxpayer stated on the taxpayer's applicable financial statement with certain modifications.
    - Generally, an applicable financial statement is a corporation's form 10-L filled with the Securities and Exchange Commission, and audited financial statement, or other similar financial statement.
  - This section is effective for **tax years beginning after December 31, 2022**.

Build Back Better Act - Business Provisions

- **Excise Tax on Repurchase of Corporate Stock**.
  - The provision imposes a **1% excise tax on a publicly traded U.S. corporation for the value of any of its stock that is repurchased by the corporation** during the tax year.
  - The term repurchase means a redemption within the meaning of Code Sec. 317(b) regarding the stock of such corporation, and any other economically similar transaction as determined by the IRS.

Build Back Better Act - Business Provisions

- **Global Intangible Low-Taxed Income (GILTI) Changes.**
  - Lowering the deduction for GILTI to 5%, making the tax rate 15%.
  - Calculate GILTI on a country-by-country basis.
  - Reduce the deduction for Qualified Business Asset Investment (QBAI) to 5%.
  - Lowering the foreign tax credit (FTC) haircut to 5%.
  - Allow FTCs to be carried forward for 5 to 10 years and disallowing FTC carrybacks.
  - Exempt GILTI from expense allocation rules.
  - The inclusion of foreign oil and gas extraction income (FOGEI).
  - Reduce the deduction for Foreign-Derived Intangible Income (FDII) to 21.875%, resulting in a tax rate of 15.8%.
  - Create a new limitation on interest expense deductions for certain multinational corporations.
  - Effective for tax years beginning after December 31, 2022

Build Back Better Act - Business Provisions

- **Research and Experimental Expenditures.**
  - This provision delays the effective date of the provision in the **Tax Cuts and Jobs Act** which provides for **amortization of research and experimental expenditures over 5 years for tax years beginning after December 31, 2021**.
  - Under this provision of the Bill, the amortization of research and experimental expenditures **will begin for amounts paid or incurred in tax years beginning after December 31, 2025**.
  - This section is effective on the date of enactment.

Build Back Better Act - Business Provisions

- **Limitations on Certain Special Rules for Section 1202 Gains.**
  - This provision amends Code Sec. 1202(a) **so that the special 75% and 100% exclusion** rates for gains realized from certain qualified small business stock **will not apply** to taxpayers with adjusted gross income equal or exceeding $400,000.
  - The baseline **50% exclusion** in Code Sec . 1202(a)(l) **remains available** for all taxpayers.
  - This section applies to sales and exchanges after September 13, 2021, subject to a binding contract exception.

Build Back Better Act - Business Provisions

- **Possessions' Economic Activity Credit.**
  - The provision creates a new economic activity credit related to active businesses conducted in a U.S. possession or possessions.
  - The new credit is a **general business credit equal to 20%** of, for wages, the sum of qualified possessions wages and fringe benefits paid or incurred by a qualified domestic corporation for a tax year.
  - For purposes of this credit, "possessions" include the fiscally autonomous territories of American Samoa, Guam, Commonwealth of Northern Marianas, Commonwealth of Puerto Rico, and the U.S. Virgin Islands.
  - This provision is effective for tax years beginning after date of enactment.

Build Back Better Act - Business Provisions

- **Advanced Manufacturing Investment Credit.**
  - The proposal creates an investment tax credit (ITC) worth up to 25% for advanced manufacturing facilities.
  - All taxpayers are eligible for an ITC of at least 5%.
  - Taxpayers paying prevailing wages and utilizing registered apprenticeship programs are eligible for an elevated ITC of 25%.
  - **The investment credit is available for property for the manufacture of semiconductors and semiconductor tooling, including buildings that are integral to such manufacturing**.
  - The ITC apply to property placed in service after December 31, 2021, and, for any property the construction of which begins prior to January 1, 2022, the ITC only applies to the extent of the basis thereof attributable to the construction, reconstruction, or erection after December 31, 2021.

Build Back Better Act - Business Provisions

- **Advanced Manufacturing Production Credit.**
  - The provision provides a production credit for each eligible component that is produced and sold in the U.S.
  - **Eligible components include solar polysilicon, wafers, cells, and modules, and wind blades, nacelles, towers, and offshore foundations**. The credits are generally provided on a mass or watt-capacity basis.
  - The credit amount allowed for eligible components is **increased by 10%** if the final assembly of such components is at a facility in the U.S. that operates under a **union-negotiated collective bargaining agreement**.
  - The credit is provided for eligible components produced and sold after January 1, 2021.
    - The credit begins to phase out for components sold in 2027 and is unavailable for components sold after 2029.

Build Back Better Act - Business Provisions

- **Reinstatement of Superfund.**
  - The Hazardous Substance Superfund financing rate is reinstated at 16.4 cents per barrel. The tax is annually indexed for inflation beginning with calendar year 2023.
  - This section is effective on July 1, 2022.
- **Credit for Public University Research Infrastructure.**
  - The proposal adds a new public university research infrastructure credit as part of the Code Sec. 38 general business credit.
  - The credit for a tax year is an amount **equal to 40% of the qualified cash contributions made by a taxpayer** during the tax year.

Build Back Better Act - Energy Provisions

- **Extension, Increase, and Modifications of Nonbusiness Energy Property Credit.**
  - Among other things, the proposal extends the Code Sec. 25C credit for nonbusiness energy property for ten years, through December 31, 2031. The proposal also increases from 10% to 30% the credit rate for qualified energy efficient improvements. The proposal replaces the lifetime credit limitation with an annual limitation of $1,200. The limit for windows is changed to a maximum of $600 per tax year. The limit for an exterior door is changed to $250 for any tax year, $500 with respect to alt exterior doors.
- **Residential Energy Efficient Property.**
  - The proposal **extends** the Code Sec 25D residential energy efficient property credit **for ten years**, through December 31, 2033. The credit also modifies the phaseout rules.
  - The proposal also **adds "qualified battery storage technology expenditures"** to the list of expenditures eligible for the residential energy efficiency property credit.

Build Back Better Act- Energy Provisions

- **Energy Efficient Commercial Buildings Deduction.**
  - The proposal temporarily modifies the Code Sec. 179D energy efficient commercial buildings deduction.
  - The modifications are in effect for tax years beginning after December 31, 2021 and ending before January 1, 2032.
  - Among other things, the proposal **reduces, from 50% to 25%,** the amount by which a building must increase its efficiency relative to a reference building to be eligible for the Code Sec. 179D deduction.
  - Under the proposal, in general, the maximum energy efficient commercial buildings deduction is changed to an amount equal $0.50 per square foot increased (but not above $1.00) by $0.02 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25%.
  - The provision also provides an alternative deduction for energy efficient retrofit property.

Build Back Better Act - Energy Provisions

- **Extension, Increase, and Modifications of New Energy Efficient Home Credit.**
  - **Extends for ten years**, through December 31,2031, the Code Sec. 45L credit for new energy efficient homes.
  - Replaces the existing credit amounts with a $2,500 credit for new homes that meet certain energy efficiency standards and a $5,000 credit for new homes that are certified as zero-energy ready homes.
  - Changes the credit for multifamily dwelling units.

Build Back Better Act - Energy Provisions

- **Refundable New Qualified Plug-in Electric Drive Motor Vehicle Credit for Individuals.**
    - The proposal creates a new Code Sec. 36C credit that effectively extends and modifies the Code Sec. 30D credit for new qualified plug-in electric drive motor vehicles (the "EV credit").
    - **The proposal eliminates the limitation on the number of credit eligible EVs each manufacturer can sell**.
    - Beginning January 1, 2022, the proposal makes the EV credit **a refundable personal income tax credit** for vehicles acquired on or after that date.

- **Credit for Previously Owned Qualified Plug-in Electric Drive Motor Vehicles.**
    - The proposal creates a new credit for each previously owned qualified plug-in electric drive motor vehicle placed in service by a qualified buyer (the "previously owned EV credit").
    - The base amount of the credit is $2,000.

Build Back Better Act - Energy Provisions

- **Qualified Commercial Electric Vehicles.**
  - The proposal creates a new credit for each qualified commercial electric vehicle ("qualified commercial EV") placed in service by the taxpayer.
  - Generally, the credit amount is the lesser of 5% (30% in the case of a vehicle not powered by a gasoline or diesel combustion engine) of the basis of a qualified vehicle or the incremental cost of the vehicle.

- **Qualified Fuel Cell Motor Vehicles.**
  - The proposal **extends the sunset date** for the credit for new qualified fuel cell motor vehicles in Code Sec. 30B **for ten years** (through December 31,2031).
  - The definition of a new qualified fuel cell motor vehicle is modified such that the vehicle may not be of a character subject to an allowance for depreciation.

Build Back Better Act - Energy Provisions

- **Alternative Fuel Refueling Property Credit**.
    - In general, the proposal **extends the sunset date** for the alternative fuel refueling property credit **for ten years** (through December 31, 2031).
    - The proposal also modifies the credit amount for certain fuel refueling property.

- **Reinstatement and Expansion of Employer-provided Fringe Benefits for Bicycle Commuting**.
    - The proposal restores and modifies the exclusion for qualified bicycle commuting reimbursements.

Build Back Better Act - Energy Provisions

- **Credit for Certain New Electric Bicycles.**
  - The proposal creates a **new refundable credit for each qualified electric bicycle** placed in service by a taxpayer (the "electric bicycle credit").
  - The credit amount is 30% of the cost of a qualified electric bicycle.
  - This section applies to property placed in service after December 31, 2021, in tax years ending after that date. The credit does not apply to bicycles placed in service after December 31, 2025.
- **Labor Costs of Installing Mechanical Insulation Property.**
  - The proposal creates a **new general business credit equal to 2% of the mechanical insulation labor costs** paid or incurred by the taxpayer during a tax year.

Depreciation

Expanded Section 179 Deduction

- The TCJA **permanently** increases the maximum amount a taxpayer may expense under **Section 179.**
- **Increased To $1,050,000**.
- The phase-out threshold amount increased to $2,620,000 in 2021.
  - If eligible Section 179 asset acquisitions exceed the phase-out threshold, then the maximum Section 179 deduction amount is reduced dollar-for-dollar by the excess over the threshold.
- The $1,050,000 and $2,620,000 amounts, as well as the $26,200 sport utility vehicle limitation, are indexed for inflation.
- **No sunset provision** for the Section 179 deduction.

Expanded Section 179 Deduction

- The TCJA expands the definition of Section 179 property to include certain depreciable ***tangible personal property used predominantly to furnish lodging*** or in connection with furnishing lodging.
    - Applies to residential rental properties, hotels, etc.
    - Furniture, appliances, etc.
- Under the TCJA, ***qualified real property*** eligible for the Section 179 deduction includes any improvement to the **<u>interior</u>** **<u>portion</u>** of a **<u>nonresidential building</u>** after the building was placed in service.

Expanded Section 179 Deduction

- ***Qualified real property*** **<u>does</u> <u>not</u>** include any improvement attributable to the following:
  - The enlargement of the building.
  - Any elevator or escalator.
  - The internal structural framework of the building.

- Under the TCJA, the definition ***qualified real property now*** includes:
  - Roofs.
  - HVAC property.
  - Fire protection and alarm systems.
  - Security systems.

Recovery Period for Real Property Shortened

- The cost recovery periods for most real property are 39 years for non-residential real property and 27.5 years for residential rental property.
- ***Cares Act - Qualified Improvement Property (QIP).***
  - Provides a technical correction to the TCJA, and specifically **designates (QIP) as 15-year property** for depreciation purposes.
  - Prior to this correction, QIP fell into the 39-year recovery period for nonresidential rental property.
  - Effective for property placed in service after December 31, 2017.
  - **Can make an accounting method change** in current year to "catch up" depreciation by filing **Form 3115** *(Rev. Proc. 2020-25).*

100% Bonus Depreciation

- **Prior Law -** An additional first-year depreciation deduction was allowed equal to 50% of the adjusted basis of qualified property placed in service before 2020.
- **TCJA -** Allows 100% expensing for qualified property (generally, depreciable assets other than buildings) that are acquired and **placed in service after September 27, 2017** and before 2023 (before 2024 for "longer production period" property and certain aircraft).
    - ***Sunset Provision*** - A 20% per year phase-down of full expensing will apply for property placed in service after 2022 and before 2027 (2023 – 80%, 2024 – 60%, 2025 – 40%, 2026 – 20%).
    - **The provision now applies to purchases of used, as well as new items.**
    - To prevent abuses, the first-year bonus depreciation deduction applies only to property purchased in an arm's-length transaction.

Section 179 Deduction & 100% Bonus Depreciation Cautions

- Claiming the Section 179 deduction or the 100% bonus depreciation on **real property** has a **downside**.
  - If the property is later sold for a taxable gain, the gain up to the amount of the Section 179 deduction and/or the bonus depreciation will be treated as depreciation recapture that is taxed at higher ordinary income tax rates (up to 37% plus another 3.8% NIIT, if applicable) .
  - However, if the real property is depreciated under the normal 39-year (commercial) or 27.5-year (residential) periods, then the maximum Federal tax rate attributable to the cumulative depreciation claimed is only 25% (plus the 3.8% NIIT, if applicable).
- Claiming the Section 179 deduction or the 100% bonus depreciation has a **downside** on the **20% QBI Deduction** as well.
  - Since QBI and taxable income is reduced from these accelerated deductions, the 20% QBI Deduction is also reduced.
- **Anticipated future tax rate increases** may also warrant electing out of these accelerated depreciation deductions.

Other Tax Updates

Tax Shelter Status

- <u>**For entities that pass their losses through to their owners**</u> this can create a major tax hurdle.
- Under the cash method of accounting rules, a tax shelter includes a syndicate.
  - <u>**A *syndicate* 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**</u>.
  - A *limited entrepreneur* is one who has an interest in an enterprise other than as a limited partner and doesn't actively participate in the management of the enterprise.
- <u>**Therefore if the entity allocates more than 35% of its losses in 2021 to owners who don't actively participate in the management of the business (like a passive investor), it will be considered a tax shelter by the IRS**</u>.
- It doesn't mean your business is engaging in tax avoidance activities.
  - It simply means that your business isn't eligible to take advantage of certain small business tax provisions such as the cash basis method of accounting.

Tax Shelter Status

- **Planning Around Tax Shelter Status.**
  - Fortunately, there are a few ways to avoid tax shelter status.
  - **First, if your entity has passive investors, consider granting them some say in the management of the business**.
    - For example, **the investors could serve on the entity's board of managers**. Another option would be to grant the investors voting rights with respect to significant management decisions.
  - **Second, you could amend your LLC's operating agreement to prevent the allocation of losses to passive investors**. You and the other members could agree to allocate tax losses only to owners who actively manage the business. Then, any future income could be first allocated to those owners up to the amount of previously allocated losses.
  - **Finally, the IRS recently released some proposed regulations that allow entities to elect to determine tax shelter status by looking at whether they allocated more than 35% of their losses to limited owners in the prior year**. This allows the entity to know early in the year whether it's a tax shelter. If your business is unable to escape tax shelter classification, we would want to at least postpone that classification for one year by pursuing this election.

Other Tax Updates

- **IRS Addresses Reliance Concerns on FAQs:** The IRS updated its process for certain Frequently Asked Questions (FAQs) on newly enacted tax legislation, as well as any later updates or revisions with dated Fact Sheet FAQs. If a Fact Sheet FAQ is later changed, taxpayers can locate the version they relied on if they later need to do so. To address concerns about the potential application of penalties to taxpayers who rely on a FAQ, the IRS released a statement clarifying that if a taxpayer relies on any FAQ in good faith and that reliance is reasonable, **the taxpayer will have a "reasonable cause" defense against any negligence penalty or other accuracy-related penalty if it turns out the FAQ is not a correct statement of the law** as applied to the taxpayer's particular facts. **News Release IR-2021-202** .

Other Tax Updates

- **New Contracts Awarded to Private Collection Agencies:** The IRS has awarded new contracts to three Private Collection Agencies (PCAs) for collection of overdue tax debts: **CBE Group, Inc., Coast Professional, Inc. (new for 2021), and ConServe**. The IRS will notify taxpayers before transferring their account to a PCA by sending Notice CP40 to the taxpayer and their tax representative informing them that their account was assigned to a PCA and give the name and contact information for the PCA. **However, taxpayers can request in writing that their account be reassigned back to the IRS**. Once the PCA has received the taxpayer's file from the IRS, the PCA will contact the taxpayer. **PCAs are authorized to discuss payment options with taxpayers but may not take enforcement actions against taxpayers**. Payments are always made directly to the IRS or the U.S. Treasury. **News Release IR-2021-191** .

Other Tax Updates

- **How the IRS Communicates with Taxpayers:** The first contact from the IRS is **normally by letter or written notice delivered by the U.S. Postal Service to a taxpayer, but not always**. Depending on the situation, **IRS employees may first call or visit with a taxpayer**. IRS revenue agents or tax compliance officers may call a taxpayer or tax professional after mailing a notice to confirm an appointment or to discuss items for a scheduled audit. IRS revenue officers and agents routinely make unannounced visits to a taxpayer's home or place of business to discuss taxes owed, delinquent tax returns or a business falling behind on payroll tax deposits. When visited by someone from the IRS, the taxpayers should always ask for credentials. **The IRS doesn't normally initiate contact with taxpayers by email and it does not send text messages or contact people through social media**. For more information, go to www.irs.gov/newsroom/taxpayers-can-protect-themselves-from-scammers-by-knowing-how-the-irs-communicates .

Other Tax Updates

- **IRS's Mission Critical Functions Webpage:** Efforts to reduce the spread of the coronavirus closed many IRS facilities or reduced the number of employees able to work at specific locations. **The IRS has provided a website to update the public on the status of IRS activities like processing returns, applying payments, replying to correspondence, assigning Individual Taxpayer Identification Numbers (ITINs) and more**. Even with many employees effectively transitioning to working from alternate locations, many IRS operations continue to experience significant delays. As of 7/17/21, there are approximately 15.6 million unprocessed individual returns. These returns may require special handling by an IRS employee and could take 90 to 120 days to issue any related refund; however, the agency is making progress toward reducing workload backlogs and resuming normal operations. See **www.irs.gov/newsroom/irs-operations-during-covid-19-mission-critical-functions-continue** for the most current status of IRS operations that the COVID-19 pandemic affected.

Other Tax Updates

- **Information Required for Filing a Valid Research Credit Claim for Refund:** Claims for a research credit under **IRC Sec. 41** are currently examined in a substantial number of cases. For a research claim for refund to be considered valid, the IRS released details, in a Legal Advice, requiring taxpayers to provide the following information at the time the refund claim is filed with the IRS: (1) identify all the business components to which the **Section 41** research credit claim relates for that year; (2) for each business component, identify all research activities performed and name the individuals who performed each research activity, as well as the information each individual sought to discover; and (3) provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year. This may be done using Form 6765 (Credit for Increasing Research Activities). **News Release IR-2021-203**.

Other Tax Updates

- **New Schedules K-2 and K-3 For Partnerships and S Corporations:** The IRS released instructions for Schedules K-2 and K-3 for Form 1065 , Form 1120-S, and Form 8865 for tax year 2021. The redesigned forms and instructions give useful guidance to on how to provide international tax information for persons filing Form 1065, Form 1120-S , or Form 8865, but only if the entity for which the form is being filed has items of international relevance (generally foreign activities or foreign partners). The final instructions (1) clarify when each part of the schedule is applicable, (2) clarify that the preparer must only complete applicable parts of the Schedules K-2 and K-3, and (3) provide instructions for requested new separate schedules regarding determination of the **IRC Sec. 250** deduction and the allocation and apportionment of expenses. **News Release IR 2021-140**.

Other Tax Updates

- **New Form 7203 - S Corporation Shareholder Stock and Debt Basis Limitations.** IRC Sec. 1366 determines the shareholder's tax liability from an S corporation. IRC Sec. 1367 details the adjustments to basis including the increase and decrease in basis, income items included in basis, the basis of indebtedness, and the basis of inherited stock. Shareholders will use Form 7203 to calculate their stock and debt basis, ensuring the losses and deductions are accurately claimed. The new form would replace the Schedule K-1 instruction worksheets and plain paper basis computation attachments with new Form 7203 to be filed with the return whenever the taxpayer previously was required to attach basis computations.

Taxpayer Wins Case for Deducting MBA Expenses

- An individual's expenses for education are deductible **Section 162** business expenses if the education maintains or improves skills required in their employment or other trade or business. The catch is that education expenses that qualify a taxpayer for a new trade or business are not deductible. This prevents many taxpayers from being able to deduct the cost of an advanced degree, because the degree qualifies them for a new trade or business. However, in *Zuo* [TC Bench Opinion, Docket No. 5716-19S (2021)], **the Tax Court recently ruled in the taxpayer's favor, allowing him to deduct the cost of obtaining a Master of Business Administration (MBA) degree**.
- Here, the taxpayer got a bachelor's degree in business administration and went to work as an employee at an investment bank. While he was employed, he also founded two entrepreneurial technology ventures. Eventually, he left his job to pursue an MBA, while continuing to work on one of his technology ventures. While he was getting the MBA, he formed a new venture with fellow students, where he worked for several years, until he left to serve as a managing partner for a business that advises entrepreneurs on staring businesses from scratch.
- The court agreed with the taxpayer that he was established as an entrepreneur before, during, and after obtaining his MBA, noting that he likely had developed significant business acumen that was useful in pursuing those ventures as an undergraduate. **While his MBA courses may have honed his skills, they did not qualify him for a new trade or business**. Rather, they maintained and refined skills he was already using in his current business**. This was a bench opinion, so it can't be relied on as precedent. However, it's good insight into the court's thinking**.

Other Tax Updates

- **Guidance on 100% Deduction for Food and Beverages:** The IRS has provided guidance on tax relief for deductions for food or beverages from restaurants. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 added a temporary exception to the 50% limit on the amount that businesses may deduct for food or beverages. Beginning **1/1/21 through 12/31/22**, the temporary exception **allows a 100% deduction for food or beverages from restaurants, as long as the business owner (or an employee of the business) is present when food or beverages are provided and the expense is not lavish or extravagant under the circumstances.** Under the temporary provision, *restaurants* include businesses that prepare and sell food or beverages to retail customers for immediate on-premises and/or off-premises consumption. However, restaurants do not include businesses that primarily sell pre-packaged goods not for immediate consumption, such as grocery stores and convenience stores. News Release IR 2021-79 and Notice 2021-25.

Other Tax Updates

Dependent Care Assistance Programs (DCAPs) COVID Relief

- **DCAPs allow employees to exclude up to $5,000 from gross income per calendar year to use toward childcare and other qualifying dependent care expenses**. The benefits are often provided by a flexible spending arrangement under a cafeteria plan, known as a dependent care FSA.
- Generally, DCAPs can't allow participants to carry over unused benefits. However, they can provide a grace period allowing an employee's unused benefits at the end of the plan year to be used to reimburse expenses incurred during the first 2 1/2 months of the following plan year. Employees forfeit any unused DCAP benefits remaining in their account at the end of the plan year (including any grace period).
- Due to the COVID-19 pandemic conditions, many DCAP participants couldn't fully utilize the amounts they contributed to their DCAPs during 2020 because their childcare provider was closed.
  - **Relief provided in the Consolidated Appropriations Act, 2021 (CAA) permits employers to amend cafeteria plans to allow employees to carry over unused DCAP benefits remaining at the end of the 2020 plan year (that otherwise would have been forfeited) to the plan year ending in 2021**.
  - The same relief also applies for unused benefits at the end of the 2021 plan year, allowing a carryover to the plan year ending in 2022.
- The carryover and extended grace period provide relief for many participants, but those with children who turned age 13 during 2020 would have been unable to seek reimbursement for childcare expenses incurred after 2020 because DCAPs generally can only reimburse childcare expenses incurred before a child turns age 13. Taking this into account, the CAA permits DCAPs to allow unused amounts remaining at the end of the 2020 or 2021 plan year (including any grace period) to be used in the next plan year for a child who attained age 13 during the plan year (until the child turns age 14) or for another child who turns age 13 during the following plan year. This relief can be adopted either with or without adopting the carryover or grace period relief.

Dependent Care Assistance Programs (DCAPs) COVID Relief

- Employers that take advantage of the CAA relief provisions and amend their plans to allow for carryovers or extended grace periods may have employees who accumulate large DCAP balances available for reimbursement in 2021.
- **To allow employees more flexibility in using their benefits, the American Rescue Plan Act of 2021 (ARPA) temporary increases the DCAP exclusion limit for calendar-year 2021 to $10,500**
  - Plan amendments can be made retroactively to incorporate the increased limit, if adopted by the last day of the plan year the amendment is effective, and the plan is operated accordingly.
- The increased exclusion amount generated questions regarding the tax consequences to employees who carried over unused balances from the 2020 plan year and then contributed $10,500 in 2021.
  - **An employee who carried over $5,000 from the 2020 plan year could have up to $15,500 in DCAP benefits to use for reimbursement in 2021**.
  - Similarly, carryovers from 2021 plan years to 2022 plan years could result in benefits exceeding the $5,000 exclusion limit applicable for 2022.
- New IRS guidance provided in **Notice 2021-26** answers this question by clarifying that unused DCAP benefits carried over from a plan year ending in 2020 or 2021, or available during an extended grace period, remain excludable from gross income for 2021 or 2022, as long as the amounts were within the exclusion limit in the year contributed to the plan.
  - This means that employees with a DCAP balance of $15,500 in 2021 ($5,000 carried over from 2020 + $10,500 contributed for 2021) can be reimbursed for the entire balance tax-free, if they incur $15,500 in qualified dependent care expenses in 2021.

Michael J. Reilly

CPA/ABV, CVA, CFF, CDA
Managing Partner

Email: mreilly@dmcpas.com

Web: www.dmcpas.com and
www.dmconsulting.com

Address:

DM Financial Plaza
221 South Warren Street
Syracuse, NY 13202

Phone: (315) 472-9127, ext. 148

Scan to add Mike Reilly
to your contacts.

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