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THE BIG BOOK™ of Taxes 2019

Seminar Edition

Editors
Lee T. Reams, EA
Marcia Salter, EA

Edition: November 2019

This text is designed to provide the experienced tax professional with theory and practical knowledge for a variety of problems encountered in preparing individual income tax returns. The topics covered are those that often raise questions, or those in which the IRS has shown an interest. Special emphasis is given to the latest tax law changes, court cases, IRS rulings and related 1040 subjects. The text incorporates examples and problems to illustrate points that have a practical application of law.

This text is used for both seminars and correspondence courses. Not all of the material in the text is covered in the seminar but is included in the text to provide the user with a practical year-round reference source.

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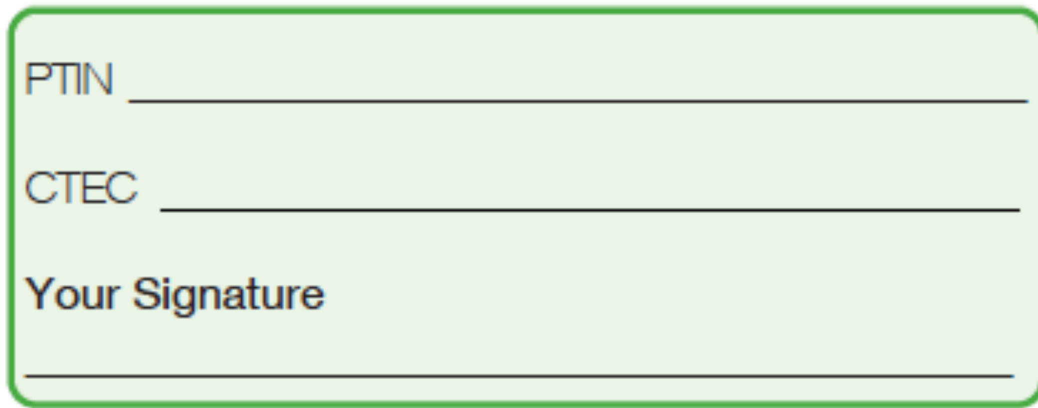
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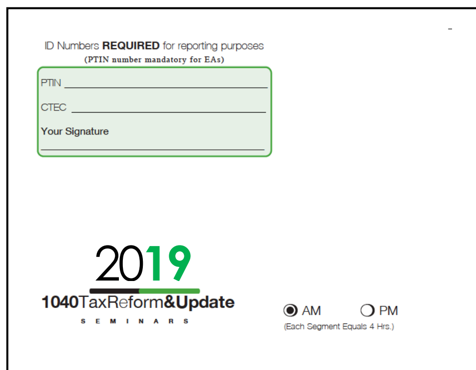

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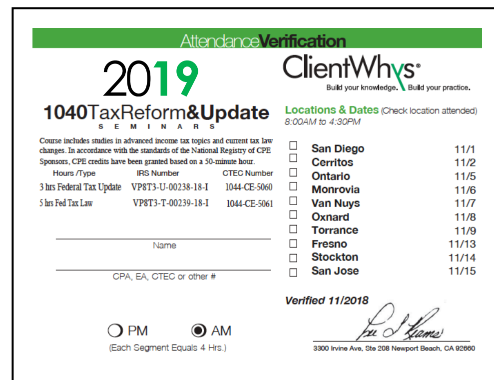

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CALIFORNIA DIFFERENCES

California differences from Federal law, if any, are explained at the end of each subject matter and are denoted with this logo.

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1.00 ELECTION TO TREAT NONRESIDENT SPOUSE AS A U.S. RESIDENT:

Generally, a U.S. citizen or a U.S. resident who is married to a nonresident alien must file as Married Separate. However, a person who is a nonresident alien at the end of his taxable year, and who is married to a U.S. citizen or a U.S. resident can be treated as a U.S. resident for income tax purposes if the spouses so elect *(Code Sec. 6013(g)(1))*.

In so doing, both spouses must agree to subject their worldwide income for the taxable year to U.S. taxation. *(Code Sec. 6013(g); Code Sec. 6013(h))*

Both parties must make the election. One party must have been, at the close of the taxable year for which the election was made, a nonresident alien individual married to a citizen or resident of the United States *(Code Sec. 6013(g)(2))*. To qualify for the election, the U.S. resident or U.S. citizen spouse needs to be a U.S. resident or U.S. citizen only at the close of the taxable year *(Reg § 1.6013-6(a)(1))*.

<u>How To Make the Choice</u> - Attach a statement, signed by both spouses, to the joint return for the first tax year for which the choice applies. It should contain the following information:

- A declaration that one spouse was a non-resident alien and the other spouse a U.S. citizen or resident alien on the last day of the tax year, and
- That the non-resident alien spouse chooses to be treated as a U.S. resident for the entire tax year.

Provide the name, address, and identification number of each spouse. (If one spouse is deceased, include the name and address of the person making the choice for the deceased spouse.) Generally, this will require obtaining an ITIN for the non-resident spouse. (Reference Pub 519)

Once made, and as long as one of the spouses is a U.S. citizen or resident, the election applies not just for the year for which it is made but for all future years until it is terminated. If the election is terminated, neither spouse is eligible to make the election for any subsequent tax year. *(Code Sec 6013(g)(6))*

<u>Terminating the Election</u> – The election terminates at the earliest of any of the following events:

- ***Revocation by taxpayer or spouse*** - Either spouse may revoke the election by filing a statement of revocation by the due date for filing the tax return for the tax year.
- ***Death*** – Death of either spouse terminates the election beginning with the first tax year following the year the spouse died. However, if the U.S. citizen or resident spouse is the surviving spouse and meets the requirements for the qualified widow(er) status, the election continues for two years following the death of the non-resident spouse.
- ***Legal separation*** - If the couple legally separates under a decree of divorce or of separate maintenance, the election terminates as of the beginning of the taxable year in which the legal separation occurs.

- ***IRS action*** – The IRS may terminate the election for any tax year for which it determines that either spouse has failed to keep or provide sufficient books, records, and other information with which to determine tax liability. *(Reg. §1.6013-6(b)(4))*
- ***Other Issues:***

  NIIT **-** Higher income taxpayers with investment income are subject to a 3.8% surtax on net investment income (see Chapter 12.05 for details). However, this tax does not apply to nonresident aliens. Therefore, when weighing the pros and cons of making the election to treat a nonresident alien spouse as a U.S. resident, the effect of the 3.8% tax on the couple's total tax picture must be considered.

  ITIN – The non-resident spouse will need an ITIN if the election to file a joint return is made. An ITIN for the non-resident spouse is not needed if the resident spouse files MFS. Page 15 of the Form 1040 instructions indicates that where a spouse is not otherwise required to have an ITIN or SSN, enter "NRA" in the space on the 1040 for the SSN/ITIN.

  FBAR – There may also be an FBAR filing requirement. For additional details related to FBAR filings see Big Book of Taxes page 01.13.05.

Filing status for California must generally be the same as the filing status used on the federal income tax return.

Exceptions: Married taxpayers who file a joint federal income tax return may file either a joint return or separate returns if either spouse was:

- An active member of the United States armed forces or any auxiliary military branch during the tax year; or
- A nonresident for the entire year and had no income from California sources during the tax year. However, if the taxpayers file a joint return and if either spouse was a nonresident during the tax year, the taxpayer must file Form 540NR, California Nonresident or Part-Year Resident Income Tax Return.

1.01 SELF-SUPPORTING CHILDREN

A child who provides over one half of his or her own support generally is not considered a qualifying child of another taxpayer. However, a child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer for purposes of the earned income tax credit.

The term "support" and "income" have entirely different meanings. The question is, does a child **provide** over half of his or her own support? A child may have income, save it and not contribute to their own support, in which case the child may very well be the qualifying child of his or her parents, who would be entitled to claim the child as a dependent and claim a higher education tax credit for the tuition they

paid. It may present an odd looking dependent of another return, but it is what it is. Also remember there is no gross income test for a "qualified child."

For a "qualifying child," the support requirement will be that the dependent had not provided over one-half of his or her own support for the calendar year in which the taxpayer's tax year begins. In determining whether a child provided more than one-half of his or her own support (for a qualifying child), or whether a taxpayer provided more than one-half of a relative's support (for a qualifying relative), the amount of support provided by the child, or by the taxpayer, will be compared to the total amount of support from all sources. The term "support" will include amounts incurred for support and/or the fair market value (FMV) of an item of support, if the item is property or lodging. The amount of total support will include support provided for the dependent's own support, and income that's excludable from gross income. Support will include amounts spent (and FMV of goods or property used) to provide: food and clothing; lodging (shelter); medical and dental care; education (but not certain scholarships); and similar items. Worksheet 2 in IRS Pub 501 is useful for determining support.

From Pub 929 – Page 18 – Support - All amounts spent to provide the child with food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. To figure your child's support, count support provided by you, your child, and others. However, a scholarship received by your child isn't considered support if your child is a full-time student.

1.01 TEMPORARY ABSENCES

We find when determining whether a child is a qualified child or whether an individual qualifies for head of household, temporary absences from home iare being overlooked. Temporary absences from home include attending school, vacations, illness, and military service. Temporary absences do not change an individual's place of abode.

1.04 POST–2018 – ALIMONY

Under TCJA the taxability of alimony is modified effective for divorce or separation instruments **entered into after 12/31/2018**. There are also special rules for divorce or separation instruments in existence before 2019 that are modified after 12/31/2018.

- **Pre-2019 divorce agreements** – For divorce or separation instruments entered into before 2019 the old rules continue to apply. Alimony continues to be deductible by the payer and is taxable income to the recipient and qualifies as earned income for an IRA deduction.
- **Post-2018 divorce agreements** - For divorce or separation instruments entered into after 12/31/2018, alimony is no longer deductible by the payer, and it is not income to the recipient and no longer qualifies as earned income for an IRA deduction.

- **Modifications after 12/31/18** – Divorce or separation instruments entered into before 2019 and modified after 12/31/18 continue to follow the pre-2019 rules and alimony continues to be deductible by the payer and taxable to the recipient. However, if a pre-2019 divorce or separation instrument is modified after December 31, 2018, the alimony can be subject to the post-2018 rules if the modification expressly provides for post-2018 treatment. (Committee reports, TCJA Section 11051) This gives couples the ability to choose between the pre-2019 rules or the post-2018 rules when they modify their agreement after December 31, 2018. This flexibility allows them to negotiate what is best both financially and tax wise for both parties.

  Example*: An alimony recipient spouse requests a post-2018 increase in alimony of $12,000, from $20,000 to $32,000, and the paying spouse counters with a proposal to keep the alimony at $20,000 but to make the alimony tax free by a "modification" to the original decree.*

"Executed" Date - TCJA specifies that the tax treatment of alimony changes for any divorce or separation agreement "executed" after December 31, 2018. The issue is with the terminology "executed." It is not a question of when the divorce is final or when the paperwork was signed by the judge or recorded – it's when the "divorce or separation instrument… is executed". (TCJA Sec 11051(c))

Note: Although TCJA repealed IRC Sec. 71 it still referred to it for the definition of a divorce or separation agreement.

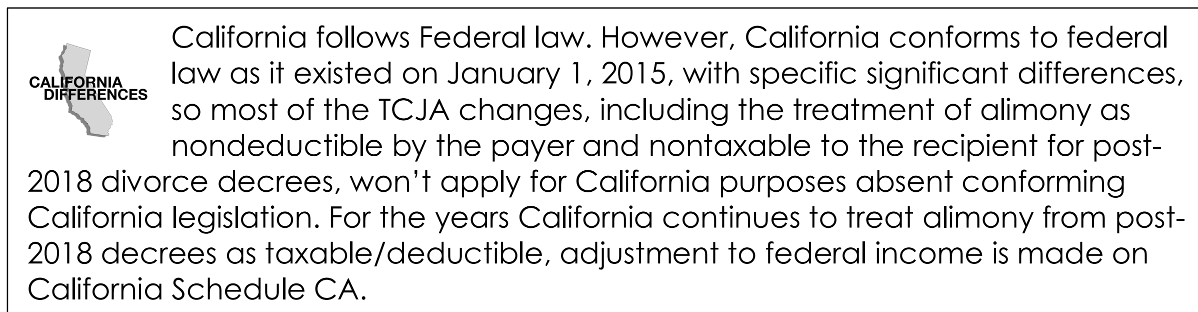
"Separation Agreement" - **Sec 71(b)(2)** defines a **"Divorce or separation instrument"** - *The term 'divorce or separation instrument' means—*

A. *a decree of divorce or separate maintenance or a written instrument incident to such a decree,*
B. ***a written separation agreement****, or*
C. *a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.*

The following are quotations from tax court cases.

- *Keegan v Comm TC Memo 1997-511:* "The term 'written separation agreement' (as used in section 71(b)(2)) is not defined by the Code, the legislative history, or applicable regulations".
- *Bogard v. Commissioner 59 TC 97, 100 (1972):* "Logically, it appears Congress was interested in a clear statement in written form of the terms of support where the parties are separated; correspondence between the attorneys representing the husband and wife does not constitute a written separation agreement within the meaning of section 71(a)(2)".
- *Ewell v. Commissioner TC Memo 1996-253* – "The term "written separation agreement" is not defined by section 71(b)(2), its legislative history, or the Commissioner's regulations. A written separation agreement is a clear, written statement of the terms of support for separated parties. It must be a writing that constitutes an agreement".

- *Other court cases of interest include:* Grant v. Commissioner TC 809, 823 (1985); Kronish v. Commissioner TC 684, 693 (1988); Nemeth v. Commissioner TC Memo 1982-646; and Osterbauer v. Commissioner TC Memo. 1982-266.

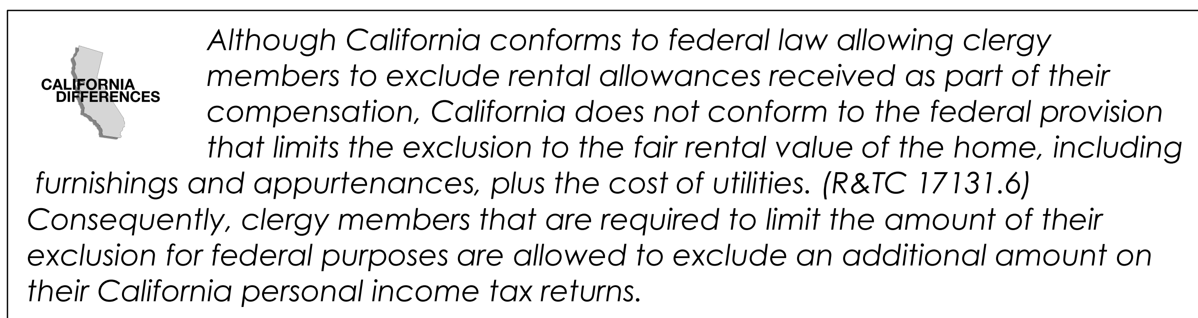


California follows Federal law. However, California conforms to federal law as it existed on January 1, 2015, with specific significant differences, so most of the TCJA changes, including the treatment of alimony as nondeductible by the payer and nontaxable to the recipient for post-2018 divorce decrees, won't apply for California purposes absent conforming California legislation. For the years California continues to treat alimony from post-2018 decrees as taxable/deductible, adjustment to federal income is made on California Schedule CA.

1.06 PARSONAGE ALLOWANCE

Previously, in US District Court for the western district of Wisconsin, Judge Barbara B. Crabb, in Gaylor v. Mnuchin (the Treasury Secretary) concluded that 26 IRC Sec. 107(2), which excludes from the gross income of a "minister of the gospel" a "rental allowance
paid to him as part of his compensation," is unconstitutional. Specifically, she concluded that IRC Sec. 107(2) violates the establishment clause of the First Amendment.

On appeal, the Seventh Circuit has overturned the district court, ruling on March 15, 2019, that the Code Sec. 107(2) provision is constitutional on the grounds that it has a secular legislative purpose; its principal effect is neither to endorse nor to inhibit religion; and it does not cause excessive government entanglement.



Although California conforms to federal law allowing clergy members to exclude rental allowances received as part of their compensation, California does not conform to the federal provision that limits the exclusion to the fair rental value of the home, including furnishings and appurtenances, plus the cost of utilities. (R&TC 17131.6) Consequently, clergy members that are required to limit the amount of their exclusion for federal purposes are allowed to exclude an additional amount on their California personal income tax returns.

1.06 CLERGY SE TAX & EMPLOYEE BUSINESS EXPENSES

Although TCJA suspended the deduction for employee business expenses as an itemized deduction, they are still allowed as a deduction against a member of the clergy's income subject to SE tax.

Reg 1.1402(a)-11(a) says "In general.—For each taxable year ending after 1954 in which a minister or member of a religious order is engaged in a trade or business, within the meaning of Section 1402(c) and § 1.1402(c)-5, with respect to service

performed in the exercise of his ministry or in the exercise of duties required by such order, net earnings from self-employment from such trade or business include the gross income derived during the taxable year from any such service, less the deductions attributable to such gross income."

In addition, the instructions for Schedule SE for 2018 say "If you were a duly ordained minister who was an employee of a church and you must pay SE tax, the unreimbursed business expenses that you incurred as a church employee are not deductible as an itemized deduction for income tax purposes. However, when figuring SE tax, subtract on line 2 [of Sch. SE] the allowable expenses from your self-employment earnings and attach an explanation."

> ***Example*** *- Pete receives a salary from the church of $30,000 and a parsonage allowance of $10,000. He has unreimbursed employee business expenses of $6,000 (before excluding nondeductible amounts attributable to his exempt income). Pete's net earnings from self-employment are $34,000 ($30,000 + $10,000 - $6,000). All of Pete's unreimbursed business expenses are deductible for self-employment tax purposes. The requirement of allocating business expenses to exempt income applies to the income tax computation, not the self-employment tax computation.*

1.08 NONMILITARY SPOUSE'S STATE OF RESIDENCE ELECTION

The Veterans Benefits and Transaction Act of 2018, sponsored by Senator Jon Tester of Montana, became public law on 12/31/2018. Sec. 302 of that legislation added the following election:

"**Election**—For any taxable year of the marriage, the spouse of a servicemember may elect to use the same residence for purposes of taxation as the servicemember regardless of the date on which the marriage of the spouse and the servicemember occurred."

The election "shall apply with respect to any return of State or local income tax filed for any taxable year beginning with the taxable year that includes the date of the enactment of this Act." Thus, this provision is effective for 2018 and future years.

Benefit - The benefit of this election is that a spouse of a servicemember stationed in a high-income tax state can elect the state of residency of the servicemember whose resident state has no or low state income tax and not be subject to the state taxes where his or her spouse is stationed. Previously, under the Military Spouses Residency Relief Act of 2009, a military spouse could claim the same resident state as the servicemember only if the spouses had the same domicile and the nonmilitary spouse moved to be with the servicemember.

> **Example** – Jack, a servicemember whose state of residence is Texas, is stationed in California. Sally, Jack's spouse, is employed in California and prior to this law change was required to pay California tax on her wages earned in California. Under this new law, Sally can elect her residency to be the same as Jack's – in this case Texas – which has no state income tax.

1.08 CERTAIN COMBAT INJURED VETERANS ENTITLED TO TAX REFUND

As a result of the 2016 Combat-Injured Veterans Tax Fairness Act, more than 133,000 injured vets may qualify for a federal tax refund. The minimum refunds are estimated to be $1,750, meaning the government will be paying out an estimated minimum of $228 million if all eligible veterans file a claim.

The tax refunds are owed to veterans who received disability severance payments after Jan. 17, 1991 and included that payment as income on their tax returns. According to the IRS, most vets who received a one-time lump-sum disability severance payment when they separated from their military service will receive a letter from the Department of Defense (DOD) explaining the process to follow in order to claim their refund.

For years for which the normal statute for claiming a refund has expired, the vets will have one year from the date of the DOD letter to file a 1040X to claim their refund. Vets have two options in determining the amount of their refund:

- Amend the original return using actual numbers from the original return, or
- Claim a standard refund amount based on the calendar year in which they received the severance payment.

When claiming the standard amount, that amount should be entered on lines 15 and 22 of the 1040-X and "Disability Severance Payment" entered on line 15. The standard amounts are:

- $1,750 for tax years 1991 – 2005
- $2,400 for tax years 2006 – 2010
- $3,200 for tax years 2011 – 2016

Claiming the standard tax refund amount is no doubt the simplest way to claim the refund, because the veteran doesn't need to access the original tax return from the year of their lump-sum disability severance payment.

For returns claiming this refund write either "Veteran Disability Severance" or "St. Clair Claim" across the top of the front page of the Form 1040X. Returns should be mailed to:

Internal Revenue Service
333 W. Pershing Street, Stop 6503, P5
Kansas City, MO 64108

Veterans who are eligible for a refund and don't receive a letter from the Defense Department can still file Form 1040-X to claim a refund but need to include both of the following to verify the disability severance payment:

- A copy of documentation displaying the exact amount of and reason for the disability severance payment, such as a letter from the Defense Finance and Accounting Services explaining the severance payment at the time of the payment or a Form DD-214, and
- A copy of either the VA determination letter confirming the veteran's disability

or a determination that the veteran's injury or sickness was either incurred as a direct result of armed conflict, while in extra-hazardous service, or in simulated war exercises, or was caused by an instrumentality of war.

Vets who don't have the necessary documentation indicating the exact amount of their disability severance payment and the reason for it will have to contact the Defense Finance and Accounting Services for the needed documents. See below for California treatment.

California does not conform to the special rules of the Combat-Injured Veterans Tax Fairness Act 0f 2016 extending the statute of limitations for veterans who received disability severance payments after Jan. 17, 1991, that were erroneously included as income on their tax returns, and also does not conform,
or have the authority to allow, the use of standard refund amounts. However, Revenue and Taxation Code (R&TC) Section 19311 allows taxpayers to file a claim for refund with FTB within 2 years from the date of a final federal determination, which is defined in R&TC Section 18622 as the date the adjustment or resolution is "assessed" or posted to the taxpayers' IRS account.

Therefore, in those instances where the normal California statute of limitation has closed, taxpayers who file these claims with the IRS may then file claims with FTB within 2 years after the claims are allowed by the IRS. This is true even if the taxpayer used the simplified method and claimed the standard refund amount shown in IR-2018-148, instead of filing an Amended U.S. Individual tax Return (1040X), with the actual excluded amount.

For California purposes though, claims must be based on the actual amount to be excluded and ideally a California Explanation of Amended Return Changes (Schedule X) will be filed with that information. However, under R&TC Section 19322, a taxpayer can file a refund claim in any format, as long as it is in writing, signed by the taxpayer or the taxpayer's representative, and states the grounds of the claim, which in this case, is that they improperly included disability severance pay in income.

Taxpayers claiming a refund as a result of the Combat-Injured Veterans Tax Fairness Act of 2016 should follow FTB's procedures for filing a general claim for refund. Additionally:

1. The taxpayer should include a copy of the letter they received from the Defense Finance and Accounting Service (DFAS) or the Internal Revenue Service, a copy of the IRS Form 1040X, and substantiation indicating the IRS allowed the refund (determination letter, refund issued, etc.).
2. Depending on the taxpayer's situation, the refund may be claimed on either a California Form 540X or through a letter claim.

1.16 CROWDFUNDING

The term "crowdfunding" generally refers to a process of raising money by an individual or business to fund a project or business venture, generally through an online site such as GoFundMe, Kickstarter or Indiegogo, that bypasses traditional lenders such as banks or venture capitalists, and instead appeals directly to the local, or even global, community for financial backing. Originally used by artists, filmmakers and musicians as a way to fund their artistic or musical endeavors, the use of crowdfunding has expanded to include activists, entrepreneurs and even those in need of medical treatment.

How Crowdfunding Works – Crowdfunding is generally done using an online platform that allows the fundraiser to explain the nature of the project or venture, including the amount of money they hope to raise, and the time frame (deadline) for the money-raising campaign. Often, the fundraiser will offer some type of reward to those who contribute (usually termed a backer). The rewards are often really just tokens – a coffee cup or t-shirt with a logo, tickets to an event, a CD – or in some cases an equity interest in the endeavor, or the right to be repaid with interest if the campaign is financially successful. Typically, backers who are interested in participating use their credit card to make a pledge, and if the campaign meets its financial goals within the deadline, the crowdfunding site will process the card-based pledges and fund the campaign.

Types – There three main types of crowdfunding:

- **Equity-Based**: Equity crowdfunding is the process by which an individual is able to invest in an early-stage company in exchange for shares in that company. This type of crowdfunding is best suited for businesses that are established but in need of capital for expansion. However, this type of fundraiser is subject to Securities Exchange Commission (SEC) regulations discussed below.
- **Donation Based**: Donor platforms allow money to be raised without any obligations to investors. Contributions to the stated cause are donations or gifts with no strings attached. Common donation-based causes include philanthropy; medical, funeral or living expenses for individuals; and disaster-relief.
- **Rewards-Based** fundraising is most commonly associated with platforms like Kickstarter and Indiegogo. Through the rewards system, individuals and businesses raise money by offering a product or service in exchange for a campaign contribution.

SEC Issues – Under the Securities Act of 1933, the offer and sale of securities must be registered unless an exemption from registration is available. Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 added Securities Act Section 4(a)(6) that provides an exemption from registration for certain crowdfunding transactions. The Securities and Exchange Commission (SEC) issued final regulations, effective May 16, 2016, implementing these JOBS Act provisions. These regulations permit companies to offer and sell securities through crowdfunding and create a regulatory framework

for the broker-dealers and funding portals that facilitate the crowdfunding transactions. These rules, which have a substantial impact on crowdfunding, include the following provisions:

- **Companies Raising Capital:**
  - The maximum amount a company can raise through crowdfunding in a 12-month period is $1.07 Million.
  - Non-U.S. companies, businesses without a business plan, Exchange Act reporting firms, certain investment companies and companies who have failed to meet their reporting responsibilities may not participate.
- **Individuals -** Amounts individuals can invest in any 12-month period is limited. These numbers are inflation adjusted. If the individual's:
  - Annual income or net worth is less than $107,000, an equity investment through crowdfunding is limited to the greater of $2,200 or 5% of their annual net worth.
  - Annual income or net worth are both at least $107,000, investment via crowdfunding is limited to 10% of the lesser of their net worth or annual income up to an aggregate limit of $107,000.

For details on these regulations, see: https://www.sec.gov - enter *crowdfunding* in the search box.

Section 61(a) of the Internal Revenue Code provides the general rule that, except as otherwise provided by law, gross income includes all income from whatever source derived. Gross income includes all accessions to wealth, whether realized in the form of cash, property or other economic benefit. However, some benefits that a taxpayer receives are excludable from income, either because they do not meet the definition of gross income or because the law provides a specific exclusion for certain benefits that Congress chooses not to tax.

In general, money received without an offsetting liability (such as a repayment obligation), that is neither a capital contribution to an entity in exchange for a capital interest in the entity nor a gift, is includible in income. The facts and circumstances of a particular situation must be considered to determine whether the money received in that situation is income.

What that means is that crowdfunding revenues generally are includible in income if they are not

1) Loans that must be repaid,
2) Capital contributed to an entity in exchange for an equity interest in the entity, or
3) Gifts made out of detached generosity and without any "quid pro quo." However, a voluntary transfer without a "quid pro quo" is not necessarily a gift for federal income tax purposes. In addition, crowdfunding revenues must generally be included in income to the extent they are received for services rendered or are gains from the sale of property.

Section 1.451-2 of the Income Tax Regulations sets forth the constructive receipt doctrine and provides that income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. The regulation further provides that income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. However, a self-imposed restriction on the availability of income does not legally defer recognition of that income.

Thus, the income tax consequences to a taxpayer of a crowdfunding effort depend on all the facts and circumstances surrounding that effort.

A taxpayer may request a private letter ruling from the Internal Revenue Service that applies the law to the taxpayer's particular facts and circumstances. The procedure for obtaining a private letter ruling is set forth in Rev. Proc. 2016-1, 2016-1 I.R.B. 1.

Does the IRS track crowdfunding payments? Maybe. It depends on the aggregate number of backers contributing to the campaign and the total amount of the payments. Code Sec. 6050W requires third party transaction companies (credit card, PayPal, etc.) to issue a 1099-K reporting the gross amount of such transactions. There is a de minimis reporting threshold of $20,000 or 200 reportable transactions per year. Question is, will the third party follow the de minimis rule?

Is the income received by the fundraiser taxable or is it a tax-free gift? It depends. Code Sec. 61(a)(1) defines gross income as "all income from whatever source derived." This definition is construed broadly and unless the taxpayer can demonstrate that the income fits into one of the exclusions provided by law it will be taxable. One of those exceptions is provided in Code Sec. 102, where the amount received is a gift if it: comes from a detached and disinterested generosity; is made out of affection, respect, admiration, charity or like impulses; is not made from any moral or legal duty, nor from the incentive of anticipated benefit of an economic nature; and is not in return for services rendered. (*Comm. v. Duberstein, (S Ct, 1960) 5 AFTR 2d 1626*) Recipients may exclude payments that they receive under Code Sec. 102 if they meet the *Duberstein* standard. If there is a quid pro quo in which the donor receives a tangible economic benefit in return for his contribution, then there isn't a gift.

So, are the rewards that backers sometimes receive for their crowdfunding participation of significant enough value that the donor receives an economic reward (thus negating a gift) or is it an inconsequential economic incentive that can be ignored? While we do not have the IRS' opinion on the question, the consensus of commentators is that if the crowdfunding is, for example, for the purpose of paying someone's medical bills, it is likely that the funds will be considered a nontaxable gift. On the other hand, if the purpose of the campaign is, for example,

to fund the fundraiser's independent film project or start or expand a business, the income is likely taxable.

If the fundraising provides equity in a company, then the one raising the capital must treat each contributor as an investor with equity or stock ownership in whatever business entity the venture is using. The SEC, under the regulations noted above, requires that each investor be included in the normal information reporting requirements, which can be quite extensive. In other words, the entity must be treated as a real business.

If a gift, is the amount subject to gift tax? Maybe. Depending on the amount of the contribution, the relationship between the fundraiser and backer, and the total amount of gifts made during the year by the backer to the fundraiser. For 2019 the annual exclusion of $15,000 is available for gifts to each donee.

Are crowdfunding project expenses deductible? It depends. Sec. 162(a) allows a deduction for all "ordinary and necessary expenses" paid or incurred during the tax year in carrying on any trade or business provided the taxpayer can show that he engaged in the activity with an actual and honest profit objective. So to answer the question, you need to know whether the crowdfunding project is a "trade or business" carried on with an expectation of profit, or whether it is an endeavor with no expectation of profit where the payback is other than monetary (e.g., "vanity" publishing).

If it is a hobby, and not a for-profit activity, deductions are only allowed to the extent of income from the activity (and only as a miscellaneous itemized deduction subject to the 2% of AGI reduction, but these deductions are suspended by the TCJA for years 2018 through 2025).

If a trade or business, the service fees charged by the crowdfunding platform would be deductible by an ongoing business, as would the cost of the rewards (mugs, shirts, etc.) discussed above and the costs related to the actual funded project. Start-up expenses up to $5,000 would be deductible if elected by the taxpayer, with start-up costs in excess of $5,000 amortized over 180 months.

Are charitable contributions allowed to the backer for his/her contribution? Only if the crowdfunding was sponsored by a qualified Sec 501(c)(3) organization and that organization was the recipient of the funds, and the donor meets all other requirements for claiming a charitable contribution (i.e., itemizes, has required receipt and/or acknowledgment, etc.). Contributions to an individual would not be deductible.

1.18 CRYPTOCURRENCIES

This is a primer on how cryptocurrencies (virtual currencies) function, along with information on IRS's guidance included in Notice 2014-21 for dealing with taxable

transactions involving virtual currency. Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.

"Virtual currency" may be used to pay for goods or services or held for investment. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction.

Bitcoin, first released as open-source software in 2009, is generally considered the first decentralized cryptocurrency. Since the release of Bitcoin, over 4,000 altcoins (alternative variants of Bitcoin, or other cryptocurrencies) have been created.

For a more detailed (and complex) understanding of cryptocurrencies, research the Internet. One such informative site is: https://www.genesis-mining.com/how-cryptocurrency-works

Value of One Bitcoin XBT	
September 1, 2016	$575
August 1, 2017	$2,778
April1, 2018	$6,855
June 1, 2018	$5,984
August 1, 2018	$7,835
September 1, 2018	$6,958
July 1, 2019	$10,880

Owner Demographics – Individuals who deal in virtual currency are generally tech savvy, might also have an inherent distrust of the government and like the lack of government regulations controlling and tracing virtual currency transactions.

Market Value Determination – The FMV of virtual currency is based on market value, i.e., what a willing buyer will pay a willing seller – much like trading in stocks. That is why the IRS made the decision to treat virtual currency transactions as property transactions.

Treated as property for federal tax purposes - Virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency (IRS Notice 2014-21, Q&A #1).

Example A: *Taxpayer buys Bitcoin (BTC) so he can use it to make on-line purchases without the need for a credit card. He buys one BTC for $2,425 and later uses it to buy goods worth $500 (BTC was trading at $2,500 at the time he made his purchase). He has a $75 ($2,500 - $2,425) reportable capital gain. This is the same result that would have occurred if he had sold the BTC at the time of the purchase and used cash to purchase the goods. This example points up the complicated record-keeping requirement to track BTC basis. Since this transaction was personal in nature no loss would be allowed if the value of BTC had been less than $2,425 at the time the goods were purchased.*

Of course, if the taxpayer in this example only sold a fraction of a Bitcoin, enough to cover the $500 purchase, the gain would only be $15: $500/$2500 = .2 x 2425 = 485; 500 – 485=15

Example B: *Taxpayer buys Bitcoin (BTC) as an investment. The same rules apply as for stock transactions, including gain/loss rules, $3,000 per year net loss allowed against other income, and the short- and long-term holding period rules.*

Character of the gain or loss - The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is held as a capital asset. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that he or she does not hold as a capital asset. Inventory and other property held mainly for sale to customers in a trade or business are examples of property that is not a capital asset.

Foreign Currency Transactions - Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes (IRS Notice 2014-21, Q&A #2).

Virtual Currency FBAR and Form 8938 Filings - The AICPA recently asked FinCEN if cryptocurrency held in foreign cryptocurrency exchanges requires FBAR and 8938 reporting.

- **FBAR** - FinCEN responded that regulations (31 C.F.R. §1010.350(c)) do not define virtual currency held in an offshore account as a type of reportable account. Therefore, it was FinCEN's opinion that virtual currency is not reportable on the FBAR, at least for now. In addition, the IRS (at the date of this publication) has not officially taken a position on whether a virtual currency account over $10,000 is subject to FBAR reporting.

  However, in a similar situation a few years back FinCEN told tax preparers they didn't need to report on-line gambling accounts with out-of-the country on-line casinos on the FBAR, but a tax court ruled differently and the taxpayer was penalized for failure to report his on-line gambling account where a foreign financial institution was involved (see Hom CA-9, 2016, Big Book of Taxes page 01.13.06). So, to be conservative and on the safe side, we are recommending cryptocurrency held in foreign cryptocurrency exchanges be reported. But of course, that is a decision you and your client will have to make. There is no penalty for over-reporting but there are severe penalties for under-reporting. See Big Book of Taxes page 1.13.02 for FBAR reporting.

- **8938 - Statement of Specified Foreign Financial Assets** – However cryptocurrency held in foreign cryptocurrency exchanges requires reporting on Form 8938 (assuming the taxpayer meets the Form 8938 filing threshold). See Big Book of Taxes page 1.13.09 for Form 8938 reporting.

Payment for Goods & Services - A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received (IRS Notice 2014-21, Q&A #3).

Get Around Money Reporting Laws - There is no bank to report transfers to the government.

How Does One Acquire Bitcoins – One can go to online exchanges and purchase Bitcoins. But care should be taken to make sure the exchange is reputable. There are even Bitcoin ATMs (kiosks) where cash can be exchanged for Bitcoins. Then you have Bitcoins in your on-line wallet and are free to spend them with anyone that accepts Bitcoins.

Bitcoin Mining – Mining is a term used to describe how cryptographic information distributed within a Bitcoin network is secured, authorized, and approved. In essence it is the processing of payments that have taken place once they occur. It takes the place of banks, merchant's accounts, and clearing houses like Visa. It essentially eliminates all the third parties' cuts of income from the transaction. It involves complex mathematical logarithms that need to be solved and the mining process, which requires high-powered computers, completes this task autonomously.

What do miners get for dedicating computer hardware and for the cost of electricity to handle the transactions? After adding a block to the ledger, the miner is given a reward for their efforts, which varies based on the cryptocurrency. For example, Bitcoin originally awarded 50 BTCs, but that award halves at preset times and today has decreased to 12.5 BTCs. It is anticipated that sometime in 2020 it will be halved again to 6.25 BTCs.

If an individual mines virtual currency, it is a trade or business subject to self-employment tax (IRS Q&A #9). The income is the value of the generated income equal to the value of the Bitcoin when mined. Although the IRS has provided no guidance at this time, it would appear that the expenses of producing the mined Bitcoins would have to be capitalized. Luckily there are only a very few individuals or businesses doing mining (estimated to be over 300,000 by btcwires.com in February 2019), so the odds of doing a miner's tax return are slim to none.

Apparently, Bitcoin miners are subject to Form 1099-K filing requirements if certain requirements are met. In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third-party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, *Payment Card and Third Party Network Transactions*, if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds $20,000.

Employee Payments - The fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions Act (FICA) tax (Social Security and Medicare A), and Federal Unemployment Tax Act

(FUTA) tax and must be reported on Form W-2, *Wage and Tax Statement*. (IRS Notice 2014-21, Q&A #11) Of course, these amounts are to be reported in U.S. dollars.

Independent Contractor Payments - The fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax (IRS Q&A #10). Payment may also be subject to informational reporting (IRS Notice 2014-21, Q&A #13).

Informational Reporting **-** A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee (IRS Notice 2014-21, Q&A #12).

Backup Withholding **-** Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payers making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payer must backup withhold from the payment if a TIN is not obtained prior to payment or if the payer receives notification from the IRS that backup withholding is required (IRS Notice 2014-21, Q&A #14).

The IRS Has Cryptocurrency on Its Radar - Back in 2018 Coinbase, a company handling cryptocurrency transactions, released the data of 14,000 of its users to the IRS after the information was subpoenaed, and cryptocurrency traders have been holding their breath as to what comes next. Well, that next is upon us, in the form of a wave of correspondence which most certainly will result in some serious enforcement actions.

IRS Compliance Program – The IRS has begun sending letters to taxpayers about their cryptocurrency activity; by the end of August, more than 10,000 taxpayers will receive one of three varieties of letters. A taxpayer who receives one of these letters, should not ignore it! The IRS compiled this list of taxpayers that it feels has not been reporting their cryptocurrency transactions from various ongoing IRS compliance efforts. The following is a synopsis of the types of letters:

Letter 6173 – Requires a response from the taxpayer, either by the taxpayer providing a statement to the IRS that they have already complied with the required reporting or by filing a return that reports their cryptocurrency transactions. For situations where the taxpayer had already filed a return but had left off the cryptocurrency transactions, an amended return (Form 1040X) will need to be filed. Taxpayers who ignore this letter may face a full-blown audit by the IRS and could be subject to penalties.

Letter 6174 – This is a "soft notice" that does not require a response, and the IRS says it won't be following up on it. However, the notice also warns that if the taxpayer had cryptocurrency gains and fails to amend their return or continues to be noncompliant on future returns despite receiving the letter, the taxpayer will be in hot water.

Letter 6174-A – The taxpayer isn't required to respond to the letter but does need to correct their prior returns in which cryptocurrency transactions have been omitted. The IRS warns of future enforcement action if the taxpayer doesn't amend their return(s) or file their delinquent returns. After receiving the letter, the taxpayer can't use an excuse of not knowing the law for failing to report their cryptocurrency gains.

Last year, the IRS announced a virtual cryptocurrency compliance campaign to address tax noncompliance related to virtual currency use through outreach and examinations of taxpayers. The IRS has announced that it will remain actively engaged in addressing non-compliance related to virtual currency transactions through a variety of efforts, ranging from taxpayer education to audits and criminal investigations.

Taxpayers who do not properly report the income tax consequences of virtual currency transactions are liable for the tax, penalties and interest. In some cases, taxpayers could be subject to criminal prosecution.

So, if your clients receive one of the above letters, especially letter 6173, be sure your clients (or you if tasked to do so by your clients) respond timely. For anyone receiving a letter be sure to counsel them on the need to report the transactions and amend any return where reporting was omitted.

As this material was being prepared a second wave of correspondence was launched.

CODE'S TIMELY MAILING RULE REPLACES COMMON-LAW RULE

The Court of Appeals has reversed a district court decision that the taxpayers timely filed their refund claim because they met the requirements of the common-law mailbox rule.

In 1954, Congress enacted Code Sec. 7502 which provides that if a filing is delivered by U.S. mail to the agency, officer, or office with which it is required to be filed, then the U.S. postmark on the cover in which the document or payment is mailed is considered to be the date of delivery or date of payment. In addition, Sec 7502(c)(1) provides that when a document is sent by registered mail, the registration date will be treated as the postmark date.

However, the courts have been split as to whether Sec. 7502 replaces the common-law mailbox rule or just provides a supplemental safe harbor. Under the common-law mailbox rule, proof of proper mailing - including by testimonial or circumstantial evidence - gives rise to the presumption that a document was physically delivered to the addressee in the time such a mailing would ordinarily take to arrive.

In a timely mailing dispute with the IRS the taxpayer relied on the common-law mailbox rule to establish that the return was timely filed and two of the taxpayer's employees testified they timely deposited the amended return in the mail at the post office.

District court agreed with taxpayer - The district court credited the testimony of the taxpayer's employees and found, on the basis of the common-law mailbox rule, that the taxpayer's claim for a refund had been timely filed.

Circuit Court reverses - The 9th Circuit Court of Appeals reversed the holding of the district court, finding that Code Sec. 7502 and Reg. § 301.7502-1(e)(2) **replaced** the common-law mailbox rule **rather than supplementing it**, and are the exclusive rules for proving timely delivery of a return to IRS and that the taxpayer did not meet those rules. Baldwin, (CA 9 4/16/2019)

So, make sure you have documentary evidence of mailing

DRAFT 1040-SR

The IRS in July released a draft of the new, Congress-mandated and supposedly simplified, 1040 for taxpayers age 65 and older. The draft strangely looks like the old 1040 before tax reform and the ill-advised and politically motivated breakup of the 1040 into 6 postcard-size schedules (repackaged into 3 schedules per the 2019 drafts). The Bipartisan Budget Act of 2018 did what lawmakers have wanted to do for a long time: provide seniors with a simplified tax form rather than having to file a 1040. In the past, most seniors could not file a 1040-EZ because of its limitations, especially since it did not include Social Security income and retirement income. Of course, now the 1040-EZ and 1040-A have been discontinued anyway. Use of 1040-SR will be optional.

The draft form can be viewed at: https://www.irs.gov/pub/irs-dft/f1040s--dft.pdf

Continue to next for draft 1040-SR

Form **1040-SR** Department of the Treasury—Internal Revenue Service (99) **U.S. Tax Return for Seniors** **2019** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

DRAFT AS OF July 11, 2019 DO NOT FILE

Filing Status Check only one box.
☐ Single ☐ Married filing jointly ☐ Married filing separately (MFS)
☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
If you checked the MFS box, enter the name of spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent. ▶

Your first name and middle initial	Last name	Your social security number
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Foreign country name | Foreign province/state/county | Foreign postal code | If more than four dependents, see inst. and ✓ here ▶ ☐

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1955 ☐ Are blind
Spouse: ☐ Was born before January 2, 1955 ☐ Is blind

Dependents (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents
				☐	☐
				☐	☐
				☐	☐
				☐	☐

Attach Schedule B if required.

Line	Description			Line	
1	Wages, salaries, tips, etc. Attach Form(s) W-2			1	
2a	Tax-exempt interest	2a	b Taxable interest	2b	
3a	Qualified dividends	3a	b Ordinary dividends	3b	
4a	IRA distributions	4a	b Taxable amount	4b	
c	Pensions and annuities	4c	d Taxable amount	4d	
5a	Social security benefits	5a	b Taxable amount	5b	
6	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			6	
7a	Other income from Schedule 1, line 9			7a	
b	Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your **total income** ▶			7b	
8a	Adjustments to income from Schedule 1, line 22			8a	
b	Subtract line 8a from line 7b. This is your **adjusted gross income** ▶			8b	
9	**Standard deduction or itemized deductions** (from Schedule A)	9			
10	Qualified business income deduction. Attach Form 8995 or Form 8995-A	10			
11a	Add lines 9 and 10			11a	
b	**Taxable income.** Subtract line 11a from line 8b			11b	

Standard Deduction See *Standard Deduction Chart* below.

Standard Deduction Chart

Don't use this chart if someone can claim you (or your spouse if filing jointly) as a dependent, your spouse itemizes on a separate return, or you were a dual-status alien. Instead, see instructions.

Add the number of boxes checked in the "Age/Blindness" section of *Standard Deduction* ▶

IF your filing status is. . .	AND the number of boxes checked is. . .	THEN your standard deduction is. . .	IF your filing status is. . .	AND the number of boxes checked is. . .	THEN your standard deduction is. . .
Single	0	$12,200	Head of household	0	$18,350
	1	13,850		1	20,000
	2	15,500		2	21,650
Married filing jointly or Qualifying widow(er)	0	24,400	Married filing separately	0	12,200
	1	25,700		1	13,500
	2	27,000		2	14,800
	3	28,300		3	16,100
	4	29,600		4	17,400

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 71930F Form **1040-SR** (2019)

Note: Schedules 2 and 3 may still need to be used

Form 1040-SR (2019)

DRAFT AS OF July 11, 2019 DO NOT FILE

12a	**Tax** (see instructions). Check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐	12a		
b	Add Schedule 2, line 3, and line 12a and enter the total . . . . ▶		12b	
13a	Child tax credit or credit for other dependents	13a		
b	Add Schedule 3, line 7, and line 13a and enter the total . . . . ▶		13b	
14	Subtract line 13b from line 12b. If zero or less, enter -0-		14	
15	Other taxes, including self-employment tax, from Schedule 2, line 10		15	
16	Add lines 14 and 15. This is your **total tax** . . . . ▶		16	
17	Federal income tax withheld from Forms W-2 and 1099		17	
18	Other payments and refundable credits:			
a	Earned income credit (EIC)	18a		
b	Additional child tax credit. Attach Schedule 8812	18b		
c	American opportunity credit from Form 8863, line 8 . . .	18c		
d	Schedule 3, line 14	18d		
e	Add lines 18a through 18d. These are your **total other payments and refundable credits** ▶		18e	
19	Add lines 17 and 18e. These are your **total payments** . . . . ▶		19	

• If you have a qualifying child, attach Sch. EIC.
• If you have nontaxable combat pay, see instructions.

Refund

20	If line 19 is more than line 16, subtract line 16 from line 19. This is the amount you **overpaid**		20	
21a	Amount of line 20 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		21a	
b	Routing number ▶ c Type: ☐ Checking ☐ Savings			
d	Account number			
22	Amount of line 20 you want **applied to your 2020 estimated tax** ▶	22		

Direct deposit? ▶ See instructions. ▶

Amount You Owe

23	**Amount you owe.** Subtract line 19 from line 16. For details on how to pay, see instructions ▶		23	
24	Estimated tax penalty (see instructions) . . . . ▶	24		

Third Party Designee (Other than paid preparer)

Do you want to allow another person (other than your paid preparer) to discuss this return with the IRS? See instructions. ☐ **Yes. Co** ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	If the IRS sent you a Protection PIN, ente (see inst.)
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent your s Identity Protection P (see inst.)
Phone no.	Email address		

Paid Preparer Use Only

Preparer's name	Preparer's signature	Date	PTIN	Chec ☐ S ☐ S
Firm's name ▶			Phone no.	
Firm's address ▶			Firm's EIN ▶	

Go to *www.irs.gov/Form1040SR* for instructions and the latest information. Form 1(

FORM 1099-NEC RESURRECTED

The Internal Revenue Service has resurrected a form that hasn't been used since the early 1980s, Form 1099-NEC, Nonemployee Compensation. Draft version is shown below. Since 1983, the IRS has required businesses to instead file Form 1099-MISC for contract workers and freelancers. The revival of Form 1099-NEC is part of an effort mandated by Congress in the PATH Act of 2015 to require businesses to file information returns with any non-employee compensation by Jan. 31 of each year. However, there were problems with the IRS's processing systems because there was still a March 31 due date for any Form 1099-MISC that didn't contain non-employee compensation. The draft 1099-NEC form is dated 2020, so it would be used for reporting nonemployee compensation paid in 2020, not for 2019.

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		OMB No. 1545-xxxx 2020 Form 1099-NEC	Nonemployee Compensation
PAYER'S TIN	RECIPIENT'S TIN	1 Nonemployee compensation $	Copy 1 For State Tax Department
		2 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐	
RECIPIENT'S name		3	
Street address (including apt. no.)		4 Federal income tax withheld $	
City or town, state or province, country, and ZIP or foreign postal code			
	FATCA filing requirement ☐		
Account number (see instructions)		5 State tax withheld $ $	6 State/Payer's state no.
			7 State income $ $

Form **1099-NEC** www.irs.gov/Form1099NEC Department of the Treasury - Internal Revenue Service

DRAFT AS OF July 24, 2019 DO NOT FILE

LONG AWAITED 2020 W-4

The IRS has released the second version of the 2020 draft W-4 and indicated there would be no substantial changes going forward. They have previously released a draft of Pub 15-T (it replaces the former Pub 15). The second draft should be released by the time this webinar is presented.

Form **W-4**

Department of the Treasury
Internal Revenue Service

Employee's Withholding Certificate

▶ **Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay.**
▶ **Give Form W-4 to your employer.**
▶ **Your withholding is subject to review by the IRS.**

OMB No. 1545-0074

2020

DRAFT AS OF
August 8, 2019
DO NOT FILE

Step 1: Enter Personal Information

(a) First name and middle initial | Last name | **(b) Social security number**

Address

City or town, state, and ZIP code

▶ **Does your name match the name on your social security card?** If not, to ensure you get credit for your earnings, contact SSA at 800-772-1213 or go to *www.ssa.gov*.

(c)
- ☐ **Single or Married filing separately**
- ☐ **Married filing jointly** (or Qualifying widow(er))
- ☐ **Head of household** (Check only if you're unmarried and pay more than half the costs of keeping up a home for yourself and a qualifying individual.)

Complete Steps 2 through 4 ONLY if they apply to you. To see if you are exempt from withholding or if you have concerns about your privacy, see page 2. Everyone must complete Step 5. See instructions on page 2.

Step 2: Multiple Jobs or Spouse Works

Complete this step if you (1) hold more than one job at a time, or (2) are married filing jointly and your spouse also works. The correct amount of withholding depends on income earned from all of these jobs.

Do **only one** of the following.

(a) Use the estimator at *www.irs.gov/W4App* for most accurate withholding; **or**

(b) Use the Multiple Jobs Worksheet on page 3 and enter the result in Step 4(c) below for roughly accurate withholding; **or**

(c) If there are only two jobs total, you may check this box. Do the same on Form W-4 for the other job. This option is accurate for jobs with similar pay; otherwise, more tax than necessary may be withheld . . . . . ▶ ☐

CAUTION: If you have privacy concerns, choose **(a)** or **(b).** If you and/or your spouse have income from self-employment, including as an independent contractor, choose **(a).**

Complete Steps 3 through 4(b) on Form W-4 for only one of these jobs. Leave those steps blank for the other jobs. (Your withholding will be most accurate if you complete Steps 3 through 4(b) on the Form W-4 for the highest paying job.)

Step 3: Claim Dependents

If your income will be $200,000 or less ($400,000 or less if married filing jointly):

Multiply the number of qualifying children under age 17 by $2,000 ▶ $

Multiply the number of other dependents by $500 . . . . ▶ $

Add the amounts above and enter the total here . . . . **3** $

Step 4 (optional): Other Adjustments

(a) Other income. If you want tax withheld for other income you expect this year that won't have withholding, enter the amount of other income here. This may include interest, dividends, and retirement income. You should not include income from any jobs . . **4(a)** $

(b) Deductions. If you expect to claim deductions other than the standard deduction and want to reduce your withholding, use the Deductions Worksheet on page 3 and enter the result here . . . . **4(b)** $

(c) Extra withholding. Enter any additional tax you want withheld each **pay period** . **4(c)** $

Step 5: Sign Here

Under penalties of perjury, I declare that this certificate, to the best of my knowledge and belief, is true, correct, and complete.

▶ **Employee's signature** (This form is not valid unless you sign it.) ▶ **Date**

Employers Only

Employer's name and address	First date of employment	Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 3. Cat. No. 10220Q Form **W-4** (2020)

1.19 CALIFORNIA CONFORMITY TO TCJA

California Assembly Bill AB91was passed and signed by the governor on 6/27/2019. It includes conformity to only a few of the changes made by TCJA. These changes will also be included in specific discussion of the subject elsewhere in the text. This is an overview of the changes.

3.01 - Accounting Methods - Generally brings California into conformity with the accounting method simplifications made by the TCJA, effective for tax years beginning on or after January 1, 2019, with a provision allowing taxpayers to elect to have the new rules apply to tax year 2018.

3.16 NOLs - For NOLs occurring in taxable years beginning after December 31, 2018, AB 91 repeals the 2-year carryback period. California continues to allow a 20-year carryover period and has not adopted the federal rule limiting the NOL deduction to 80% of the carryover year's taxable income. Thus, 100% of the unused CA NOL is carried over.

3.20 Tax-Deferred Exchanges - The TCJA provision that limits Sec 1031 treatment only to exchanges of real property was adopted by California in AB 91, with two significant differences: the provision only applies to taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate) and only applies to exchanges **completed** after January 10, 2019.

3.25 Excess Business Loss - California adopts the TCJA change relating to the limitation on excess business losses of noncorporate taxpayers. For CA the disallowed loss is carried over separately and does not add to the NOL carryover.

5.05 529 Plans - Generally conforms to the changes relating to Sec 529 plans made by the TCJA and the Consolidated Appropriations Act of 2016.

5.06 ABLE Accounts - AB 91 generally conforms CA law to the changes relating to qualified ABLE accounts made by the TCJA and the Consolidated Appropriations Act of 2016.

6.02 Higher Education Interest Deduction - Conforms California law to the TCJA provision that certain student loan debt cancelled upon the death or disability of the student is not taxable, effective for loans cancelled after December 31, 2018.

9.03 Earned Income Tax Credit - As of 2020, if a taxpayer's earned income is $30,000 or more, the phaseout will reduce the California EITC to zero.

9.02 Young Child Tax Credit - Effective for years beginning on or after January 1, 2019, allows a refundable "young (under age 6) child tax credit." The maximum credit for 2019 is $1,000 and fully phased out once the earned income exceeds $30,000.

2.01 - MEDICAID WAIVER PAYMENTS

Background: IRS Notice 2014-7 specified the IRS would no longer challenge the excludability of Medicaid waiver wages and instead will treat the payments as

excludable from gross income under IRC Sec 131 (qualified foster care payments) if they meet certain requirements. Note: IRC Sec 131(a) specifies that the exclusion of qualified foster care payments is mandatory, and since the Medicaid waiver payments are considered difficulty of care foster care payments, the notice ruled a taxpayer may not choose to include them in gross income.

This change was a double-edged sword, as some caregivers qualified for the earned income tax credit (EITC) and additional child tax credit (ACTC) in the past based upon this income. As a result of these payments being mandatorily excluded from income, these caregivers lost their EITC and ACTC based upon that income.

Tax Court Case (*Feigh (2019) 152 TC No.15*): The taxpayers in the court case received payments under a state Medicaid waiver program for providing care to their adult disabled children in the family home, and excluded the Medicaid waiver payments from income but still treated them as earned income when computing the EITC and ACTC, disregarding Notice 2014-7. The IRS disallowed the credits and the taxpayers filed a timely Tax Court petition.

The Tax Court held that Notice 2014-7 could not reclassify the taxpayer's Medicaid waiver payment to remove a statutory tax benefit. Specifically, the Court found that where income does not fall within the plain text of a statutory exclusion from gross income, IRS cannot reclassify that income through a Notice so that it no longer qualifies as "earned income" for the purpose of determining tax credits.

The Court reasoned that IRS cannot remove a statutory benefit provided by Congress. Interpretive rulings do not have the force and effect of regulations, and they may not be used to overturn the plain language of a statute which was exactly what IRS sought to do with Notice 2014-7. The EITC and the ACTC are acts of legislative grace provided by Congress. While deductions and credits are allowed only to the extent authorized by statute, the IRS is not free to circumscribe the credits that the legislature has chosen to authorize through statute; that is a power only Congress has. Accordingly, to the extent IRS sought to use Notice 2014-7 to deprive the taxpayers of a benefit bestowed by Congress, the Court held that it was prohibited from doing so.

Not addressed by the Tax Court in the *Feigh* case was the question of whether the taxpayers should have included their Medicaid waiver payment in gross income as IRS did not raise this issue in its notice of deficiency or plead it in this case. IRS chose not to argue in the alternative that the taxpayers' Medicaid waiver payment should be included in gross income, but instead argued that the taxpayers were precluded by Notice 2014-7 from including their payment in gross income for purpose of the credits.

The IRS has since modified their online Q&A on the subject. Q&A #9 asked whether a taxpayer could choose to include the Medicaid waiver payments in gross income (thus qualifying for EITC). The IRS's original answer was no. Now Q&A #9 says "reserved".

Amended Opportunity? This is an apparent amended opportunity for all open years. Even though the court case constitutes substantial authority, the IRS has not stated

whether they will acquiesce to the case. So, since an amended return would be taking the court's position over Notice 2014-7, it would be wise to attach a Form 8275, Disclosure Statement, stating the Tax Court case as the reason for disregarding the provisions of Notice 2014-7. (See Reg Section 1.6662-3(a) & Reg Section 1.6662-4(d)(2) for rules for disclosure of return reporting positions that are contrary to an IRS Notice.)

It may be best practice to wait and see how this plays out. Currently open years are not affected until April 15, 2020.

2.01 - RENTER LEASE BUY-OUT

What are the consequences of a landlord buying out the remaining lease term of a tenant either by cash or a period of free rent? Section 61 provides that a taxpayer's gross income includes all income from whatever source derived, except as otherwise provided by law. A taxpayer's Section 61 gross income is not limited to the actual receipt of gain, but also includes the receipt of any economic benefit unless excluded by law. See Glenshaw Glass Co. v. Commissioner, 348 U.S. 426 (1955).

Stotis v. Commissioner, T.C. Memo. 1996-431, involves the case of a residential leasehold. Mr. Stotis, the petitioner, leased space in an apartment building that he used as a residence. The landlord, desiring to use the real estate for other purposes, entered into a surrender agreement with the petitioner whereby the petitioner exchanged his right in the property for a cash payment. The Tax Court held that the petitioner's leasehold interest in a residence was a capital asset, and that the petitioner's sale of the leasehold interest constituted a sale or exchange, taxable as capital gain.

Further, a taxpayer's interest in a leasehold is either a capital asset under Section 1221 or real property used in a trade or business under Section 1231. Either way the sale of a leasehold interest is treated as a long-term capital gain if held over one year.

2.01 - W-2 AFTER DEATH

When a taxpayer passes away, employers frequently incorrectly handle and report wage payments, often to their own detriment, and end up paying matching payroll taxes when they are not required to do so. According to the IRS W-2/W-3 Instructions (page 8):

- *Payment made after death but in year of death* – Withhold SS and Medicare taxes and only report the income in boxes 3 and 5 to ensure proper Social Security and Medicare credit was received. Do not show the payment in box 1. Also issue a 1099-MISC and report the payment in Box 3 for payment to the estate or beneficiary.
- *Payment made after the year of death* - Do not report it on Form W-2 (thus no withholding or payroll taxes). Issue a 1099-MISC and report the payment in Box 3 for payment to the estate or beneficiary.

Where an employer has handled the wage payment made in a year after death incorrectly, the correct thing to do would be to have the employer amend the W-2 to no W-2 and refund the taxpayer's estate all the withholding and payroll taxes, and issue a 1099-MISC. No doubt the employer will be reluctant to do all that especially after the 1099 and W-2 due dates have gone by. As a work-around the estate could forego the SS and Medicare taxes and report the W-2 wages on a 1041.

2.15 INTEREST TRACING

How to treat interest expense for tax purposes is sometimes complicated. The simple answer is that it depends on the character of the interest. That is, we know personal interest is not deductible while business interest is. The character of the interest depends on the character of the loan and the character of the loan depends on what the loan proceeds were spent on. In other words, the use of the loan funds must be "traced". If the loan was used for personal purposes, like funding a cruise, the character of the loan is personal and may not be deducted (Section 163(h)(1)). If the funds were used for purchase of a business car (assume 100%) or for funding working capital in a business, the interest is business and is deductible (Section 163(a) & Section 162).

In the same way, if a taxpayer borrows money secured by rental #1 and uses the loan proceeds to purchase rental #2, then the character of the interest would be related to and deductible on the Schedule E of rental #2. If loan proceeds are used to buy stocks and bonds, then the interest paid is allocable to purchase of the securities and therefore becomes investment interest.

One of the more complicated, misunderstood and often overlooked tax issues is this concept of interest tracing. The income tax regulations refer to it as "allocation" of debt and interest. Though the concept is straightforward, it can get complicated. The tracing rules are generally summed up as follows:

> *In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. This section prescribes rules for tracing debt proceeds to specific expenditures. (Reg Section 1.163-8T(a)(3))*

Interest expenses generally fall into commonly understood categories, and the treatment of the interest for tax purposes depends upon which category it falls into:

1. **Personal interest** – Not deductible says Section 163(h)(1);
2. **Trade or business interest -** Generally deductible under Section 163(a) and Section 162;
3. **Investment interest –** Generally deductible under Section 163(a) and Section 212(1) and/or (2) but investment interest is limited, however, by Section 163(d) to net investment income;

4. **Interest related to a passive activity**, which is taken into account under Section 469 in computing income or loss from a passive activity.
5. **Qualified residence interest** within the meaning of Section 163(h)(3);
6. **Educational loans. –** Any interest paid on educational loans and allowable as a deduction under Section 221. (Note that educational loans are personal and would not be deductible because of Section 163(h)(1) were it not for Section 221.)

Home Equity Debt – An interest deduction on home equity debt is suspended for years 2018-2025. But there is an opportunity to trace the use of the home equity debt to another deductible purpose such as investment or business. How this is accomplished was changed by TCJA. The following explains how it was handled pre-TCJA (and supposedly after 2025 when the suspension of the home equity debt interest deduction expires) and during the years 2018 through 2025 while the suspension is in place.

- _Pre-TCJA_ - Under the pre-TCJA law the interest on the first $100,000 of equity debt secured by a taxpayer's home had to be deducted as "qualified residence interest" (home mortgage interest) regardless of how the funds were used **unless** the election to unsecure the debt under regulation Section 1.163-10T9(o)(5) was made.

> ***CAUTION:*** *If before the passage of TCJA (before 2018) a taxpayer had utilized the unsecured election, that election is irrevocable without IRS consent and thus the loan continues to be treated as unsecured, and since home acquisition mortgage debt is defined as being secured by the home, none of the interest allocated to home acquisition mortgage debt is deductible on Schedule A or anywhere else.*

- _2018 through 2025_ - For 2018 through 2025, the interest tracing rules can be applied to **ALL** debt secured by the home – both home acquisition debt and equity debt – since home equity interest is suspended during that period. That means there is no need to use the unsecured election, since all the interest on a refinanced loan (secured by the home), both home acquisition and excess debt, can be traced to the use of the loan proceeds.

Example – 2018 through 2025: A home has an existing home acquisition debt balance of $40,000 and the taxpayer refinances the home for $200,000. The $40,000 portion of the refinanced debt continues to be home acquisition debt and thus 20% ($40,000/$200,000) x 100)) of the interest on that portion of the refinanced mortgage is deductible on Schedule A. The deductibility of the balance of the interest (80%) depends (is traceable) to the use of the $160,000 proceeds from the refinance.

Special Issues:

- *Home Equity Line of Credit (HELOC)* – Just because banks refer to them as equity debt does not mean the interest on a HELOC loan is not traceable to purposes other than non-deductible personal interest. Like any other debt the use of the loan proceeds determines if the interest on the loan is deductible and where it is deducted. Thus, it is possible for the interest on a HELOC loan to be home acquisition interest, business interest, investment interest, personal interest, etc.
- *Debts Traced to the Purchase of Tax-Exempt Securities* – The interest on loan proceeds used to acquire tax exempt securities is non-deductible investment interest. This rule also applies to any interest paid on a loan to produce any tax-exempt income (Sec 265).
- *Higher Education Loans* - If a student loan is not subsidized, guaranteed, financed, or is not otherwise treated as a student loan under a program of the Federal, state, or local government or an eligible educational institution, a payee (lender) must request a certification from the payor (borrower) that the loan will be used solely to pay for qualified higher education expenses (Reg.1.6050S-3(e)(2)). Form W-9S, Request for Student's or Borrower's Social Security Number and Certification, is used for this purpose. See Big Book of Taxes chapter 6.02 for more on higher education loan interest.

Examples: The best way to understand the tracing rules is by example. The following are a variety of situations to help understand the application of the tracing rules.

- **Example 1:** A taxpayer takes out a loan secured by his rental property and uses the proceeds to finance a European vacation. The use of the funds was to pay for a vacation and thus the interest on the loan is non-deductible personal interest expense.

- **Example 2:** A taxpayer refinances an existing loan ($150,000 amortized balance) secured by his rental property for $200,000 and uses the excess proceeds to buy for $50,000 a car for personal use. The taxpayer must trace the use of the refinanced loan proceeds ("allocate the proceeds") to the portion used to pay off the existing amortized rental loan of $150,000 and the $50,000 portion, used to purchase the car. The loan interest expense is then proportionally allocated between rental interest ($150,000/$200,000) and personal interest ($50,000/$200,000) for the purchase of the car. So 75% ($150,000/$200,000) is related to the rental property and is deductible on Schedule E and 25% ($50,000/$200,000) is non-deductible personal interest. **Note:** it does not matter that the new loan is secured by the business property; the interest allocated to the personal use of the loan proceeds is not deductible.

- **Example 3:** The taxpayer borrows $50,000 secured by his home to be used as working capital in his consulting business. He has no other debt on his home. He deposits the $50,000 into a checking account that's devoted to his business, and he uses the money in that account only for his business.
  - *For years before 2018 and after 2025* – He must deduct the interest as home equity debt interest on his Schedule A since the debt is secured by his home and the debt is less than the $100,000 limit for equity indebtedness. However, the election to unsecure the debt from the home could have been used, in which case the interest on the debt would have been traceable to the use of the loan proceeds.
  - *For 2018 through 2025*– He must trace the use of the funds and since the loan proceeds were used in his business, the interest is an expense of the business.

- **Example 4:** The taxpayer wants to acquire an additional rental, so she refinances one of her existing rentals to obtain the down payment. Here the tracing rules are used to trace the use of the funds. The interest on the refinanced loan must be allocated between the portion of the refinanced debt used to refinance the existing rental loan and the portion of the debt used to acquire the new rental. Thus, the interest is proportionally allocated between the two rentals.

- **Example 5:** The taxpayer owns a rental property and wants to purchase a personal residence. So, he obtains a $200,000 loan on the rental to refinance the existing amortized acquisition debt of $40,000 and to purchase the personal residence for $160,000. Under the tracing rules the taxpayer must trace the use of the refinance proceeds to its uses. Since $40,000 of the new debt was used to pay off the debt related to the rental property, the character of $40,000 of the new debt takes on the same character as the old debt. The $160,000 balance of the refinance proceeds is traced to the purchase of the taxpayer's home. However, the definition of home acquisition loan debt requires the debt to be secured by the home, which it is not. Thus, the interest on the $160,000 portion of the refinanced debt is not deductible.

- **Example 6:** The taxpayer wants to purchase a lot and build a rental on it. He plans to purchase the lot with cash savings and then build the house with a construction loan. Once the construction is complete, he intends to refinance the construction loan with a take-out loan and use part of the debt to restore the savings account for the funds used to purchase the lot. Under the tracing rules he must trace the interest based upon the use of the refinanced loan proceeds. The portion of the loan used to refinance the construction loan can be traced to the rental, and thus is deductible as rental interest. The portion reimbursing the taxpayer for the cost of the lot must be traced to the use of those funds, and assuming the taxpayer

banked those proceeds, that portion of the interest would be treated as investment interest.

- **Example 7:** The taxpayer borrows $20,000 on a margin account held by his broker. He uses the $20,000 to buy additional securities. The interest he pays on the margin account is treated as investment interest.

- **Example 8:** Taxpayer purchases a property he intends to use as a rental. The property is in such bad condition that he cannot obtain a loan. So, he purchases it with cash from his savings and fixes up the property, also using cash from his savings. When the work is complete, and the property is available for rent, he finances the rental and deposits the proceeds in his savings account. Following the tracing rules, we trace the use of funds to determine if the interest is deductible and where. In this case funds were deposited in the taxpayer's savings account and as a result the interest on the loan becomes investment interest.

  But that is not the end of the story. Since the proceeds of the loan are now in the taxpayer's savings account, if he subsequently uses some of those proceeds (takes money out of the savings account) and uses it for another purpose, we again have to trace the use of the savings withdrawal to follow the money. If used for a personal purpose the interest on that portion of the loan is not deductible. If used for a business purpose, then the interest on that part of the original loan would become business interest.

  As you can imagine, this would become a tracing recordkeeping nightmare.

- **Example 9 - Special rule that only applies to first and second homes:** The taxpayer has an opportunity to purchase a home in a quick sale and does not have time to obtain financing and so makes the purchase with cash. Then after escrow has closed, he obtains financing for the home. Notice 88-74 states that where a taxpayer is purchasing a residence the debt may be treated as incurred to acquire the residence ("acquisition debt") to the extent of expenditures to acquire the residence made within 90 days before or after the date that the debt is incurred.

See Big Book of Taxes chapter 7.05 for additional examples where debt secured by the home is used for other purposes.

California conforms to the interest tracing rules. However, California has not conformed to the TCJA provision that home equity debt interest is not deductible as mortgage interest for 2018-2025.

2.16 QUALIFIED OPPORTUNITY FUNDS

The TCJA created new Code Sections 1400Z-1 and 1400Z-2 related to qualified opportunity zones (QOZ), which are intended to promote investments in certain economically distressed communities through qualified opportunity funds (QOF). Tax incentives were included in the legislation to encourage investment in these funds.

Related IRC and IRS Publications and Forms

- IRC Sec 1400Z-1
- IRC Sec 1400Z-2
- Notice 2018-48 - List of QOZs
- Notice 2019-42 - List of QOZs
- Opportunity Zone Resources: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
- Form 8996 - Qualified Opportunity Fund
- Form 8949 – Sales and Other Dispositions of Capital Assets

Reinvesting Gain – Starting in 2018, a taxpayer who has a capital gain on the sale or exchange of any property to an unrelated party may elect to defer, and potentially partially exclude, the gain from gross income if the gain is reinvested in a QOF within 180 days of the sale or exchange. Only one election may be made with respect to a sale or exchange. If less than the full amount of the gain is reinvested in the QOF, the part not reinvested is taxable as usual in the sale year. Unlike Sec 1031 deferrals, the amount of the gain, not the amount of the proceeds of sale, is what needs to be reinvested in order to defer the gain.

Making the Election – According to the instructions of the 2018 Form 8949, when electing to defer the gain on an eligible asset, report the sale as usual on Form 8949, and then report the deferral of the eligible gain on its own row of Form 8949 (Part I with box C checked if short-term gain or Part II, box F, if long-term gain). If multiple investments were made in different QOFs or in the same QOF on different dates, a separate row needs to be used for each investment. If eligible gains of the same character (i.e., ST or LT) but from different transactions on the same date were invested in the same QOF, these can be grouped on the same row. In column (a), enter only the EIN of the QOF into which the investment was made and in column (b), enter the date of the investment. Leave columns (c), (d) and (e) blank, and enter code Z in column (f) and put the amount of the gain being deferred as a negative number in column (g).

There is no need to trace or allocate the funds invested in a QOF to the specific gain being deferred, but the QOF investment must have occurred within the 180-day period beginning on the date the deferred gain was realized. If both short-term and long-term gains were realized during the 180-day period the taxpayer can choose how much of each gain to defer by reporting the deferral in Part I or Part II, as applicable. The character of the eligible gain transfers to the investment in the QOF so that when the eligible gain is recognized, the gain recognized will be the same character as the gain deferred.

Deferral Period - The gain income is deferred until the earlier of the date the

investment in the QOF is sold or December 31, 2026. If the taxpayer continues to hold the investment after December 31, 2026, the taxpayer still has to include the deferred gain in the 2026 tax return. If that is the case, the gain reported in 2026 adds to the basis of the QOF.

Qualified Opportunity Fund Basis - To the extent the QOF is purchased with the deferred gain, the basis in the QOF is zero. Then when the QOF is sold, the deferred gain subject to tax is the excess of the lesser of (a) or (b), below, over the QOF's basis (or enhanced basis (explained next), if applicable):

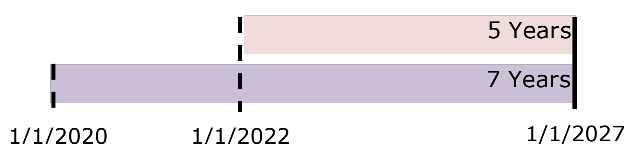
(a) The deferred gain, or

(b) The fair market value of the investment as determined at the end of the deferral period.

Enhanced Basis – If the taxpayer holds the QOF for 5 years, the basis of the QOF investment is increased by 10% of the deferred gain, and if held for 7 years, the basis is increased by an additional 5%, for a cumulative increase of 15%. In other words, if held at least 5 years, 10% of the original gain is excluded, or if held 7 years, 15% of the original gain is excluded. When the deferred gain is included in income – either as of 12/31/2026 or when sold, if before 12/31/2026 –the amount of the deferral that is taxable also increases basis. (IRC Sec.1400Z-2(b)(2)(B)(ii))

> Example 1: Phil sold a rental apartment building June 30, 2018 for $3 million, which resulted in a gain of $1 million. He invests the $1 million within the statutory 180-day window into a QOF and elects the temporary gain deferral exclusion. On July 1, 2026 the QOF is sold for $1.5 million. Since Phil had held the investment over seven years, his basis is enhanced by $150,000 (15% of $1 Million). The deferral period ends on the date of sale since the investment is sold before 12/31/2026. The deferred gain that will be included in Phil's 2026 income is $850,000 ($1,000,000, which is the lesser of the deferred gain or the FMV of the QOF on the sale date, less basis of $150,000). The $850,000 reportable deferred gain then increases his basis back to $1 million, and so the difference between the sales price of $1.5 million and $1 million, or $500,000, is a long-term capital gain. Thus, the total gain that's taxable is $1.35 million.

CAUTION: Because only gains incurred before 2027 can be deferred, the clock is ticking on the extra 5% basis increase, since the gain must be incurred before 1/1/2020 (see adjacent diagram).



That means gains incurred after 2019 will not qualify for the 5%. In addition, to qualify for 10% basis adjustment the gain must be incurred before 2022 meaning gains after 2021 will not qualify for the 10% basis adjustment.

10 Year Election - If the QOF is held for 10 years or longer before it is sold, the taxpayer can elect to increase the basis to the fair market value amount. The effect of this adjustment is that none of the appreciation since the QOF was purchased is

taxable when it is sold. This provision applies only to the investment in the QOF that was made with deferred capital gains. (Prop. Reg. 1.1400Z-2(c)-1(a))

All qualified opportunity zones now in existence will expire on December 31, 2028. So after the relevant qualified opportunity zone loses its designation, will investors still be able to make a basis step-up election for QOF investments from 2019 and later? Yes, according to proposed regulations. Although the statute doesn't so specify, the proposed regulations would permit taxpayers to make the basis step-up election under section 1400Z-2(c) after a qualified opportunity zone designation expires for dispositions of QOFs up to December 31, 2047. (Prop. Reg. 1.1400Z-2(c)-1(b))

> Example 2: Same facts as Example 1, except Phil didn't sell the QOF until 2030, having held it nearly 12 years. Since he had the investment on December 31, 2026, he was required to include $850,000 ($1 million – ($1 mil x 15%)) of deferred gain on his 2026 return, and his basis in the QOF was increased from zero to $850,000. The QOF's sale price was $1.5 million. Phil elects to permanently exclude the gain by increasing his basis to $1.5 million, the fair market value at the date of sale. Thus, there is no gain ($1.5 mil – $1.5 mil).

Mixed Investments – Investment in a QOF isn't limited to deferred capital gain from the sale of another asset; a taxpayer can purchase an interest in a QOF with other funds. Where a taxpayer's investment in a QOF consists of both deferred gain and additional investment funds, the investment is treated as two separate investments with the tax benefits of both the gain deferral election and the 10-year gain exclusion election applying only to the deferred gain portion.

Qualified Opportunity Funds (QOF) – To take advantage of the tax deferral of gains available from the TCJA-enacted opportunity zone program, taxpayers must invest in a QOF, which is any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) acquired after December 31, 2017. The fund must hold at least 90% of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the fund on the last day of the first 6-month period of the fund's tax year and on the last day of the fund's tax year. Taxpayers may not invest directly in QOZ property.

Partnerships – Because the basis of the QOF purchased with deferred capital gains is zero, taxpayers that invest in QOFs organized as a partnership may be limited in deducting losses that may be generated by these partnerships.

Qualified Opportunity Zones (QOZ) – These are population census tracts that are low-income communities that are specifically designated as QOZs after being nominated by the governor of the state or territory in which the community is located. After the governor notifies the Treasury Secretary in writing of the selected QOZs, the Treasury Secretary must certify the community as a QOZ. Qualified opportunity zones retain this designation for 10 years. More information about QOZs and a link to a list of designated opportunity zones is available at: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

More Details to Come - The Treasury Department and the IRS will be providing further details, including additional legal guidance on this new incentive in the coming months. See also: https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

Questions & Answers - The following are selected and sometimes reworded excerpts from the IRS Q&As modified for the current year:

Question: I sold stock for a gain in 2019 and during the 180-day period beginning with the date of the sale, I invested the amount the of the gain in a QOF. Can I defer paying tax on that gain?

Answer: Yes, you may elect to defer the tax on the amount of the gain invested in a Qualified Opportunity Fund. Therefore, if you only invest part of your gain in a Qualified Opportunity Fund(s), you can elect to defer tax on only the part of the gain which was invested.

Question: How do I elect to defer my gain on the 2019 sale of stock?

Answer: You may make an election to defer the gain, in whole or in part, when filing your 2019 Federal Income Tax return. That is, you may make the election on the return on which the tax on that gain would be due if you do not defer it. For additional information, see How to Report an Election to Defer Tax on Eligible Gain Invested in a QO Fund in the Form 8949 instructions.

Question: Can I elect to defer tax on gain if I already filed my tax return?

Answer: Yes, but you will need to file an amended return, using Form 1040-X and attaching Form 8949.

Question: I deferred gain into a QOF and now the QOF has dissolved before the end of my deferral period. What happens to my deferred gain?

Answer: When the QOF dissolved, the deferral period ended, and you must include the deferred gain when you file your return, reporting the gain on Form 8949.

Question: I deferred a gain into a QOF and then gave the investment to my children before the end of the deferral period. Is there anything I need to do?

Answer: Yes, the deferral period ended when you gave away the QOF investment. You must include the deferred gain when you file your return for the year of the gift, reporting the gain on Form 8949.

> **Note**: Inheritance by a surviving spouse is not a taxable transfer, nor is a transfer, upon death, of an ownership interest in a QO Fund to an estate or a revocable trust that becomes irrevocable upon death.

Question: Can I defer section 1231 capital gains net income for a taxable year into a QOF?

Answer: Yes, if a taxpayer's section 1231 gains for any taxable year exceed the section 1231 losses for that year, the net gain is long-term capital gain. A taxpayer can elect to defer some or all of this capital gain under section 1400Z-2 by making an investment of a corresponding amount in a Qualified Opportunity Fund (QOF) during the 180-day period that begins on the last day of the taxpayer's taxable year.

Question: Can I transfer property other than cash as an investment in a QOF?

Answer: Yes. A taxpayer can transfer property other than cash as an investment to a QOF. However, a transfer of non-cash property may result in only part of the investment being eligible for opportunity zone tax benefits, so that not all of the taxpayer's capital gain is able to be deferred. See proposed regulations §1400Z2(a)-1(b)(9) & (10).

Question: When I transfer property to a QOF, does my holding period of the property also transfer to the QOF?

Answer: No. The opportunity zones tax incentives provisions determine a taxpayer's holding period in a qualifying investment in a QOF without regard to the holding period of the cash or other property transferred to the QOF.

Question: I made an investment in a QOF. After holding it for at least 10 years, I sell or exchange it. Can I adjust the basis to fair market value?

Answer: Yes, but only if you made the investment in connection with a proper deferral election. Also, the election must have remained in effect until that post-10-year sale or exchange. The election didn't cease to be in effect solely because – on December 31, 2026 – the law requires you to include in your income the gain that you had deferred under that election.

Question: I had ordinary gain from the sale of property in 2018. During the 180-day period beginning on the date of the sale, I invested the amount of that gain in a QOF. In 2029, I sell my interest in the QOF. Can I adjust my basis to fair market value?

Answer: No. Because the gain wasn't capital gain, you can't elect to defer it. So, your investment in the QOF wasn't made in connection with a proper deferral election. For this reason, the basis adjustment to FMV isn't available for that investment.

Question: What is a Qualified Opportunity Fund?

Answer: A Qualified Opportunity Fund is an investment vehicle that files either a partnership or corporation federal income tax return and is organized for the purpose of investing in Qualified Opportunity Zone property.

Question: How does a corporation or partnership become certified as a Qualified Opportunity Fund?

Answer: To become a Qualified Opportunity Fund, an eligible corporation or partnership self-certifies by filing Form 8996, Qualified Opportunity Fund, with its federal income tax return. For additional information, see Form 8996 and its instructions. The return with Form 8996 must be filed timely, taking extensions into account.

Question: Can a limited liability company (LLC) be an Opportunity Fund?

Answer: Yes, a LLC that chooses to be treated either as a partnership or corporation for federal tax purposes can organize as a Qualified Opportunity Fund.

Question: When is tangible property "original use" tangible property?

Answer: Tangible property is original use on the date first placed in service in the qualified opportunity zone for purposes of depreciation or amortization. Used tangible property satisfies the original use requirement if the property has not been previously placed in service in the qualified opportunity zone.

Question: Can inventory in transit be "Qualified Opportunity Zone business property"?

Answer: Yes, inventory of a QOF, including raw materials, does not fail to be "used in a Qualified Opportunity Zone" solely because the inventory is in transit from a vendor to the QOF or from the QOF to a customer.

Question: What is the 50-percent-of-gross-income test?

Answer: A Qualified Opportunity Zone business must earn at least 50 percent of its gross income from business activities within a QOZ. It must do so for each taxable year. The proposed regulations provide three safe harbors that a business may use to meet this test. These safe harbors are the:

- Hours-of-services-received test.
- Amounts-paid-for-services test.
- Necessary-tangible-property-and-business-functions test.

Question: Must a Qualified Opportunity Zone business meet all three safe harbors to satisfy the 50-percent-of-gross income test?

Answer: No. It's enough for a QOZ business to satisfy just one safe harbor.

For example, 50 percent or more of all the hours of services that a business receives and uses were performed in one or more QOZs. This business satisfies the hours test and, therefore, the 50-percent-of-gross-income test.

Second example, a QOF owns a business that operates in multiple QOZs. The business received and used 100,000 hours of services during the year. Of those:

- Employees spent 25,000 hours in QOZ 1.
- Independent contractors spent 20,000 hours in QOZ 2.
- Employees of independent contractors spent 10,000 hours in QOZ 3.
- The remaining 45,000 hours were outside of a QOZ.

This business satisfies the hours test and therefore the 50-percent-of-gross-income-test. The aggregate hours of services in QOZs during the tax year were at least 50 percent of all hours of services obtained by the business in all locations.

At publication the states that have not yet conformed to the OZ program, include California, Arizona, Hawaii, Massachusetts, Minnesota, North Carolina and Pennsylvania.

Sec 1400Z-1 allows each Governor to designate up to 25% of census tracts that either have poverty rates of at least 20% or median family incomes of no more than 80% of statewide or metropolitan area family income.

There are 3,516 census tracts in 54 California counties that would qualify under one or both of the mandatory criteria, which allowed Governor Brown to designate up to 879 tracts. After he did so the U.S. Department of the Treasury certified those 879 tracts as qualified opportunity zones. http://dof.ca.gov/Forecasting/Demographics/opportunity_zones/

California has not conformed to the tax benefits of QOZs, so any deferred gains reinvested under this program will be taxable in the sale year for California, and the basis of the investment in a QOF will be different for federal and state.

3.00 - PARTNER EXPENSES

A frequent question that arises is how to handle the deductible business expenses of individuals in a partnership. Generally, the partnership should reimburse each partner for any allowable expenses; those expenses would then be deducted on the partnership's 1065 return.

If the partnership does not reimburse these expenses, the following instructions from Part II of Form 1040, Schedule E apply: "You can deduct unreimbursed ordinary and necessary expenses you paid on behalf of the partnership **if you were required to pay these expenses under the partnership agreement.**"

The inference here is that, if the partnership agreement does not require the partner to pay expenses, those expenses are not deductible.

If they are deductible, the expenses are claimed on Part II of Schedule E. See line 27 (page E-10) of the 2018 Schedule E instructions to learn how to fill in the entry on line 28 based on whether the activity is passive or active. Be sure to check the "yes" box on line 27 to indicate that there are unreimbursed partnership expenses. Refer to your software's instructions on how to achieve the desired result.

Whatever you do, do not adjust the K-1. That is the incorrect place to do so; in addition, not using the numbers from the filed K-1 necessitates that Form 8082 (Notice of Inconsistent Treatment) also be filed.

Additional Issue – QBI (for Sec 199A deduction) must be reduced by these expenses.

3.01 ACCOUNTING METHODS

TCJA (effective beginning in 2018) allows businesses (termed “small business taxpayers”) to use the cash method of accounting if they have average annual gross receipts of $25 million (indexed for inflation after 2018) or less during the preceding three years. The amount is $26 million for tax years beginning in 2019. In addition, the taxpayer’s method of accounting for inventory won't be treated as failing to clearly reflect income if the method: (Code Sec. 471(c)(1)(B))

(1) Treats inventory as non-incidental materials and supplies (Code Sec. 471(c)(1)(B)(i)), or

(2) Conforms to the taxpayer's method of accounting reflected in an "applicable financial statement" (i.e., an AFS, defined on Big Book of Taxes page 3.01.02) of the taxpayer for that tax year or, if the taxpayer doesn't have any AFSs for the tax year, the taxpayer's books and records prepared in accordance with the taxpayer's accounting procedures (Code Sec. 471(c)(1)(B)(ii)).

AB 91 (signed by the governor 6/27/2019) generally brings California into conformity with the accounting method simplifications made by the TCJA. The legislation is effective for tax years beginning on or after January 1, 2019. This is one year later than the Federal effective date of 2018 which creates a disparity for the 2018 tax year between federal and CA law.

Retroactive Elections - However, AB 91 also included a provision allowing taxpayers to make a retroactive election to have the new rules apply to tax year 2018. A taxpayer can retroactively adopt the new Federal small business accounting rules on either a paper-filed original or amended 2018 CA return by doing the following:

- Include a statement stating the taxpayer is electing the Federal TCJA small business accounting for a year beginning on or after January 1, 2018. Specify in the statement which election(s) is/are being adopted.
- Add “AB 91 – Small Business Accounting Election” in blue ink on the top of the first page.
- Mail the return (do not e-file) to: Franchise Tax Board, PO Box 942857, Sacramento, CA 94257-0500

Refer to FTB Notices 2019-03 and -04 for additional information, including the procedure when the taxpayer would otherwise be required to file electronically.

3.02 HOBBY LOSS RULES UNDER TCJA

Some hobbyists try to get a tax deduction for their hobby expenses by treating their hobby as a trade or business. By disguising hobbies as a trade or business, and where the hobby expenses exceed the hobby income, they think they can report the difference between hobby income and expenses as a deductible business loss. Not so! To curtail hobbies being treated as businesses the tax code includes rules where losses are not permitted for not-for-profit activities such as hobbies. Not-for-profit rules are often referred to as the hobby loss rules.

The distinction between a hobby and a trade or business sometimes becomes blurred, and the determination depends upon a series of factors with no one factor being decisive, and all of these factors have to be considered when making the determination:

1. Is the activity carried on in a businesslike manner?
2. How much time and effort does the taxpayer spend on the activity?
3. Does the taxpayer depend on the activity for a source of income?
4. Are losses from the activity the result of sources beyond the taxpayer's control?
5. Has the taxpayer changed business methods in attempts to improve profitability?
6. What is the taxpayer's expertise in the field?
7. What success has the taxpayer had in similar operations?
8. What is the possibility of profit?
9. Will there be a possibility of profit from asset appreciation?

See *Estate of Power v Commissioner* 736 F.2d 826 (1st Cir. 1984) for an application of these 9 factors:
https://law.justia.com/cases/federal/appellate-courts/F2/736/826/90938/

Because making a determination using the factors is so subjective, the IRS regulations provide that the taxpayer has a presumption of profit motive if an activity shows a profit for any three or more years during a period of five consecutive years. However, if the activity involves breeding, training, showing or racing horses, the period is two out of seven consecutive years.

Making the proper determination is important because of the differences in tax treatment for hobbies and trades or businesses. Where an activity is determined to be a trade or business that the owner materially participates in, the owner can deduct a loss on their tax return, and it is not uncommon for a business to show a loss in the startup years.

However, for hobbies (not-for-profit activities) there are special, unfavorable, rules for reporting the income and expenses which have been exacerbated by the passage in 2017 of the Tax Cuts and Jobs Act (tax reform). These rules are:

1. The income is reported directly on the hobbyist's 1040;
2. The expenses, not exceeding the income, are deducted as a miscellaneous itemized deduction. Thus, the expenses are only allowed if a taxpayer is itemizing deductions rather than taking the standard deduction, and
3. Due to tax reform, for tax years 2018 through 2025, miscellaneous itemized deductions that must be reduced by 2% of the taxpayer's adjusted gross income – which is the category into which the hobby expenses fall – have been suspended (are not deductible). Thus, for those years there is no deduction at all for hobby expenses and any hobby income is fully taxable.

> ***Example:*** *Marcia has income of $750 from her hobby (a not-for-profit activity) of coin collecting and expenses of $500. So, Marcia must include the $750 on her 1040. But because miscellaneous itemized deductions are currently suspended, she will not be able to deduct her $500 of expenses, leaving the full $750 as taxable income.*

Another concern related to hobbyists who are reporting income from their hobby on their 1040 is whether or not that income is subject to self-employment tax. Luckily there is an exception for sporadic or one-shot deals and hobbies, and they are not subject to self-employment tax.

3.04 BONUS DEPRECIATION

Property Acquired and Placed in Service After 9/27/17 - The Act allows 100% expensing of tangible business assets (except structures) acquired after September 27, 2017 and through 2022, at which point it begins to phase out *(IRC Sec. 168(k) amended by TCJA Sec. 13201(a).* The bonus percentage will be:

- 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.

A special phase out applies to aircraft and certain long-production period property; see summary table below.

Qualifying property can be **new or used** and the bonus rate applies to:

- All tangible assets except structures with a MACRS life of 20 years or less,
- Qualified film productions.
- Qualified television productions.
- Qualified live theatrical productions.
- Certain fruit and nut trees grafted or planted after September 27, 2017.

Specifically excluded from qualified property is public utility property and vehicle dealer property.

Commentary: Both the bonus depreciation and the Sec 179 expensing provide means of substantially reducing business profits. However, TCJA has added some new issues that need to be considered before utilizing these provisions.

1. The new Sec 199A deduction is based on qualified business income (QBI). QBI is generally net profits for Schedule Cs and Fs, real estate rentals (Schedule E), and flow-through income from partnerships and S-Corporations. Writing off large capital purchases reduces an entity's profit and in turn will generally reduce the amount of the Sec 199A deduction.
2. On the flip side, lowering a taxpayer's taxable income may be helpful in avoiding certain 199A phase-outs and limitations.

Revoking the Bonus Depreciation Election **-** Generally, the election out of bonus depreciation can only be revoked with IRS consent, except that if made on a timely filed return, the election-out can be revoked on an amended return filed within six months of the original return's due date (excluding extensions). (Reg § 1.168(k)-1(e)(7))

> *Reg § 1.168(k)-1(e)(7)(ii) - Automatic 6-month extension* - If a taxpayer made an election specified in paragraph (e)(1) of this section for a class of property, an automatic extension of 6 months from the due date of the taxpayer's Federal tax return (excluding extensions) for the placed-in-service year of the class of property is granted to revoke that election, provided the taxpayer timely filed the taxpayer's Federal tax return for the placed-in-service year of the class of property and, within this 6-month extension period, the taxpayer (and all taxpayers whose tax liability would be affected by the election) files an amended Federal tax return for the placed-in-service year of the class of property in a manner that is consistent with the revocation of the election.

Qualified Leasehold Improvement, Restaurant and Retail Improvement Property - Qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property **DO NOT QUALIFY** for bonus depreciation. The final regs issued September 16, 2019 make it clear that TCJA Sec. 13204 amended Code Sec 168(k) to eliminate the 15-year MACRS classification for these properties and therefore they revert to 39-year property. Since bonus deprecation only apples to property with a recovery period of 20 years or less, these properties no longer qualify for the bonus depreciation.

The preamble to the final regulations acknowledges there was confusion related to this issue and it was widely reported that these Act changes were in error. However, they go on to say that a legislative change must be enacted to provide for a recovery period of 20 years or less for qualified improvement property placed in service after 2017 in order for it to be qualified property. As a result, qualified improvement property has a MACRS life of 39 years and is not eligible for the bonus depreciation.

California does not conform to bonus deprecation – none is allowed.

3.06 SECTION 179 EXPENSING

Taxpayers, **except trusts, estates and certain noncorporate lessors**, can **elect** (on Form 4562) to expense the cost of qualifying property used in the active conduct of a trade or business. The portion of the cost not expensed under Sec 179 is depreciable. If the taxpayer's use of the property drops to 50% or less in a subsequent year, recapture of some of the deduction benefit is required. Limits:

Taxable Income Limit - The amount of deduction is further 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:

1. The cost of any qualified expense property,
2. The above-the-line deduction for a portion of self-employment tax,
3. Any net operating loss carryback or carryforward, and
4. Any deductions suspended under the passive activity rules.

Employees are considered to be engaged in the active conduct of the trade or business of their employment. Thus, **wages, salaries, tips and other compensation** (not reduced by unreimbursed employee business expenses) derived by an employee are included for purposes of the taxable income limit (Reg § 1.179-2(c)(6)(iv)).

> ***Example - Computing Taxable Income Limits for Section 179:*** *Joe purchased and placed in service office equipment at a cost of $12,000. In the year he purchased the equipment, Joe's taxable income from his business was $7,000 (without regard to any Section 179 deduction for the equipment). Joe has a W-2 for $2,000 from a part-time job. His Section 179 deduction is limited to $9,000, but he may carry $3,000 forward to future years.*

Qualifying Property - Generally, qualifying property is purchased tangible personal property, either new or used, purchased for use in the active conduct of a trade or business eligible for ACRS or MACRS depreciation. However, buildings and their structural components, **other than** "qualified real property," **do not qualify**. The following are eligible property:

	2017	2018	2019	2020
Expense Limit	$510,000	$1,000,000	$1,020,000	1,040,000
Investment Limit	$2,030,000	$2,500,000	$2,550,000	$2,590,000

- Tangible personal property, either new or used,
- Off-the-self software
- Portable heating and air conditioning (AC) units (after 2015)
- Vines and fruit bearing trees (once in production stage)
- Qualified Real Property, generally includes:
    - Qualified leasehold improvement property
    - Qualified restaurant property
    - Qualified retail Improvement property
- Non-residential Real Property –post construction improvements (listed below)

<u>*Examples of Qualifying Property*</u>:

- ***Personal Tangible Property -*** Grocery counters, refrigerators, display racks, shelves, neon signs, machinery, equipment, gas pumps, gas storage tanks, grain storage bins, autos, trucks, elevators, escalators, certain livestock, greenhouses, single-purpose livestock structures, and coin-operated vending machines.
- ***Off-the-Shelf Computer Software*** – Off-the-shelf computer software (made permanent by the PATH Act of 2015).
- ***Air Conditioning and Heating Units*** - Beginning after 2015, AC and heating units qualify for Sec 179 expensing, but only if they are Sec 1245 property, such as portable units – for example a window air conditioner and portable plug-in unit heaters. An example of an air conditioning or heating unit that will not qualify as Sec. 179 property is any component of a central air conditioning or heating system of a building, including motors, compressors, pipes, and ducts, whether the component is in, on, or adjacent to a building. However, AC and heating units that meet the definition of qualified real property (see below), placed in service after 2015 (Rev. Proc. 2017-33), and HVAC equipment put in service after 2017 in nonresidential real estate (see below), may qualify if the taxpayer so elects.
- ***Furnishings*** – Beginning after 2017 furnishings, e.g., beds and other furniture, refrigerators, ranges, and other equipment – used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) used predominantly to furnish lodging or in connection with furnishing lodging.

  The code is poorly written and uses an apartment house or dormitory as examples leaving one to wonder whether property in a single-family resident rental would qualify. Reg. Sec. 1.48-1(h) says property used for lodging except for "***Nonlodging commercial facility.*** A nonlodging commercial facility which is available to persons not using the lodging facility on the same basis as it is available to the tenants of the lodging facility shall not be treated as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. **Examples of non-lodging commercial facilities** include restaurants, drug stores, grocery stores, and vending machines located in a lodging facility.

  Thus, it seems clear that furnishing in a single-family residence rental will qualify for Sec 179 expensing.

  Commentary: Previously Sec. 179 could only be used for a *transient* lodging activity, such as hotels and motels.

- ***Post-Construction Improvements to Non-residential Real Property -*** As qualified real property, any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service and after 2017: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.
-

- ***SUV Limitations*** - The 2019 Sec 179 deduction for SUVs is limited to $25,500 (up from $25,000 in 2018) and applies to sport utility vehicles rated at 14,000 pounds gross vehicle weight or less. **Excluded from this limitation** is any vehicle that:
  - is designed for more than nine individuals in seating rearward of the driver's seat;
  - is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length, **or**
  - has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

  The $25,000 limitation is adjusted for inflation in $100 increments for tax years beginning after 2018. (IRC Sec 179(b)(6)(B), as added by the TCJA)

- ***Vineyards*** **-** In Chief Counsel Advice (CCA201234024), IRS has concluded that vineyards are eligible for the Code Sec. 179 expensing deduction.

  Fruit bearing trees and vines aren't considered placed in service until they have reached an income-producing stage. (Reg. § 1.46-3 (d)(2)(iii)) To utilize the Sec 179 deduction, the cost of a newly planted vineyard must be capitalized until such time as the vines reach the income producing stage (placed in service) and then capitalized costs may be expensed under Sec 179.

- ***Qualified Real Property*** – Includes the following property. (Under TCJA the property in the first 3 bullets below were combined into the single definition of qualified real property.):
  - Qualified leasehold improvement property,
  - Qualified restaurant property, and
  - Qualified retail improvement property.
  - Effective for property placed in service after 2017, any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

  Qualified improvement property generally means an internal improvement to nonresidential real property if the improvement is placed in service after the date the building was first placed in service but does not include any improvement that enlarges the building, any elevator or escalator, or the internal structural framework of the building. (Code Sec. 168(e)(6)).

  For this purpose, the term "**qualified real property**" means property acquired by purchase for use in the active conduct of a trade or business (Sec. 179(d)(1)), is property that is normally depreciated (Sec. 179(d)(1)) and **is not:**

- (prior to 2018) property used for lodging, except for property used by a hotel or motel in which the predominant portion of the accommodations is used by transients;
- property used outside the U.S; and
- property used by governmental units, foreign persons or entities, and certain tax-exempt organizations, and
- (prior to 2016) air conditioning or heating units.

Example: *A small business owner with a retail clothing store can expense under Sec 179 improvements that were made inside the store, such as built-in cabinets to better stock clothing or lights to brighten the fitting rooms.*

3.09 – EMPLOYEE OR INDEPENDENT CONTRACTOR

READ FIRST: The distinction between an employee and an independent contractor is governed by both federal law and state law. Because of the significant payroll tax revenues involved the states are the most aggressive in classifying workers as employees. Big Book Chapter 3.09 covers both the federal issues and classification provisions under California AB5. This material includes only the provisions of CA Assembly Bill 5 and how it will affect the classification of employees in California.

THIS WILL PROBABLY NOT BE THE END OF THE ISSUE: AB5 stifles the gig economy and will have a huge impact on the likes of Uber, Lyft and Grubhub. Uber is even discussing making a ballot issue out of it. Time will tell, but for now we need to follow AB5.

In California there has been a landmark court case that went all the way to the highest court in the state. In that case the CA Supreme Court confirmed a Los Angeles County Superior Court finding against Dynamex, a trucking company that was treating its drivers as independent contractors. In arriving at a decision, the court adopted the so-called "ABC" Rule being used by other states.

California Assembly Bill 5, AB5, was subsequently passed by a large margin in both the state Assembly and the state Senate. This bill codifies the ABC test adopted by the Supreme Court in the Dynamex case with some exceptions and phase-in.

CA Assembly Bill 5 – AB5 was passed by the state Assembly by a margin of 61 to 16 and by the Senate by 29 to 11, mostly along party lines. In general, this is what the legislation provides:

- It codifies the Dynamex decision for using the "ABC" test.
- Where a court rules the ABC test cannot be applied, then contractor status will be determined under the tests adopted in S.G. Borello & Sons, Inc. vs the Dept. of Industrial Relations (1989) 48 Cal.3d 341 (Borello).

- o Exempts certain occupations from the provisions.

CAUTION: Be aware that AB5 does not provide a bright line simplified definition for either an employee or independent contractor and is filled with exceptions that should make labor attorneys elated with its passage.

"ABC" Test - Several states, including Massachusetts and New Jersey, have also adopted this so-called "ABC" test. The test is a broad means of determining a worker's status as either an employee or a contractor by considering the following criteria (CA Labor Code 2750.3(a)(1)):

(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.

The objective of the ABC test is to create a simpler, clearer test for determining whether the worker is an employee or an independent contractor and *presumes a worker hired by an entity is an employee* and places the burden on the hirer to establish that the worker is an independent contractor.

Examples: A plumber temporarily hired by a store to repair a leak or an electrician to install a line would be an independent contractor. But a seamstress who works at home to make dresses for a clothing manufacturer from cloth and patterns supplied by the company, or a cake decorator who works on a regular basis on custom-designed cakes, would be employees.

Borello Application – AB5 provides the determination of employment status will be based upon the criteria set forth in the Borello case instead of the ABC tests where:

- A court of law rules the ABC test cannot be applied to a particular case (CA Labor Code 2750.3(a)(3)), or
- Certain occupations that AB5 exempts from the application of the ABC tests. Those occupations generally include (CA Labor Code 2750.3(a)(1)):

PROFESSIONS SPECIFICALLY SUBJECT TO BORELLO

(CA Labor Code *2750.3(a)(1)*

- Insurance Agents
- Physician and surgeon
- Dentist
- Podiatrist
- Psychologist
- Veterinarian
- Lawyer
- Architect
- Engineer
- Private investigator
- Accountant
- Securities broker-dealer
- Investment adviser
- Direct sales salesperson
- Commercial fisherman

(1) A person or organization who is licensed by Depart of Insurance.
(2) A physician and surgeon, dentist, podiatrist, psychologist, or veterinarian licensed by the State of California.
(3) An individual who holds an active license from the State of California and is practicing one of the following recognized professions: lawyer, architect, engineer, private investigator, or accountant.
(4) A securities broker-dealer or investment adviser or their agents and representatives that are registered with the Securities and Exchange Commission or the Financial Industry Regulatory Authority or licensed by the State of California.
(5) A direct sales salesperson as described in Section 650 of the Unemployment Insurance Code.
(6) A commercial fisherman working on an American vessel – **but only until January 1, 2023** unless extended by the legislature

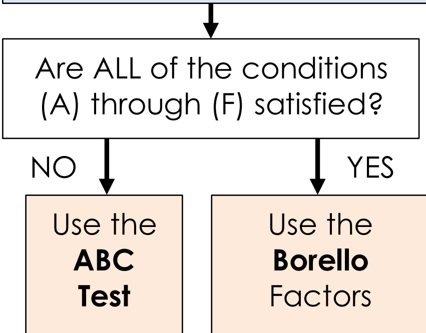
Professional Services (CA Labor Code *2750.3(c)* – AB5 specifies that certain professional services are not subject to the ABC test and instead are also subject to the Borello criteria if **ALL** of the following are conditions are satisfied:

(A) The individual maintains a business location, which may include the individual's residence, that is separate from the hiring entity. Nothing in this subdivision prohibits an individual from choosing to perform services at the location of the hiring entity.
(B) If work is performed more than six months after the effective date of this section, the individual has a business license, in addition to any required professional licenses or permits for the individual to practice in their profession.
(C) The individual has the ability to set or negotiate their own rates for the services performed.
(D) Outside of project completion dates and reasonable business hours, the individual has the ability to set the individual's own hours.
(E) The individual is customarily engaged in the same type of work performed under contract with another hiring entity or holds themselves out to other potential customers as available to perform the same type of work.

PROFESSIONAL SERVICES
(CA Labor Code 2750.3(c)

- Marketing
- Human Resources Admin.
- Travel Agent
- Graphic Design
- Grant Writer
- Fine Artist
- Enrolled Agent
- Payment Processing Agent
- Still Photographer
- Photojournalist
- Freelance writer
- Editor
- Newspaper Cartoonist
- Esthetician*
- Electrologist*
- Manicurist*
- Barber*
- Cosmetologist*

**See special qualifications; no longer applies to manicurists on 1/1/2022.*



(F) The individual customarily and regularly exercises discretion and independent judgment in the performance of the services.

Professional services mean services provided by an individual providing services through a sole proprietorship, or other business entity that meet any of the following:

(i) *Marketing*, provided that the contracted work is original and creative in character and the result of which depends primarily on the invention, imagination, or talent of the employee or work that is an essential part of or necessarily incident to any of the contracted work.

(ii) *Administrator of human resources*, provided that the contracted work is predominantly intellectual and varied in character and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

(iii) *Travel agent services* (See CA Labor Code 2750.3(c)(2)(B)(iii) for additional limitations).

(iv) *Graphic design*

(v) *Grant writer*

(vi) *Fine artist*

(vii) *Enrolled agent*

(viii) *Payment processing agent* through an independent sales organization.

(ix) *Still photographer or photojournalist* who do not license content submissions to the putative employer more than 35 times per year. This clause is not applicable to an individual who works on motion pictures. (See CA Labor Code 2750.3(c)(2)(B)(ix) for additional limitations).

(x) *Freelance writer, editor, or newspaper cartoonist* who does not provide content submissions to the putative employer more than 35 times per year. (See CA Labor Code 2750.3(c)(2)(B)(ix) for additional limitations).

(xi) *Licensed esthetician, licensed electrologist, licensed manicurist, licensed barber, or licensed cosmetologist* provided that the individual:

- Sets their own rates, processes their own payments, and is paid directly by clients.
- Sets their own hours of work and has sole discretion to decide the number of clients and which clients for whom they will provide services.
- Has their own book of business and schedules their own appointments.
- Maintains their own business license for the services offered to clients.
- If the individual is performing services at the location of the hiring entity, then the individual issues a Form 1099 to the salon or business owner from which they rent their business space.

This subdivision shall become inoperative, with respect to licensed manicurists, on January 1, 2022.

This will definitely put a crimp in the way many beauty and barber shops currently function.

Determined by Business and Professions Code *(*CA Labor Code *2750.3(d)* – The following categories are not subject to the holding in Dynamex and instead the status of employee or independent contractor are governed by the Business and Professions code.

- *Real estate Licensees* – Determined by subdivision (b) of Section 10032 of the Business and Professions Code.
- *A licensed repossession agency* – provided repossession agency is free from the control and direction of the hiring person.

Business-to-business Contracting Relationships *(*CA Labor Code *2750.3(e)* – are not subject to the Dynamex holding if the business entity is formed as a sole proprietorship, partnership, LLC, or corporation that contracts to provide services to another business. The determination of employee or independent contractor status of the business services provider shall be governed by Borello, if the contracting business demonstrates that all of the following criteria are satisfied:

(A) The business service provider is free from the control and direction of the contracting business entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.

(B) The business service provider is providing services directly to the contracting business rather than to customers of the contracting business.

(C) The contract with the business service provider is in writing.

(D) If the work is performed in a jurisdiction that requires the business service provider to have a business license or business tax registration, the business service provider has the required business license or business tax registration.

(E) The business service provider maintains a business location that is separate from the business or work location of the contracting business.

(F) The business service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed.

(G) The business service provider actually contracts with other businesses to provide the same or similar services and maintains a clientele without restrictions from the hiring entity.

(H) The business service provider advertises and holds itself out to the public as available to provide the same or similar services.

(I) The business service provider provides its own tools, vehicles, and equipment to perform the services.

(J) The business service provider can negotiate its own rates.

(K) Consistent with the nature of the work, the business service provider can set its own hours and location of work.

(L) The business service provider is not performing the type of work for which a license from the Contractor's State License Board is required, pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code

This foregoing does not apply to an individual worker, as opposed to a business entity, who performs labor or services for a contracting business.

The determination of whether an individual working for a business service provider is an employee or independent contractor of the business service provider is governed by the ABC test unless a court of law applies Borello.

The following applies to construction workers and construction truckers

Contractor and Individual Contracting Relationships (CA Labor Code *2750.3(f)* - the holding in Dynamex does not apply to the relationship between a contractor and an individual performing work pursuant to a subcontract in the construction industry, and instead the determination of whether the individual is an employee of the contractor shall be governed by Section 2750.5 and by Borello, if the contractor demonstrates that all the following criteria are satisfied:

A(1) The subcontract is in writing.

(2) The subcontractor is licensed by the Contractors State License Board and the work is within the scope of that license.

(3) If the subcontractor is domiciled in a jurisdiction that requires the subcontractor to have a business license or business tax registration, the subcontractor has the required business license or business tax registration.

(4) The subcontractor maintains a business location that is separate from the business or work location of the contractor.

(5) The subcontractor has the authority to hire and to fire other persons to provide or to assist in providing the services.

(6) The subcontractor assumes financial responsibility for errors or omissions in labor or services as evidenced by insurance, legally authorized indemnity obligations, performance bonds, or warranties relating to the labor or services being provided.

(7) The subcontractor is customarily engaged in an independently established business of the same nature as that involved in the work performed.

(8) (A) Paragraph (2) shall not apply to a subcontractor providing construction trucking services for which a contractor's license is not required provided that all of the following criteria are satisfied:

(i) The subcontractor is a business entity formed as a sole proprietorship, partnership, limited liability company, limited liability partnership, or corporation.

(ii) For work performed after January 1, 2020, the subcontractor is registered with the Department of Industrial Relations as a public works contractor pursuant to Section 1725.5, regardless of whether the subcontract involves public work.

(iii) The subcontractor utilizes its own employees to perform the construction trucking services, unless the subcontractor is a sole

proprietor who operates their own truck to perform the entire subcontract and holds a valid motor carrier permit issued by the Department of Motor Vehicles.

(iv) The subcontractor negotiates and contracts with, and is compensated directly by, the licensed contractor.

(B) For work performed after January 1, 2020, any business entity that provides construction trucking services to a licensed contractor utilizing more than one truck shall be deemed the employer for all drivers of those trucks.

(C) For purposes of this paragraph, "construction trucking services" mean hauling and trucking services provided in the construction industry pursuant to a contract with a licensed contractor utilizing vehicles that require a commercial driver's license to operate or have a gross vehicle weight rating of 26,001 or more pounds.

(D) **This paragraph shall only apply to work performed before January 1, 2022.**

(E) Nothing in this paragraph prohibits an individual who owns their truck from working as an employee of a trucking company and utilizing that truck in the scope of that employment. An individual employee providing their own truck for use by an employer trucking company shall be reimbursed by the trucking company for the reasonable expense incurred for the use of the employee owned truck.

Relationships Between Referral Agencies and Service Provider (CA Labor Code *2750.3(g))* – If a business entity formed as a sole proprietor, partnership, limited liability company, limited liability partnership, or corporation ("service provider") provides services to clients through a referral agency, the determination whether the service provider is an employee of the referral agency shall be governed by Borello, if the referral agency demonstrates that all of the following criteria are satisfied:

(A) The service provider is free from the control and direction of the referral agency in connection with the performance of the work for the client, both as a matter of contract and in fact.

(B) If the work for the client is performed in a jurisdiction that requires the service provider to have a business license or business tax registration, the service provider has the required business license or business tax registration.

(C) If the work for the client requires the service provider to hold a state contractor's license pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code, the service provider has the required contractor's license.

(D) The service provider delivers services to the client under service provider's name, rather than under the name of the referral agency.

(E) The service provider provides its own tools and supplies to perform the services.

(F) The service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed for the client.

(G) The service provider maintains a clientele without any restrictions from the referral agency and the service provider is free to seek work elsewhere, including through a competing agency.

(H) The service provider sets its own hours and terms of work and is free to accept or reject clients and contracts.

(I) The service provider sets its own rates for services performed, without deduction by the referral agency.

(J) The service provider is not penalized in any form for rejecting clients or contracts. This subparagraph does not apply if the service provider accepts a client or contract and then fails to fulfill any of its contractual obligations.

The foregoing does not apply to an individual worker, as opposed to a business entity, who performs labor or services for a contracting business.

The determination of whether an individual working for a business service provider is an employee or independent contractor of the business service provider is governed by the ABC test unless a court of law applies Borello.

Retroactive Application (CA Labor Code *2750.3(i))* - Insofar as the application of CA Labor Code *2750.3(b)* through (h) of this section would relieve an employer from liability, those subdivisions shall apply retroactively to existing claims and actions to the maximum extent permitted by law.

Effective Date (CA Labor Code *2750.3(i)* - Except as provided these provisions of the Labor Code shall apply to work performed on or after January 1, 2020.

Injunctive Relief (CA Labor Code *2750.3(i)*- In addition to any other remedies available, an action for injunctive relief to prevent the continued misclassification of employees as independent contractors may be prosecuted against the putative employer in a court of competent jurisdiction.

Borello Test Factors - The *Borello* test involves the principal factor of 'whether the person to whom services is rendered has the right to control the manner and means of accomplishing the result desired' as well as the following nine additional factors.

(1) right to discharge at will, without cause;

(2) whether the one performing the services is engaged in a distinct occupation or business;

(3) the kind of occupation, with reference to whether in the locality the work is usually done under the direction of the principal or by a specialist without supervision;

(4) the skill required in the particular occupation;

(5) whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;

(6) the length of time for which the services are to be performed;

(7) method of payment, whether by the time or by the job;
(8) whether or not the work is part of the regular business of the principal; and
(9) whether or not the parties believe they are creating the relationship of employer-employee."

These individual factors cannot be applied mechanically as separate tests; they are intertwined, and their weight depends often on particular combinations making the outcome subjective.

Civil Penalties For Willful Misclassification - California Senate Bill 459 (Ch 11-706), signed into law by the governor October 9, 2011 and effective January 1, 2012, makes the willful misclassification of employees as independent contractors unlawful and allows California's Labor and Workforce Development Agency, or a court, to impose a civil penalty of $5,000 to $15,000 ($10,000 to $25,000 if there is a pattern and practice of misclassifications) for each violation found to be "willful." Each misclassified individual is one violation. These civil penalties are in addition to other assessments and penalties that may be imposed under other laws. ***(Labor Code Sec. 226.8)***

In addition, any violator will be required, for one year, to post a notice signed by an officer (owner if sole proprietor) on its Internet website (or otherwise prominently display the notice if the violator does not have a website) that explains the violation in detail. The notice must contain the following:

(1) That the Labor and Workforce Development Agency or a court, as applicable, has found that the person or employer has committed a serious violation of the law by engaging in the willful misclassification of employees.
(2) That the person or employer has changed its business practices in order to avoid committing further violations of this section.
(3) That any employee who believes that he or she is being misclassified as an independent contractor may contact the Labor and Workforce Development Agency. (The notice must include the mailing address, e-mail address, and telephone number of the Agency.)
(4) That the notice is being posted pursuant to a state order.

If the violator is a licensed contractor, the Labor Agency is required to notify the Contractors' State License Board, which must initiate an action against the licensee within 30 days.

"Willful Misclassification" - is defined as "avoiding employee status for an individual by voluntarily and *knowingly* misclassifying that individual as an independent contractor."

Paid Advisors Also Subject to Penalty - Under this law, paid advisors (excluding attorneys and employees of the company) who "knowingly advise" employers to treat an individual as an independent contractor to avoid employee status for that individual **are jointly and severally liable for any penalties** imposed on the employer if the individual is found not to be an independent contractor. *(**Labor Code Section 2753)***

CAUTION: Given the advisor liability provision, consultants, Enrolled Agents, CPAs, return preparers and others who might otherwise advise their clients on how to classify workers should instead refer the client to an employment attorney.

3.11- TRADE-IN OF A BUSINESS AUTO

Prior to 2018, when a business vehicle was traded-in for a new business vehicle, the transaction was actually a Section 1031 exchange, reported on IRS Form 8824. After 2017, Sec 1031 only applies to real estate property, and as a result, no longer applies to the trade-in of a vehicle. Thus, whether sold or traded in, the transaction is treated as a sale.

TIP: Since all trade-ins are treated as sales (Sec 1031 no longer applies after 2017), all things being equal, one would want to negotiate a lower trade-in value and higher purchase price as opposed to a higher trade-in value and a lower purchase price to minimize gain or maximize the loss from the disposition of the trade-in.

CAUTION: California conformity has created a complicated issue for vehicle trade-ins. Read the following very carefully.

For most individuals, California also has not conformed to the TCJA change limiting Sec 1031 to real property. Therefore, most taxpayers who trade in a business-use vehicle must treat that transaction as a Sec 1031 exchange for CA purposes and a sale for federal purposes.

However, CA conforms to the Federal treatment for high income taxpayers for exchanges completed after January 10, 2019. High income taxpayers are taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate).

CAUTION: Where a trade-in is treated as a 1031 exchange in CA and not for Federal it creates a different basis for each.

CA has not conformed to the Federal suspension of Tier 2 miscellaneous itemized deductions, including employee business deductions such as employment-related use of a personal auto, which are still deductible for CA purposes.

3.16 NET OPERATING LOSS

For NOLs arising in years beginning after 2017, the TCJA generally repealed the 2-year carryback, except for certain farm losses, and provides that the carryover is no longer limited to 20 years and is indefinite until it is used up.

Note: NOLS prior to this change are unaffected and are still allowed at 100% and only have a carryforward of 20 years. (Sec. 172(b)(1)(A) Effective for NOLs arising in years beginning after 2017, the NOL deduction is limited to the lesser of:

- The aggregate of the NOL carryovers to that year, plus the NOL carrybacks to that year, or
- 80% of the taxable income computed without regard to the NOL deduction for the year. (IRC Sec. 172(a))

Excess Business Loss Adds to NOL – The TCJA added a provision that non-corporate taxpayers' business loss deductions are limited to a threshold amount. When there is a nondeductible excess business loss, this amount is carried forward and treated like a net operating loss carryover to the next tax year.

California Conformity:

2018 –California still allowed carrybacks and limited the carryover to 20 years and generally conformed to the Pre-TCJA federal NOL rules.

2019 - For NOLs occurring in taxable years beginning after December 31, 2018, AB 91(signed by the governor 6/27/2019) repeals the 2-year carryback period. California continues to allow a 20-year carryover period and has not adopted the federal rule limiting the NOL deduction to 80% of the carryover year's taxable income. Thus, 100% of the unused CA NOL is carried over. With regard to excess business losses, for California the disallowed loss is carried over separately and does not add to the NOL carryover.

3.17 SHORT-TERM RENTALS

Many taxpayers will rent their first or second homes using rental agents or online rental services that match property owners with prospective renters, such as Airbnb, VRBO and HomeAway. When a taxpayer rents property for a short period, special (and sometimes complex) taxation rules come into play, which can make the rents excludable from taxation; other situations may force the rental income and expenses to be reported on Schedule C (as opposed to Schedule E). The following is a synopsis of the rules governing short-term rentals.

Rented for Fewer Than 15 Days During the Year: When a property is rented for fewer than 15 days during the tax year, the rental income is not reportable (*IRC Section 280A(g)*), and the expenses associated with that rental are not deductible. Interest

and property taxes are not prorated, and the full amount of the qualified mortgage interest and property taxes, within the limits imposed by the TCJA, are reported on the taxpayer's Schedule A.

<u>*The 7-Day and 30-Day Rules*</u>: Rentals are generally passive activities. However, an activity is NOT a rental activity if (*Reg Sec 1.469-1T(e)(2)(ii)*):

A. The **average** customer use of the property is for 7 days or fewer—or for 30 days or fewer if the owner (or someone on the owner's behalf) provides significant personal services.

B. The owner (or someone on the owner's behalf) provides extraordinary personal services without regard to the property's average period of customer use. Extraordinary services are where the rental of the property is incidental to providing the services. Examples: Hospital's boarding facilities and a boarding school's dormitory room rental.

Since the activity is a trade or business that is not classified as a rental for Schedule E purposes, the only other option is to report the income and expenses on Schedule C. That opinion is shared by IRS Publication 527, which states: "If you provide substantial services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C." Substantial services do not include the furnishing of heat and light, the cleaning of public areas, trash collection, and such. Thus, the rental income and expenses, including interest and taxes, are included on Schedule C.

<u>*Exception to the 30-Day Rule*</u> – If the personal services provided are similar to those that generally are provided in connection with long-term rentals of high-grade commercial or residential real property (such as the cleaning of public areas and trash collection), and if the rental also includes maid and linen services, the cost of which is less than 10% of the rental fee, then the personal services are neither significant nor extraordinary for the purposes of the 30-day rule (*Reg. 1.469-1T(e)(3)(viii), Example 4*).

<u>*SE Tax on Profits & Losses on Schedule C*</u> **–** Profit from a rental activity that is reported on Schedule E is not subject to self-employment (SE) tax. But what about short-term rentals reported on Schedule C – are they subject to SE tax? Even though Pub 527, Page 12, indicates taxpayers "may" have to pay self-employment tax on short-term rental income, the "may" applies to real estate dealers. To quote Pub 334, "You are a real estate dealer if you are engaged in the business of selling real estate to customers with the purpose of making a profit from those sales. Rent you receive from real estate held for sale to customers is subject to SE tax. However, rent you receive from real estate held for speculation or investment is not subject to SE tax." (IRC Sec 1402(a)(1))

A loss from this type of activity is still treated as a passive activity loss and thus is limited under Sec 469 unless the taxpayer meets the material participation test or follows the real estate professional rules. Note that the special allowance for rental

real estate activities with active participation, which permits a loss against nonpassive income of up to $25,000 (phasing out when modified adjusted gross income (MAGI) is between $100K and $150K), does **NOT** apply when the activity is reported on Schedule C (*Form 8582, Worksheet 3 and instructions*).

CA conforms to the federal treatment of short-term rentals

3.18 ROOM RENTAL

Expenses allocable to a portion of a dwelling unit rented out are deductible under the vacation home rules. The amount of the deductible rental expenses would be the expenses attributable to that portion of the unit. And the days to be taken into account under that limitation rule would be the days on which the portion of the unit is rented at fair rental during the tax year and the days on which the portion of the unit is used for any purpose during the tax year.

Any reasonable method for dividing the expenses may be used. The two most common methods for allocating expenses, such as mortgage interest and heat for the entire house, are based on the number of rooms in the house and square footage of the home.

> ***Example -*** *Taxpayer's home has 1,800 square feet. He rents out one room that is 180 square feet for the entire tax year. Taxpayer can deduct as a rental expense 10% of any expense that must be divided between rental use and personal use. Thus, if taxpayer's heating bill for the year for the entire house was $600, $60 ($600×10%) is a rental expense and the $540 balance is a nondeductible personal expense. If the home consisted of eight rooms, the taxpayer could presumably deduct 12.5% (one-eighth) of the expenses as rental expenses rather than the 10% that is based on square footage. The expenses that belong only to the rental part of the property, for example painting the room, don't have to be divided.*

If a taxpayer rents rooms or other space in a home and the rented portion does not have facilities (bathroom and kitchen) that would make it a dwelling unit on its own, the taxpayer and the renter may be considered to be occupying one dwelling unit, and any loss on the rental may be disallowed under §280A.

Where a loss is not allowed, the deductions are claimed in the following order. If the result is a loss, the expenses are only allowed until the income is reduced to zero.

1. Mortgage interest and taxes.
2. Operating expenses (examples: repairs, utilities, maintenance, insurance)
3. Depreciation.

<u>Bottom Line</u>: Under these rules if a taxpayer were to rent a bedroom in their home, the income would be reported on Schedule E and the result cannot be a loss. However, the deductions that are not allowable because of the rental income

limitation may be carried over to the next tax year and used to offset that year's rental income, subject to the same limitations.

CA conforms to the federal treatment of room rentals

3.20 - TAX DEFERRED EXCHANGES

Prior to the TCJA both personal and real property used in a trade or business or for investment were eligible for the provisions of IRC Sec 1031. In light of the TCJA expanded expensing provisions for personal property and certain building improvements, Congress felt there was no need for Sec 1031 to apply to anything other than real property. Thus after 2017, TCJA limits the application of Sec 1031 to real property.

California Conformity:

California in AB91 (signed by the governor 6/27/2019), conforms to limiting Sec 1031 only to real property with two significant differences:

- The provision only applies to taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate) and
- Only applies to exchanges **completed** after January 10, 2019.

Thus, the conformity does not apply to lower income taxpayers and the pre-TCJA Sec 1031 provisions still apply for them.

3.24 SEC 199A PASS-THROUGH DEDUCTION

The 199A can be very simple or it can be very complex. In fact, it may be one of the most complex deductions ever to come out of Congress. So, before getting into the nitty-gritty of this deduction we will first look at it in its simplest form and work up to the more complex issues.

To begin, let's first get an understanding of some of the terminology and definitions used in computing the Sec 199A deduction:

1. Taxable Income – When figuring the deduction for each pass-through activity of an individual, the deduction may be limited based upon the individual's 1040 taxable income (before the deduction). Do not confuse the taxpayer's 1040 taxable income with a pass-through activity's taxable income.
2. Qualified Business Income (QBI) – Is generally the net profit from a Schedule C, E or F, a 1065 K-1, and 1120S K-1, a 1041 K-1, REITS (dividends) and pass-through income from publicly traded partnerships (PTP). But also see *QBI Reductions for AGI Adjustments* on page 90 of this text.

3. The Deduction - The deduction is equal to 20% of the pass-through income (the qualified business income (QBI)) from various business activities. For purposes of the introduction we will only consider QBI from sole proprietorships (Schedule C net profit), partnership K-1s (but not including guaranteed payments) and S-corporation K-1s.

4. Business Categories - There are two categories of business entities when computing the deduction (note: there is actually a third category for farming cooperatives which is quite complicated that we discuss later in the course).
    a. Qualified Trades or Businesses (QTB), and
    b. Specified Service Trades or Businesses (SSTB) – Which are basically those businesses providing personal services, such as tax practitioners. More details later in the course.

Why are QTB and SSTB In Separate Categories?

If you recall, the purpose of the prior Sec 199 domestic production deduction was to promote manufacturing in the U.S. and only allowed the deduction for the production of goods and not services. Sec 199A replaces the prior Sec 199 and in doing so carried over some of its characteristics which leads us to believe that is why QTBs and SSTBs (which only provide services) have been put into separate categories.

5. Limitations – The major distinction between QTBs and SSTBs is that the 199A deduction phases out for SSTBs for taxpayers with 1040 taxable incomes between the threshold and the cap shown in the table below, while QTBs continue to qualify if they pay wages or have qualified property.

Filing Status	Threshold			(Excess over threshold)	Cap		
	2018	2019	2020		2018	2019	2020
Married Joint	315,000	321,400	326,600	100,000	415,000	421,400	426,600
Single & Hd of Hshld	157,500	160,700	163,300	50,000	207,500	210,700	213,300
Married Separate	157,500	160,725	163,300	50,000	207,500	210,725	213,300

Note: Using the inflation adjusted numbers tends to complicate the calculations for teaching purposes. So, **the examples throughout this course material continue to use the 2018 amounts**.

Sec 199A Table - The most difficult concept in understanding how the Sec 199A deduction works is the relationship of:

- Filing status
- The taxpayer's 1040 taxable income, and
- The type of trade or business.

To help with that we have developed the chart below that allows you to quickly determine whether a deduction is allowed, and if so, what limitations apply.

> ***Example –*** Assume you have a married couple filing jointly for 2018, they have a 1040 taxable income (before the 199A deduction) of $469,000, and the trade or business is a SSTB. First select the box with their filing status, then move to the right to the correct range of taxable income, and lastly go down in that column to align with the type of business. In this case the SSTB does not qualify for the 199A deduction.

Taxpayer's Filing Status	**1040 Taxable Income (2018)** (Before the 199A deduction)		
Married Filing a Joint Return	Less Than $315,000	Between $315,000 and $415,000	Greater than $415,000
Other filing Statuses	Less Than $157,500	Between $157,500 and $207,500	Greater than $207,500
Type of Business	**The 199A Deduction***		
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

** This is the 199A deduction for a single trade or business activity and is only the first step in determining a taxpayer's overall 199A deduction, which may include multiple sources of 199A deductions that are combined and limited to 20% of the taxpayer's taxable income without capital gains.*

<u>*Taxable Income Below the Thresholds*</u> – Note from the chart above, as long as the taxpayer's taxable income is below the threshold both QTB and SSTB have no limitations and the Sec 199A deduction is a simple 20% of QBI (before applying the 1040 taxable income limitation discussed next).

<u>*1040 Taxable Income Limitation*</u> – Another confusing issue related to this deduction is the fact that after computing the 199A deduction for each of a taxpayer's pass-through business activities and then summing them all up for the total Sec 199A deduction, that deduction is then limited to the lesser of the 199A sum or 20% of the taxpayer's taxable income, less net capital gain. For this purpose, net capital gain includes qualified dividends.

<u>*Specified Trade or Business (SSTB) Examples*</u> – Since those that are taking this course are for the most part tax preparers, Enrolled Agents, and CPAs and they are all SSTBs we will first look at the examples for SSTBs.

<u>*SSTB Computation*</u> - Probably the best way to understand this deduction is by doing a simple example:

SSTB Example #1 – Taxable Income Below Threshold - *Gary, who files jointly with his spouse, is a CPA and his 2018 net profit (QBI) from his Schedule C sole proprietorship is $350,000. He had no capital gains. Gary's 1040 taxable income before the 199A deduction is $300,000.* ***Since his taxable income is below the $315,000 threshold*** *there are no limitations and Gary's preliminary Sec 199A deduction is $70,000 (20% of $350,000). However, his deduction will be limited by his taxable income to $60,000 (20% x $300,000).*

Note 1: *If Gary's $350,000 of QBI had been from a partnership K-1 (not counting guaranteed payments) the result would have been the same. It could have also been from an S-corporation K-1 with the same result.*

Note 2: To keep this example and those that follow as uncluttered as possible, we are ignoring that some of the pass-through income is subject SE Tax. However, if it is subject to SE tax, the taxpayer would be entitled to an adjustment to income for ½ of the SE tax which would reduce the taxable income and provide a different 20% of taxable income result. Further, before multiplying the QBI by 20%, the QBI must be reduced by the SE tax deduction, as well as any adjustment the taxpayer claimed for SE health insurance premiums and certain retirement plan contributions. Thus, the preliminary QBI deduction will also be less. Again, we are omitting this adjustment from the examples to minimize the clutter and concentrate on the concepts.

Commentary: It is important to note the taxpayer's 1040 taxable income is the decisive factor whether or not any limitations are triggered. In the prior example the QBI income was purposely made higher than the taxpayer's taxable income to illustrate that point.

So, what happens when the taxpayer's taxable income exceeds the threshold? This is where things get to be tricky. Remember SSTBs are treated differently than other qualified trades or businesses and are far less complicated.

SSTB Example #2 – Taxable Income Above the Phaseout Cap - *If Gary's 2018 taxable income in Example #1 was above the cap of $415,000 (threshold of $315,000 plus $100,000), then Gary's 199A deduction for would be zero, completely phased out.*

Now this brings us to the complicated example, where Gary's taxable income is above the threshold ($315,000 for MFJ) and below the cap ($415,000). This is where the deduction is phased out.

SSTB Example #3 – Taxable Income Between the Threshold and Phaseout Cap - *If Gary's taxable income in Example #1 had been $365,000 his 199A deduction would be partially phased out. For this computation we have developed a worksheet to do the phase-out calculation. We also need some additional information from Gary's Schedule C: the wages Gary paid his employees (for this example $50,000) and the unadjusted basis of his business equipment (we will use $20,000).*

We have developed a SSTB worksheet that includes the phase-out computation.

The phase-out is an awkward calculation that takes into consideration the wages paid by the business and the qualified property of the business. **Both of these items will be explained later in the course**. As you can see from the worksheet, Gary's deduction has been partially phased out and his deduction is only $22,500.

199A SSTB Worksheet (2018)

For use **ONLY** with Specified Service Trades or Businesses)

Business Name: ____________________

☐ Schedule C ☐ Schedule E ☐ Schedule F ☐ 1065 ☐ 1120-S

1.	Qualified Business Income (QBI)	350,000
2.	Taxpayer's 1040 Taxable Income (before the 199A deduction)	365,000
3.	Threshold (enter $315,000 if MFJ; otherwise enter $157,500)	315,000
4.	Differential (enter $100,000 if MFJ; otherwise enter $50,000)	100,000
5.	Line 3 plus Line 4 (top of threshold range)	415,000
6.	If Line 2 equals or exceeds Line 5, **STOP** and enter zero on Line 22. Note: The 199A deduction for this business is zero. If Line 2 is less than Line 5, enter zero here and continue to Line 7.	- -0-
7.	Tentative 199A deduction (20% of Line 1)	70,000
8.	If Line 2 is less than Line 3, **STOP** and enter the amount from Line 7 on Line 22. Note: The preliminary 199A deduction for this business is the full 20% of QBI. If line 2 is greater than Line 3, enter zero here and continue to Line 9.	-0-
9.	Wages paid by this business	50,000
10.	Assets (unadjusted basis of this business' eligible tangible property)	20,000
11.	50% of wages	25,000
12.	25% of Wages	12,500
13.	2.5% of Assets	500
14.	Line 12 plus line 13	13,000
15.	Wage Limit – Greater of line 11 or Line 14	25,000
16.	Subtract Line 3 from Line 2	50,000
17.	Divide Line 16 by Line 4	0.500
18.	If Line 7 is greater than Line 15, enter ((Line 7 – Line 15) x Line 17). Otherwise enter zero.	22,500
19.	Line 7 less Line 18	47,500
20.	1 minus Line 17	0.500
21.	Line 20 times Line 19	23,750
22.	**Preliminary Section 199A Deduction –** Lesser of Line 18 or Line 21	22,500

Qualified Trade or Business **-** Now let's take a quick look at the results had Gary's business not been a SSTB and instead was a QTB.

> ***QTB Example #4 – Taxable Income Below Threshold*** *– Using the same situation as Example #1 the results would have been exactly the same since neither a QTB nor a SSTB has any limitations when the taxpayer's taxable income is below the threshold amount for the taxpayer's filing status. Thus, as with Example #1, Gary's preliminary 199A deduction would be $70,000 (20% of $350,000) but limited by his taxable income to $60,000 (20% x $300,000).*

> ***QTB Example #5 – Taxable Income Above the Threshold –*** *Unlike a SSTB whose 199A deduction is completely phased out when the taxpayer's taxable income exceeds the cap, a QTB can still have a deduction based on a so-called wage limitation. Although referred to as the wage limitation, it sometimes includes a percentage of the taxpayer's business assets.*

Wage Limitation - We will cover the wage limitation in more detail later in the course, but here is generally how it works:

When the taxpayer's 1040 taxable income exceeds the cap, in Gary's case $415,000 ($315,000 + $100,000), the deduction is limited to the **lesser** of:

1. 20% of QBI (net of adjustments, discussed later), or
2. The wage limitation

   The wage limitation is the greater of:

   - 50% of the W-2 wages paid by the business or
   - 25% of the W-2 wages paid by the business plus 2.5% of the unadjusted basis of the business's qualified property (abbreviated UBIA). More on UBIA later.

> **QTB Example #6 – Taxable Income Between the Threshold and Cap –** As with a SSTB there is a complicated phaseout calculation. So rather than trying to explain how this works, we included the phaseout computation in the QTB worksheets that we have developed. There is also an example on page 62 of this text.

Ok, now that you understand the basic concepts of the Sec 199A deduction it is time to learn some definitions related to this deduction.

Taxable Income (TI) - There are actually two definitions for TI:

1. When figuring the preliminary 199A deduction for a specific qualified trade or business the taxpayer's 1040 taxable income before deducting the 199A deduction is used.
2. After the preliminary 199A deductions for each qualified trade or business are determined, combined with the 199A deductions from real estate investment trusts (REITs) and publicly traded partnerships (PTPs), that total is then limited

to 20% of the taxpayer's taxable income. For purposes of this computation the term taxable income refers to the taxpayer's 1040 AGI minus standard or itemized deductions, but without regard to the Sec 199A deduction and without any net capital gain. Thus, the 199A deduction itself is not considered when determining the taxable income for this purpose.

Threshold Amount - For the 199A deduction the term "threshold" is used to both phase out and phase in limitations.

1. **Specified Service Trades or Businesses** – When used in conjunction with the 199A computation for SSTBs, the term threshold refers to the taxable income (TI) level at which the 199A deduction begins to phase out for higher income taxpayers.
2. **Qualified Trades or Businesses** - When used in conjunction with the 199A computation for qualified trades or businesses, the term threshold refers to the TI level at which the wage limitation begins to phase in for higher income taxpayers.

The 199A threshold is actually the same threshold as for the 32% tax bracket under TCJA for 2018 and is inflation adjusted annually. Thus for 2018 it is $315,000 for married taxpayers filing jointly or $157,500 for other filing statuses. The cap (top of the phase-out/phase-in range) is reached when the taxpayer has an additional $100,000 of taxable income for married filing joint taxpayers and $50,000 for others. Thus for 2018 the cap is $415,000 for married taxpayers filing jointly or $207,500 for other filing statuses. See page 50 above for 2019 and 2020 amounts.

Phaseout Cap – Although there is no official name assigned to this value, we will refer to it as the phaseout cap in this course. Some call it a ceiling. It is the sum of the threshold amount and the delta amount for a taxpayer's filing status. So, for 2018, for MFJ taxpayers it is $415,000 ($315,000 + $100,000) and for others it is $207,500 ($157,500 + $50,000).

Trade or Business - One of the more important issues related to the legislation is the definition of a "trade or business" since that describes the kind of activity that can create income for purposes of the 199A deduction.

The tax code does not provide a definitive "bright line" definition of a trade or business, and the regulations simply adopted an existing subjective definition that relies on the outcomes of past court cases and interpretive rules the IRS has issued under Code Sec. 162, which is the most familiar provision using the term "trade or business." This leaves some room for interpretation; most notably whether or not rental real estate income qualifies for the Sec. 199A deduction. Our research finds that except for totally passive rental real estate activities such as triple net leases, a rental real estate activity is a trade or business for purpose of Section 199A. But more on this later in the course.

The regulation also specifies a "qualified trade or business" means any trade or business other than a specified service trade or business, or the trade or business of performing services as an employee. This was done for the following reasons:

- Specified Service Trade or Business – A special computation was carved out for SSTBs; thus they are included in the term qualified trade or business.
- Performing Services as an Employee – Congress does not want employees claiming this deduction on the basis of their wage earnings. With the suspension of the deduction for employee business expenses from the Schedule A for 8 tax years, they specifically added this phrase to make it clear employees do not qualify for the deduction.

The rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a Section 162 trade or business is nevertheless treated as a trade or business for purposes of Section 199A, but only if the property is rented or licensed to a trade or business which is commonly controlled under §1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under §1.199A-4(b)(1)).

Pass-through Entities - The Sec 199A deduction applies to pass-through entities and certain other sources of pass-through income, subject to certain limitations. The following are entities to which the deduction may apply:

- Schedule C
- Schedule E
- Schedule F
- Partnership*
- S-Corporation*
- Real Estate Investment Trust*◆
- Publicly Traded Partnership* ◆

*Deduction is determined at the partner or shareholder level.

◆This component of the Section 199A deduction is not limited by W-2 wages or UBIA of qualified property.

Qualified Business Income (QBI) - QBI is generally the net amount of income, gain, deduction, and loss relating to any qualified trade or business of the taxpayer to the extent these items are effectively connected with the conduct of a trade or business within the U.S. and included or allowed in determining taxable income for the year.

- **QBI Includes:**
    - Ordinary gain attributable to the sale of partnership interest is included in QBI. (Sec 751)
    - Changes in accounting method adjustments, both positive and negative, are taken into account when figuring QBI. (Sec 481)
    - Puerto Rico - If all of an individual's QBI from sources within the Commonwealth of Puerto Rico are taxable to the U.S., then the QBI will qualify for the Section 199A deduction.
- **QBI does *not* include:**
    - Certain investment items;
        - Any short- or long-term capital gain or loss.

        - Any dividend, income equivalent, or payment in lieu of dividends.
        - Any interest income other than that which is allocable to the trade or business.
        - Any item of gain or loss from commodity transactions or foreign currency transactions (as described in Sec 954(c)(1) subparagraphs (C) and (D) by substituting qualified trade or business for controlled foreign corporation).
        - Annuity income that is not received in connection with a trade or business.
        - Any item of deduction or loss described in the prior clauses.
    - Reasonable compensation paid to the taxpayer;
    - Guaranteed payment to a partner for services;
    - Guaranteed payment to a partner for use of capital; or
    - Payment to a partner for services rendered with respect to the trade or business.

Specified Service Trades or Businesses (SSTB) - The deduction is limited as to how it applies to specified service trades or businesses described in Sec. 1202(e)(3)(A) but excluding engineering and architecture and trades or businesses that involve the performance of services that consist of investment-type activities.

Specified service trades or businesses are described by the IRS as being trades or businesses in the fields of:

- ***Health*** – The performances of services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient. Does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.
- ***Law*** – The performance of services in the field of law means services provided by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. The performance of services in the field of law does not include providing services that do not require skills unique to the field of law – for example, services provided to a lawyer by printers, delivery services, or stenography services.
- ***Accounting*** - The performance of services in the field of accounting means services provided by accountants, enrolled agents, tax return preparers, financial auditors, and similar professionals in their capacity as such. Provision of services in the field of accounting is not limited to services requiring state licensure as a certified public accountant (CPA). The field of accounting does not include payment processing and billing analysis.

- ***Actuarial Science*** – The performance of services in the field of actuarial science means the services provided by actuaries and similar professionals in their capacity as such. It does not include the services provided by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.
- ***Performing Arts*** - The performance of services in the field of the performing arts means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. It does not include providing services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, persons who broadcast or otherwise disseminate video or audio of performing arts to the public are not considered to be providing services in performing arts.

Commentary*: The preamble of the final regulation used "****writers****" as an example of an occupation that may or may not be a SSTB. To quote the preamble: "To the extent that a writer is paid for written material, such as a song or screenplay, that is integral to the creation of the performing arts, the writer is performing services in the field of performing arts".*

Applying that standard, it would seem the following professionals could fall into the definition of a SSTB: makeup artists, costume designers, set designers, lighting designer and director, sound and music directors, film editors, etc. However, remember Sec 199A does not apply to the earnings of those paid as employees. For example, a self-employed lighting director would be an SSTB while a lighting technician on payroll would not.

- ***Athletics*** - The performance of services in the field of athletics means the performances of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. It does not include providing services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. It also does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.
- *Consulting* **-** The performance of services in the field of consulting means providing professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes lobbyists and other similar professionals performing services in their capacity as such. It does not include minor consulting that accompanies the sale of a product. A trade or businesses is not an SSTP if less than 10% of gross receipts are from consulting (5% where the gross receipts are greater than $25 Million).

- *Financial services* - The definition of financial services applies to services typically performed by financial advisors and investment bankers and provides that the field of financial services includes providing the following financial services to clients: managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 (bankruptcy) or similar cases), and raising financial capital by underwriting, or acting as the client's agent in the issuance of securities, and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals, but does not include banking services such as taking deposits or making loans.
- *Brokerage Services* **-** The field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities for a commission or fee. This includes services provided by stock brokers and other similar professionals but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

> **Commentary:** Final regulation §1.199A-5(b)(2)(x) confirms that this does not include services provided by **real estate agents and brokers, or insurance agents and brokers**. Thus, these activities are **not SSTBs**.

- *Reputation or Skill* - The original legislation included in its list of trades or businesses that were SSTBs, those where the principal asset of a trade or business is the reputation or skill of one or more of its employees or owners. Did this mean, for example, that a self-employed plumber who provided his skill for the business wouldn't be eligible for the 199A deduction? Luckily, in a taxpayer-friendly interpretation, the tax regulations have generally defined "reputation and skill" to mean:

  (1) Receiving income for endorsing products or services for which the individual provides endorsement services;

  (2) Licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or

  (3) Receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players).

> **Examples**: Alex Trebek endorsing Colonial Penn Insurance, Shaquille O'Neal – Celebrity Cruise Lines and the General Insurance.

(4) Investing and investment management – see description in Reg. 1.199A5(b)(2)(xi)

(5) Trading – see description in Reg. 1.199A-5(b)(2)(xii)

(6) Dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) – see description in Reg 1.199A-5(b)(2)(xiii)

$25 Million Rule (inflation adjusted to $26 Million in 2016)

- **$25 Million or Less** - A trade or business (determined before aggregation) is not an SSTB if the trade or business has gross receipts of $25 million or less (in a taxable year) **and** less than 10% of the gross receipts of the trade or business is attributable to the performance of services in an SSTB.
- **More Than $25 million** - For trades or businesses with gross receipts greater than $25 million (in a taxable year), a trade or business is not an SSTB if less than 5% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB. (Reg. Sec.1.199A-5(c)(1))

Determining W-2 Wages - Although determining the wages for the purposes of computing the Sec 199A wage limitation would seem to be a simple matter of just adding up the wages the business paid, unfortunately it is not. Wages for this purpose will only include wages paid during the calendar year. The wages include wages paid to employees, and if an S corporation, to the officers of the corporation. Reg 1.199A-2(b)(2)(iv) provides the following options in determining wages.

Step One – Determine the W-2 wages. The IRS provides 3 methods to determine the wage amounts with the unmodified box method being the simplest but the one that results in a lower wage number. These methods are the same three options IRS allowed for determining wages eligible for the now-repealed Sec 199 domestic production activities deduction.

- **Unmodified Box Method** – It is the lesser of:
  - Total entries in Box 1 of all Forms W-2 filed with SSA, or
  - Total entries in Box 5 (Medicare wages) of all Forms W-2 filed with SSA.

UNMODIFIED BOX METHOD	
1. Total amounts in Box 1 of W-2s filed for the business entity…	
2. Total amounts in Box 5 of W-2s filed for the business entity…	
TOTAL – UNMODIFIED BOX METHOD – Lesser of 1 or 2	

- **Modified Box 1 Method** – Determined as follows:
  - Total the entries in Box 1 of all Forms W-2 filed with SSA, then
  - Subtract the amounts in the Box 1 total that are not wages for FIT withholding, such as supplemental unemployment benefits, annuity payments and sick pay. (Sec 3402(o))
  -

- o Finally add the total amounts reported in box 12 (excludable pension contributions) codes D, E, F, G, and S.

MODIFIED BOX 1 METHOD	
1. Total amounts in Box 1 of W-2s filed for the business entity…	
2. Amounts in Box 1 not subject to withholding (supplemental unemployment, annuity payments and sick pay)…	< >
3. Total pension plan exclusions included in Box 12 codes D, E, F, G, and S…	
4. TOTAL – MODIFIED BOX 1 METHOD (combine 1, 2 & 3)	

Example: *Modified Box 1 method for SL Lewis, Inc., an S Corporation with two shareholders, Susan Lewis who owns 80% of the stock and Jack Miller who owns 20% of the stock. The total Box 1 wages for the stockholders and employees for the year is $300,000. The $300,000 amount included $4,000 of supplemental unemployment compensation benefits. In addition, Box 12 included $35,000 code D amounts (employee 401(k) contributions). The Modified Box 1 amount is $331,000 ($300,000 – 4,000 + $35,000) which is allocated $264,800 to Susan (80% of $331,000) and $66,200 to Jack (20% of $331,000).*

- **Tracking Wages Method** – The taxpayer actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications. W-2 wages using the tracking wages method are determined as follows:
  - o Total of the entries in Box 1 of all Forms W-2 filed with SSA, **plus** the total amounts reported in Forms W-2 box 12 that are coded:
  - o D – Sec 401(k) elective deferrals
  - o E – Sec 403(b) elective deferrals
  - o F - Sec 408(k) salary reduction SEP
  - o G – Sec 457(b) deferred compensation plan
  - o S – Sec 408(p) salary reduction SIMPLE plan

TRACKING WAGES METHOD	
1. Total amounts in Box 1 of W-2s filed for the business entity…	
2. Total pension plan exclusions included in Box 12 codes D, E, F, G, and S.	
3. TOTAL TRACKING WAGES METHOD (line 1 + line 2)	

Compensation paid to statutory employees (Form W-2 box 13 is checked), is not includible in the calculation of W-2 wages under any of these methods. Wages paid by another employer, such as a staffing agency, are included, but both businesses can't claim the same wages.

Step Two – Properly allocate W-2 wages so only wages associated with QBI are included in the wage limitation calculation. A business entity could have non-U.S. source income, investment income, and capital gains income – none of which is QBI. An activity may have a concoction of business activities and perhaps not all of the activities produce QBI, and an adjustment may be required. (Sec 1.199A(b)(4))

Qualified Property - Qualified property is defined as meaning tangible, depreciable property which is **held by** and **available for use** in the qualified trade or business at the close of the tax year, which is **used at any point** during the tax year **in the production of qualified business income**, and the depreciable period for which has not ended before the close of the tax year (Code Sec. 199A(b)(6)(A)). Qualifying **tangible depreciable** property would include, for example:

- Machinery
- Tools
- Vehicles
- Residential Buildings (but not land; land is not depreciable)
- Commercial Buildings (but not land; land is not depreciable)
- Home office (see discussion below)
- Office furnishings
- Computer systems
- Bundled software (sold with the computer)
- Over the counter software
- Qualifying property (leasehold improvements, restaurant property and retail improvement property)
- Racehorses
- Certain fruit and nut trees and vines (once they reach production stage)
- Certain livestock (generally those purchased for draft, breeding or dairy)
- Farm buildings (but not land; land is not depreciable)
- See IRS Publication 225 for other depreciable farm property
- See IRS Publication 949 for other depreciable property

NOT included would be Sec. 197 intangibles such as:

- Goodwill and going concern value
- Workforce in place
- Know-how
- Customer and supplier-based intangibles
- Government licenses and permits
- Franchises, trademarks, trade names

Special Circumstances – Placed in Service Date

- MACRS property acquired in Sec 1031 Exchange or Involuntary Conversion - Split Basis:
  - *Exchanged Basis - Date placed in service will be date the relinquished property was placed in service.*
  - *Excess Basis – Date the replacement property was placed in service.*

- Acquired in Sec 1031 Exchange or Involuntary Conversion – Electing Out of Split Basis - Date the replacement property was placed in service.

Unadjusted Basis Immediately After Acquisition (UBIA) – Generally means cost or other depreciable basis on the date placed in service. (Code Sec. 199A(b)(6)(B)(3)).

- It is not reduced for depreciation.
- It is not adjusted for any tax credits allowed.
- Not reduced for bonus depreciation.
- Not reduced for Sec 179 expensing.
- It is reduced for any personal use during the year – such as personal use of a vehicle.
- In the case of real property it does not include land.
- Improvements are treated as separate qualified property.
- Property is not qualified property if 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. However, ok if taxpayer can show the purposes was not to increase the 199A deduction.

Home Office – Reg Sec 1.199A-2(a)(3) provides: *"The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business)."* This means that the UBIA must be "determined and reported" on the tax return. Where a taxpayer is figuring a business tax deduction for the portion of their home used for business, they have two options: either use the actual expense method or the simplified method prescribed by Rev Proc 2013-13. In using the simplified method, it is not necessary to calculate ("determine and report…") the adjusted basis of the portion of the home used as an office. (See section 4.06 of Rev Proc 2012-13). However, if the taxpayer uses the simplified method in one year and the actual expense method in the next year the adjusted basis of the portion of the home used as an office must be computed in that subsequent year (see section 4.07(1) of Rev Proc 2012-13). So, it would seem if the simplified method is used in the first year or years, then the home office is not included in UBIA. However, if the taxpayer switches to the actual method in a subsequent year and the depreciation is "determined and reported" then the home office would be included in UBIA for the year of the switch.

Except as outlined above, the section 199A regulations do not include any restrictions related to the inclusion in UBIA of the potion of the home used as an office.

It is significant to note that the benefit is generally trivial, as the following example demonstrates:

> ***Example:*** *Assume the home's unadjusted basis is $500,000 and the land portion is valued at $200,000. If the business use of the home is 10% then the UBIA of the home office would be $30,000 (($500,000 - $200,000) x 10%). 2.5% of the $30,000 would be only $750, and that would increase the 199A deduction only by $150.*

Allocating UBIA – Where a taxpayer is a partner or shareholder the partnership or S corporation must allocate the UBIA among the shareholders and partners in the same manner as depreciation is allocated to the shareholder or partner. If the qualified property does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended):

- In the case of a partnership, each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners if the qualified property were sold at fair market value in a hypothetical sale for cash.
- In the case of an S corporation, each shareholder's share of the UBIA of the qualified property is based on the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation.

NOTE: There are adjustments related to corporate and partnership dispositions not covered in this material.

Depreciable Period – For this purpose the term depreciable period means the period beginning on the date the taxpayer first puts the property in service and **ending on the later of:**

(a) 10 years after the placed-in-service date or

(b) The last day of the last full year of the applicable MACRS recovery period of the property (Code Sec. 199A(b)(6)(B)).

Item	*Property*	*Cost*	*Life*	*In Service*	*Method*	*Qualifying 199A Property*
1	*Display cases*	*$4,500*	*7*	*2007*	*Depreciate*	*$ 0*
2	*Additional display cases*	*$2,500*	*7*	*2009*	*100% Bonus*	*$ 2,500*
3	*Storage racks*	*$1,200*	*7*	*2016*	*Sec 179*	*$ 1,200*
4	*Cash register*	*$900*	*5*	*2010*	*Depreciate*	*$ 900*
5	*Price labeling machine*	*$175*	*5*	*2010*	*Expense*	*$ 175*
6	*Computer system*	*$2,300*	*5*	*2015*	*Sec 179*	*$ 2,300*
7	*Delivery Truck (light)*	*$8,700*	*5*	*2012*	*Depreciate*	*$ 8,700*
	TOTAL					***$ 15,775***

Example #7 – Retail Store - *Gary has a retail store that he operates in rented retail space. His property that he used in his business* ***during 2018*** *is listed in the table above.*

When looking at the example, remember that the value we use for "qualifying 199A property" is the unadjusted basis. So, depreciation and expensing is ignored for this purpose. However, property counts as "qualifying property" within its depreciable life or 10 years, whichever is greater. Item numbers 1, 4, 5 and 7 are past their MACRS recovery periods but only #1 has been in service for a period greater than 10 years. So, all of Gary's property except item #1 counts as "qualifying 199A property". Thus, when the wage limitation is computed for Gary the qualifying property used in the computation will be $15,775.

UBIA Example #8: *Richard is a 25% shareholder in an S-Corporation that is not a specified service trade or business. During 2018 the S-corporation had $30,000 of qualified property it used during the year. Thus, when the wage limitation is computed for Richard, the qualifying property used in the computation will be $7,500 (25% of $30,000).*

UBIA Example #9: *Joyce owns a rental property. She originally purchased the property 12 years ago for $500,000 and the land value was $200,000. $300,000 ($500,000 - $200,000) would be the qualified property value for Joyce's rental property.*

Real Estate Investment Trust (REIT) – Sec 199A also includes qualified REIT dividends as pass-through income. However, for this purpose qualified REIT dividends do not include any portion of a dividend received from an REIT that is a capital gain dividend or qualified dividend.

Qualified Publicly Traded Partnership Income – The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of:

(A) The net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in Sec 199A(c)(3) and determined after the application of Sec 199A(c)(4) from a publicly traded partnership with pass-through income (Sec 7704(c)), and

(B) Any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under Sec 751(a) (unrealized receivables of the partnership).

REITS and Publicly Traded Partnerships - The regulations make it clear that the 199A computation for REITS and publicly traded partnerships (PTPs) is separate from that of the other 199A computations and has no effect on the other's computation. Thus, should the QBI from REITS and PTPs be negative, the result will be a separate loss carryover and will have no effect on the taxpayer's computation of the business entity 199A deduction.

Cooperative Dividends – Cooperatives are not eligible for the deduction. Instead, cooperatives must provide the necessary information to their patrons on Form 1099-PATR or an attachment to help eligible patrons figure their deduction. See the Instructions for Form 1120-C, U.S. Income Tax Return for Cooperative Associations, for rules applicable to agricultural and horticultural cooperatives.

Qualified Trade or Businesses

Now we can continue our study of QTB and learn how to apply the wage limitation to QBI from QTBs.

So even though a taxpayer's 1040 taxable income is above the phaseout cap, they can still get a Sec 199A deduction for a QTB so long as the business entity paid

wages and/or has UBIA from qualified property. Those are the elements that make up the wage limitation.

Wage Limitation: When a taxpayer's 1040 taxable income exceeds the phaseout cap the preliminary QBI deduction is limited to the lesser of 20% of QBI or the wage limitation. The wage limitation is the greater of:

- 50% of the W-2 wages that the business paid, or
- 25% of the W-2 wages from the business plus 2.5% of the unadjusted basis of the business's qualified property.

However, TCJA phased in this limitation for taxpayers whose taxable income is between the threshold and the cap, resulting in a rather complicated calculation. So, we will study the limitation as it applies to taxpayers whose taxable income exceeds the phaseout cap and rely on the worksheet for those with 1040 taxable incomes between the threshold and the phaseout cap. We start with a taxpayer that is an S corporation stockholder:

Example #10 – Taxable Income Above the Phaseout Cap - *Therese, who is married and filing a joint return, is an active shareholder (meaning she works in the business and is not simply an investor) in an S-corporation and owns 40% of the stock in the corporation. For 2018 she receives a W-2 in the amount of $250,000 as her compensation for working in the business and a K-1 that includes her flow-through income, QBI, of $150,000. Her taxable income (AGI less standard or itemized deductions) from her 1040 is $500,000, which is above the $415,000 cap, so she is subject to the wage limitation. The corporation paid $600,000 in wages during the year, which includes the $250,000 paid to her, and had $100,000 of qualified property. So, her 199A deduction is determined as follows:*

Summary:
QBI = $150,000
Her share of Wages = $240,000 (40% of $600,000)
Her share of qualified property = $40,000 (40% of $100,000)
20% of her QBI = $30,000
50% of her share of the wages = $120,000 (50% of $240,000)
25% of her share of the wages = $ 60,000 (25% of $240,000)
2.5% of the qualified property = $1,000 (2.5% of $40,000)

The preliminary 199A deduction is limited for this activity to the lesser of 20% of QBI ***($30,000)*** *or the greater of:*

- *50% of the W-2 wages from the business* ***($120,000)*** *or*
- *25% of the W-2 wages ($60,000) from the business plus 2.5% of the unadjusted basis of the business's qualified property ($1,000), which totals* ***$61,000****.*

$120,000 is greater than $61,000 so the preliminary 199A deduction for this entity is the lesser of the $120,000 W-2 limitation or $30,000; thus, ***the deduction is $30,000****.*

Example #11 – Wages Adjusted - *But what would have been the result if Therese had taken a W-2 salary of only $90,000 instead of $250,000 and the difference ($160,000) had been added to her QBI (flow-through income)? Her QBI would be $310,000 ($160,000 + $150,000). The wages paid by the S-corporation would drop to $440,000 ($600,000 - $160,000). The qualified property would remain the same and we have a substantially different result.*

Summary:
QBI = $310,000.   Her share of Wages = $176,000 (40% of $440,000)
Her share of qualified property = $40,000 (40% of $100,000)
20% of her QBI = $62,000
50% of her share of the wages = $88,000 (50% of $176,000)
25% of her share of the wages = $44,000 (25% of $176,000)
2.5% of the qualified property = $1,000 (2.5% of $40,000)
*So, the preliminary deduction is limited to the lesser of 20% of QBI **($62,000)** or the greater of:*

- *50% of the W-2 wages from the business **($88,000)** or*
- *25% of the W-2 wages ($44,000) from the business plus 2.5% of the unadjusted basis of the business's qualified property ($1,000), which totals **$45,000**.*

*$88,000 is greater than $45,000 so the preliminary 199A deduction for this entity is the lesser of the $88,000 W-2 limitation or $62,000; thus **the preliminary deduction is $62,000**.*

Continue to Worksheet – Next Page

199A QTB Worksheet (2018)

1	Qualified Business Income (QBI)	310,000
2	Taxpayer's 1040 Taxable Income (before the 199A deduction)	500,000
3	Threshold (enter $315,000 if MFJ; otherwise enter $157,500)	315,000
4	Differential (enter $100,000 if MFJ; otherwise enter $50,000)	100,000
5	Line 3 plus Line 4 (top of threshold range)	415,000
6	Tentative 199A deduction (20% of Line 1)	62,000
7	If Line 2 is equal to or less than Line 3, skip to line 21 and enter the amount from Line 6 on Line 21. If Line 2 is greater than line 3, continue to Line 8 (leave Line 7 blank).	
8	Taxpayer's share of the total wages paid by this business	176,000
9	Taxpayer's share of qualified business property for this business	40,000
	If Lines 8 and 9 are both zero, skip Lines 10 through 13 and enter zero on Line 14.	
10	50% of Line 8	88,000
11	25% of Line 8	44,000
12	2.5% of Line 9	1,000
13	Line 11 plus Line 12	45,000
14	Wage Limitation – **Greater** of Line 10 or Line 13	88,000
15	If Line 2 is equal to or greater than Line 5, skip to Line 21 and enter the **lesser** of Line 6 or Line 14. Otherwise continue to Line 16.	
16	If Line 14 is greater than Line 6, skip to Line 21 and enter the amount from Line 6. If Line 14 is equal to or less than Line 6, continue to Line 17.	
17	Subtract line 3 from Line 2	
18	Divide Line 17 by Line 4	
19	Subtract Line 14 from Line 6	
20	Multiply Line 18 by Line 19	
21	**Preliminary Sec. 199A Deduction** for this business (Line 6 minus Line 20)	62,000

Example #12 – Different Results for Different Taxpayer - *Consider also that the S-corporation that Therese was a shareholder in had other shareholders that were drawing a W-2 wage. If they also shifted more of their wages to pass-through income, the S-corporation's wages could be reduced to the point that the wage limitation might become the limiting factor. Consider further if the shareholders were the only employees and they all took no W-2 salary, the W-2 limit would be the 2.5% of qualified property and the maximum 199A deduction would be $2,500 (2.5% of $100,000) split between them.*

Commentary: These two examples highlight the issue of "reasonable compensation" in the context of an S-corporation, since the Sec 199A deduction only applies to the K-1 pass-through income, not wages paid to the shareholder. See page 75 for further discussion on this topic.

Caution: Reasonable compensation is not an amount determined to suit the best tax advantages of the stockholder. It is based on the facts and circumstances of the situation such as what others are paid for doing the same job, cost of living in the area and a number of other factors. See page 75 for further discussion of reasonable compensation as it applies to the Sec 199A deduction. Also see Big Book of Taxes chapter 3.29 for a detailed discussion of reasonable compensation.

K-1 Pass through Data – Where a taxpayer has an interest in a pass-through activity, the K-1 from the activity will provide the necessary data to compute the 199A deduction for the activity.

If you are the tax preparer receiving a K-1, as opposed to the one who is preparing the K-1, you are not responsible for making the decision of whether the business entity is a qualified trade or business, or a specified service trade or business. Those determinations are made at the entity level, and you as the preparer simply use the information provided with the K-1. The K-1 or an attachment to the K-1 should show the owner's (stockholder, partner, or beneficiary) share of the information required to compute the 199A deduction for that particular entity.

If the K-1 or attachment doesn't include the owner's (taxpayer's) share of the required data, the owner's share will be presumed to be zero. (Reg. Sec. 1.199A-6(b)(iii))

The table below includes the boxes and code numbers for where the information was located on the 2018 K-1s. The data provided includes QBI, wages, UBIA, REIT dividends and publicly traded partnership income. Makes it easy for the 1040 preparer, but pretty gnarly for the preparer of the 1041, 1065 and 1120-S returns. The determination of whether an entity is a SSTB should be provided as a supplement to the K-1.

Sec 199A K-1 Box Codes			
Form	*1120-S*	*1065*	*1041*
Box	*17*	*20*	*14*
QBI	*V*	*Z*	*I*
Wages	*W*	*AA*	*
UBIA	*X*	*AB*	*
REIT	*Y*	*AC*	*
PTP	*Z*	*AD*	*

** This data provided on a supplemental statement*

Observations:

1. *For S-corporations, planning to maximize the 199A deduction becomes a balancing act between wages and QBI while walking a tightrope with the reasonable compensation issue.*
2. *Just as a reminder, the 199A deduction is figured at the individual, partner or stockholder level. The other stockholders, such as those besides Therese in our examples above, might have taxable incomes below the threshold and would not be subject to the W-2 limitation.*
3. *If the business in the examples above had been a partnership the net profit would have flowed through to the individual partners as QBI. Where the partnership has no employees and no qualified property the W-2 limitation would be zero, and those partners with taxable income above the cap ($415,000 for MFJ and $207,500 for others) would have no 199A deduction (those between the threshold and cap would a get a partial 199A deduction). The same would apply to a sole proprietorship with no W-2 wages or qualified property.*
4. *That brings up another conflicting issue: employee or independent contractor? Before TCJA, many smaller employers wanted to treat workers as independent contractors as opposed to employees to avoid payroll taxes, reporting and ACA issues. But keep in mind payments to independent contractors don't count in the wage limitation and can have an effect on the 199A deduction.*
5. *On the other hand, there are individuals who are currently treated as employees who would like to be independent contractors for any number of reasons, some legitimate and some not. But the primary issues include:*
   a. *They have substantial employee business expenses and can no longer deduct them under TCJA.*
   b. *They would like to benefit from the 199A deduction.*

   Of course, there are negatives: Paying SE tax instead of only the employee share of the FICA and giving up whatever fringe benefits the employer might offer.

Qualified Trade or Businesses

Where you are computing the 199A deduction for **other** than a specified service trade or business when the taxpayer's 1040 taxable income is <u>between the threshold amount and the cap</u>.

Congress, rather than having a step function, established a gradual transition to the W-2 limitation between the threshold ($315,000 for MFJ and $157,500 or others) and the cap ($415,000 for MFJ and $207,500 for others).

In order to do this, they had to phase-out the 20% of QBI deduction and phase-in the W-2 limitation. This computation is best understood by example.

QTB-Example #13 - Taxable Income Between Threshold and Cap *- In this example we have a taxpayer filing a joint return.*

Taxable Income (TI): $385,000
Threshold: $315,000
Differential: $100,000
QBI: $190,000
*Tentative 199A deduction: **$38,000** (20% of $190,000)*
W-2 Wages paid by business: $10,000
Qualified Property: $200,000
***a**. 50% of Wages: $5,000 (50% of $10,000)*
***b.** 25% of Wages: $2,500 (25% of $10,000)*
***c**. 2.5% of Qualified Property: $5,000 (2.5% of $200,000)*
***d**. Wage Limitation: Greater of a. or (b. + c.) = $7,500*
***e**. Difference between TI and Threshold = $70,000*
***f**. e. divided by the differential = .70 ($70,000/$100,000)*
***g**. Tentative 199A deduction less Wage Limitation = $30,500 ($38,000 - $7,500)*
***h**. Phase-out = f. times g. = $21,350 (.70 x $30,500)*
I. Preliminary Section 199A deduction:
*Tentative 199A deduction less h. = **$16,650** ($38,000 – $21,350)*

SEE COMPLETED WORKSHEET NEXT PAGE

199A QTB Worksheet (2018)

1	Qualified Business Income (QBI)	190,000
2	Taxpayer's 1040 Taxable Income (before the 199A deduction)	385,000
3	Threshold (enter $315,000 if MFJ; otherwise enter $157,500)	315,000
4	Differential (enter $100,000 if MFJ; otherwise enter $50,000)	100,000
5	Line 3 plus Line 4 (top of threshold range)	415,000
6	Tentative 199A deduction (20% of Line 1)	38,000
7	If Line 2 is equal to or less Line 3, skip to line 21 and enter the amount from Line 6 on Line 21. If Line 2 is greater than Line 3, continue to Line 8 (leave Line 7 blank).	
8	Taxpayer's share of the total wages paid by this business	10,000
9	Taxpayer's share of qualified business property for this business	200,000
	If Lines 8 and 9 are both zero, skip Lines 10 through 13 and enter zero on Line 14.	
10	50% of Line 8	5,000
11	25% of Line 8	2,500
12	2.5% of Line 9	5,000
13	Line 11 plus Line 12	7,500
14	Wage Limitation – **Greater** of Line 10 or Line 13	7,500
15	If Line 2 is equal to or greater than Line 5, skip to Line 21 and enter the **lesser** of Line 6 or Line 14. Otherwise continue to Line 16.	
16	If Line 14 is greater than Line 6, skip to Line 21 and enter the amount from Line 6. If Line 14 is equal to or less than Line 6, continue to Line 17.	
17	Subtract line 3 from Line 2	70,000
18	Divide Line 17 by Line 4	.7000
19	Subtract Line 14 from Line 6	30,500
20	Multiply Line 18 by Line 19	21,350
21	**Preliminary Section 199A Deduction** for this business (Line 6 minus Line 20)	16,650

Official IRS 2018 QTB Worksheet Can Be Found on Pages 55-56 of IRS Pub 535

QBI Adjustments

Seems the IRS decided that certain AGI adjustments were business deductions that must reduce QBI.

<u>QBI Reductions for AGI Adjustments</u> - The final regulation §1.199A-3(b)(1)(vi) (page 43-44 final regs) specifies that **solely for the determination of QBI** from a trade or business, the following are included as deductions from adjusted gross income when determining the activity's QBI.

- **Self-employment tax deduction** under Sec. 164(f).
- **Self-employed health insurance deduction** under Sec 162(l).
- **Deduction for qualified retirement plans** under Sec 404.
- **Charitable contributions** under Sec 170 – Sec 199A(c)(1) defines QBI as the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer and Sec 199A(c)(3) defines the term "qualified items of income, gain, deduction, and loss" to mean items of income, gain, deduction, and loss to the extent such items are <u>effectively connected with the conduct of a trade or business</u> within the U.S. Thus, a charitable contribution made at the partnership level will reduce QBI even though the charitable contribution is passed through separately to the partners. This is because charitable contributions, although not a business expense, are deemed to be "effectively connected with" the related passthrough entity. So charitable contributions made by a passthrough entity reduce QBI, and the partners' 199A deduction.

> ***Commentary:*** *Passthrough entities should avoid making charitable contributions and instead, should distribute the funds to the business owners who can then make any charitable contribution themselves. The end result is the same, since the entity contributions are passed through to the owners anyway. But making contributions at the entity level can reduce the 199A deduction as much as 20% of the charitable contribution amount.*

- **Unreimbursed partnership expenses** under Sec 162 – There is a provision where partners may separately deduct unreimbursed partnership expenses on the Schedule E if the partnership agreement requires the partner to pay the expenses. When a partner takes such a deduction, the partner must reduce the QBI from the partnership by the amount of the expenses deducted.
- **Interest expense on purchase debt financing -** Where a partner or S corp. stockholder financed the purchase the entity, the interest on that debt is deductible on separate line of Schedule E, column II labeled "business interest" and the name of the partnership or S corporation (Schedule E Instructions Line 28). These amounts reduce the QBI.
- **Business Interest Expense Limitation** under Sec 163(j) – Where a business does not meet the inflation income exception amount of $25M ($26M for 2019 and 2020) the amount of deductible interest is limited under Sec 163(j) (See page 111). Limiting the interest deduction has the effect of increasing the QBI

leading one to question if entire amount of interest should be used when computing QBI for the 199A deduction. The regs and the IRS do not provide definitive guidance on this issue. **This is a wait and see issue**.

Where an individual has multiple activities with qualified business income (QBI) the foregoing adjustments to AGI are proportionately allocated among the business activities.

Example: A self-employed individual has a net profit of $130,000. His SE tax deduction for the tax year would be $9,184. He also has a self-employed health insurance deduction of $20,000 and contributed $5,000 to his SEP account.

QBI Before Adjustments:	$130,000
SE Tax Deduction:	< 9,184>
SE Health Insurance Deduction:	< 20,000>
SEP contribution:	< 5,000 >
QBI for 199A purposes:	**$ 95,816**

If the taxpayer had other business activities, these adjustments would have been proportionately applied to the QBI from each.

Observation – An IRA is not a qualified retirement plan under Sec 404. Thus, the taxpayer might have been able to make a deductible contribution of $5,000 to a traditional IRA instead of the SEP and would not have had to reduce his QBI by the $5,000.

Farming Activities and Horticultural Cooperatives

Cooperatives – As the law was originally written, some farmers would have been allowed an overly generous and unfair deduction of 20% of their qualified cooperative dividends, calculated on a *gross* basis. This was referred to as the "grain glitch" and was fixed by the Consolidated Appropriations Act, 2018. With the fix, the deduction for a specified agricultural cooperative is calculated and passed through to patrons under the rules for the domestic production activities deduction (DPAD) that existed before the repeal of Code Sec. 199. Thus, the cooperative's deduction is generally 9% of the lesser of its taxable income, or its qualified production activities income, but limited to 50% of the co-op's W-2 wages paid that are properly allocable to domestic production gross receipts. Some or all of the co-op's deduction may be passed through to its patrons (the farmers), which then reduces the patron's general QBI deduction. The cooperative must provide its patrons with the necessary information on Forms 1099-PATR or an attachment so each patron can figure their deduction. Starting with 2019 this will be done on Schedule D of Form 8995-A. *Note:* the draft version of the 2020 Form 1099-PATR includes several new boxes that provide the needed information and that aren't on the 2019 version of the form.

Farming Activities – Other than co-op related, are treated the same as any other QTB when computing the 199A deduction.

What about multiple business activities with QBI?

The preliminary 199A deduction must be determined separately for each individual entity of a taxpayer and the various limitations and restrictions are applied at that level. Then all of the preliminary 199A deductions from the taxpayer's sources are combined and limited to 20% the taxpayer's taxable income reduced by net capital gains.

Example #15 – Multiple Activities - *The Morgans file a joint return. Their taxable income is $300,000, which includes $25,000 of net capital gains and REIT dividends of $500. They also have the following business activities for which you have computed the preliminary 199A deduction:*

Schedule C Business	*$42,000*
Schedule E Rental	*4,500*
1120-S K-1	*15,500*

First, sum up all the preliminary 199A deductions for all of the taxpayer's activities. That would include the following:

20% of the REIT Dividends	*$ 100*	
Schedule C Business	*42,000*	
Schedule E Rental	*4,500*	
1120-S K-1	*15,500*	
Total		***$62,100***

Next, compute the taxable income limit:

Taxable Income	*$ 300,000*	
Net Capital Gains	*<25,000>*	
Adjusted Taxable Income	*$ 275,000*	
20% of the Adjusted Taxable Income		***$55,000***

The taxpayer's 199A deduction is the lesser of $62,100 or $55,000, so in this example the taxable income limited the deduction to ***$55,000****.*

NOTES

199A Summary Worksheet (2018)

Instructions: This worksheet is designed to summarize all of the preliminary 199A deductions of the taxpayer and apply the final taxable income limit. It does not accommodate situations where one or more of the taxpayer's pass-through businesses has a negative QBI.

1	REIT Dividends		500
2	Qualified Publicly Traded Partnership (PTP) Income		
3	Sum of Lines 1 & 2		500
4	199A Deduction for REITs and PTPs (20% of Line 3)		100
	INCOME FROM INDIVIDUAL FLOW-THROUGH BUSINESS ACTIVITIES		
	Description of Flow-Through Business Activities	**Preliminary 199A Deduction**	
5	Schedule C Business	42,000	
6	Schedule E Rental	4,500	
7	Form 1120-S K-1	15,500	
8	TOTAL lines 5, 6, and 7		62,000
9	Tentative 199A Deduction (Sum of lines 4 and 8)		62,100
	DETERMINATION OF TAXABLE INCOME LIMIT		
10	Enter the taxpayer's Taxable Income (Before the 199A deduction)		300,000
11	Enter the Taxpayer's Net Capital Gains		25,000
12	Adjusted Taxable Income (Line 10 less Line 11)		275,000
13	Taxable Income Limit (Line 12 times 20%)		55,000
14	**Section 199A Deduction for this taxpayer** (lesser of Line 9 or Line 13)		55,000

NUANCES AND SIDE ISSUES:

Not an Adjustment to Gross Income - The deduction is not allowed in computing AGI, but rather is allowed as a deduction reducing taxable income. (Code Sec. 62(a), as added by Act Sec. 11011(b)). Thus it will have no impact on AGI limitations. The IRS added line 9 to the 2018 Form 1040 (line 10 on 2019 draft) to accommodate the 199A deduction.

SE Tax - The deduction is only used to offset taxable income, so it does not reduce the net earnings for self-employment used to compute self-employment (SE) tax. Thus, it will not be used to reduce SE tax.

Reasonable Compensation - With the advent of the Sec 199A deduction the issue of "reasonable compensation" takes on a whole new meaning for S-Corporation shareholders. This has been an issue of contention in the past, with shareholders that are actually working in the business and not just being investors taking minimum or no salary and having all the income pass through via the K-1 as investment income, thus avoiding payroll taxes on the income that should have been treated as W-2 compensation.

As an advisor to your clients it is you who will normally provide guidance to your clients to minimize their tax liability. However, you also have to be concerned about the client's IRS jeopardy for not paying themselves an adequate amount for the services provided and instead treating all remuneration as return on investment.

For S-corporations, the Sec 199A deduction only applies to the K-1 pass-through income, not wages paid to the shareholder. The lure of this 20% deduction will only tempt more employee-shareholders to ignore the reasonable compensation requirements.

See page 123 for an in-depth discussion of reasonable compensation.

LOSSES FROM QUALIFIED TRADE OR BUSINESS ACTIVITIES

- *Single Activity* – Where there is only a single activity qualifying for the 199A deduction and that activity has a loss, the QBI from that activity is zero, and the loss is carried over to the subsequent year's 199A computation.
- *Multiple Activities All Negative QBI* – Where there are multiple business activities and the QBI from each is negative, the QBI is zero and the negative QBI for each is separately carried over and is used to determine the QBI of each activity in the subsequent year.
- *Multiple Activities But Net QBI Is Positive* - When there are multiple activities involved and one or more have negative QBI, but the total QBI from all activities is positive, the QBI for the positive QBI activities is proportionally reduced by the negative QBI before computing the 199A deduction, and the ones that were negative will have no 199A deduction and no carryover.

The reason for the allocation is that some businesses in the group may be SSTBs and the 199A deduction may be subject to phase-out while other businesses may be subject to the wage limitation, which will limit the 199A differently for each activity.

Example #16 - Losses: *Jake has QBI from three qualified trades or businesses as illustrated in the table below. #1 and #2 show positive incomes while #3 shows negative income. Because the overall QBI is positive, the QBI for #1 and #2 must be proportionately reduced by the negative amount from #3 before the 199A deduction is determined for #1 or #2. The 199A deduction for #3 is zero and there is no negative QBI carryover because the QBI of #1 and #2 have been adjusted for the negative amount.*

Business	QBI	Percent	Adjustment	Adjusted QBI
#1	$20,000	20%	<2,000>	$18,000
#2	$80,000	80%	<8,000>	$72,000
#3	<$10,000>			
Total	$90,000			$90,000

The regulations make it clear that these QBI carryovers and adjustment have no effect on the gain or loss computations or passive loss carryovers for the regular tax computation. They are figured separately without regard to the Sec 199A computations.

Previously suspended losses - Several sections of the Code, including:

- 465, At-Risk Limitation,
- 469, Passive Loss Limitations,
- 704(d), Partnership Losses In Excess of Basis, and
- 1366(d), Shareholder Losses In Excess of Basis

provide carryover losses to subsequent years. For purposes of the 199A deduction to the extent that any previously disallowed losses or deductions are allowed in the taxable year, they are treated as items attributable to the trade or business. These losses are to be used in order from the oldest to the most recent on a first-in, first-out (FIFO) basis. However, losses or deductions that were disallowed for taxable years beginning before January 1, 2018, are not taken into account for purposes of computing QBI in a later taxable year. (Reg. Sec 1.199A-3(b)(1)(iv))

Example #17 – Previously Suspended Losses - *John is preparing his 2018 tax return. He has a rental activity that qualifies for the 199A deduction. John also has a $17,000 passive loss carryover from 2017 for that rental. In 2018 John's rental shows a $12,000 loss.*

- ***Regular Tax Computation*** *- For regular tax purposes John's net passive loss for 2018 is $29,000 ($17,000 + $12,000). John's AGI for the year is less than $100,000, so he is entitled to claim a $25,000 rental loss and has a passive loss carryover of $4,000 to 2019.*
- ***199A Computation*** *– For the 199A computations we do not take into account (we disregard) any passive loss carryovers for any years beginning before January 1, 2018. Thus, we disregard the $17,000 passive carryover from 2017. So John's rental QBI for 2018 is a negative $12,000 and since his rental is his only qualified trade or business his 199A deduction for the year is zero. Now the $12,000 loss becomes a QBI carryover to 2019 and will be taken into account when figuring John's 199A deduction in 2019.*

Possible Unexpected Outcome

Since most rentals are qualified trades or businesses for purposes of Sec 199A, and because of substantial depreciation, many of these rentals will be producing negative QBI. Where a taxpayer has positive QBI from other qualified businesses, the negative QBI will reduce the 199A deduction for those other businesses, something the taxpayer may not have been expecting. Claiming the 199A deduction is not an option if the taxpayer qualifies. IRC Sec 199A(a): "Allowance of deduction - In the case of a taxpayer other than a corporation, there shall be allowed as a deduction…" and "shall" means the deduction is mandatory if qualified to claim it.

TRADE OR BUSINESS AGGREGATION

Aggregating (grouping) trades or businesses offers taxpayers a means of combining their trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations and potentially maximizing the deduction under Section 199A. If such aggregation were not permitted, taxpayers could be forced to

incur costs to restructure their business activities solely for tax purposes. In addition, business and non-tax law requirements may not permit many taxpayers to restructure their operations. The IRS feels Sec 469 passive activity grouping is inappropriate relative to the 199A deduction, and therefore provides a separate from of grouping for 199A purposes, that permits the aggregation of separate trades or businesses, provided certain requirements are satisfied.

These grouping rules can become quite complicated because they may be made at the business entity level as well as the individual level. For purposes of this material, although we do include the rules applicable to entity aggregation, we will generally limit the discussion to aggregations at the individual level.

Who Should Consider Aggregation? Taxpayers whose taxable income exceeds the 199A deduction phaseout thresholds and who must rely on the wage limitation in order to qualify their QTB (not SSTB) for a deduction. Taxpayers with taxable income below the phaseout threshold amount do not benefit from aggregation. Aggregation is optional.

Before getting into an illustration, remember the 199A deduction figured at entity level is the **lesser** of:

1. 20% of QBI (net of the SE tax, SE health insurance premium and other adjustments as discussed above), or
2. The wage limitation.

   The wage limitation is the **greater** of:

   - 50% of the W-2 wages paid by the business or
   - 25% of the W-2 wages paid by the business plus 2.5% of the unadjusted basis of the business's qualified property (abbreviated UBIA).

Illustrations – The illustrations below assume the taxpayer's taxable income is such that the wage limitation will apply in all cases. It also assumes that none of the businesses are SSTBs, which cannot be included in an aggregation. The 199A deduction determined in the illustrations is the amount determined before the final limitation that caps the combined 199A deductions from all sources to 20% of the taxpayer's taxable income before the 199A deduction and net of any capital gains.

Illustration #1 – To simplify the comparison, this illustration assumes the QTBs only have wages and no UBIA. The outcome is that aggregating these three QTBs results in a substantial increase in the 199A deduction.

Trade or Business (QTB)	QBI	A 20% of QBI	Wages	B 50% of Wages	199A Deduction Lesser of A or B
X	$900,000	$180,000	$500,000	$250,000	$180,000
Y	$800,000	$160,000	$80,000	$40,000	$40,000
Z	$2,000	$400	$400,000	$200,000	$400
The combined 199A Deductions for the trades or businesses figured separately:					**$220,400**
Aggregated Businesses	$1,702,000	$340,400	$980,000	$490,000	**$340,400**

Illustration #2 – This illustration assumes the QTBs only have UBIA and no wages. The results show that aggregating these three QTBs provides the taxpayer a substantial increase in the 199A deduction.

Trade or Business (QTB)	QBI	A 20% of QBI	UBIA	B 2.5% of UBIA	199A Deduction Lesser of A or B
L	$25,000	$5,000	$250,000	$6,250	$ 5,000
M	$40,000	$8,000	$80,000	$2,000	$2,000
N	$15,000	$3,000	$900,000	$22,500	$3,000
The combined 199A Deductions for the trade or businesses figured separately:					**$10,000**
Aggregated Businesses	$80,000	$16,000	$1,230,000	30,750	**$16,000**

QBI Losses – When making the aggregation analysis remember that losses from any QTB or SSTB entity proportionally reduce the QBI of the taxpayer's other entities (see page 94). So, an aggregation excluding an entity with a loss does not overcome the reduction of QBI for the profitable entities.

Next Step – The next step is to see if the proposed aggregation is permissible under the "aggregation qualification general rules" discussed next and whether the taxpayer is willing to abide by the "operating rules" and the "aggregation rules" also discussed later in this material. One important issue to consider is that once aggregated the eligible QTBs are generally aggregated for all future years.

Aggregation Worksheet

A worksheet taking into account both wages and UBIA is included on page 103 of this text.

(b)(1) - Aggregation Qualification General Rules

Under regulation §1.199A-4, Trades or businesses may be aggregated only if an individual or relevant passthrough entity (RPE) can demonstrate that:

A. The same person, or group of persons, directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. In the case of trades or businesses owned by an S-Corp, own 50% or more the outstanding shares of stock and in the case of a partnership, have 50% or more of the capital or profits in the partnership.

B. The ownership exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income.

C. All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;

D. None of the aggregated trades or businesses can be an SSTB.

E. Individuals and trusts must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors are:

1. The businesses provide products, property or services that are the same (for example, a restaurant and a food truck) or they provide products, property or services that are customarily provided together (for example, a gas station and a car wash);
2. The businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or
3. The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies).

F. Consistent with other provisions in the proposed regulations, each trade or business must itself be a trade or business as defined in §1.199A-1(b)(13).

Operating Rules

(i) Individuals.

- An individual may aggregate trades or businesses operated directly or through an RPE (relevant pass-through entity) to the extent an aggregation is not inconsistent with the aggregation of an RPE.
- If an individual aggregates multiple trades or businesses, QBI, W-2 wages, and UBIA of qualified property must be combined for the aggregated trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations of the wage limitation.
- An individual may not subtract from the trades or businesses aggregated by an RPE but may aggregate additional trades or businesses with the RPE's aggregation if the aggregation rules are otherwise satisfied.

(ii) RPEs.

- An RPE may aggregate trades or businesses operated directly or through a lower-tier RPE to the extent an aggregation is not inconsistent with the aggregation of a lower-tier RPE.
- If an RPE itself does not aggregate, multiple owners of an RPE need not aggregate in the same manner.
- If an RPE aggregates multiple trades or businesses, the RPE must compute and report QBI, W-2 wages, and UBIA of qualified property for the aggregated trade or business.
- An RPE may not subtract from the trades or businesses aggregated by a lower-tier RPE but may aggregate additional trades or businesses with a lower-tier RPE's aggregation if the rules of this section are otherwise satisfied.

An individual is permitted to aggregate trades or businesses operated directly and trades or businesses operated through relevant pass-through entities (RPEs.). Individual owners of the same RPEs are not required to aggregate in the same manner.

Aggregation Rules (Reg 1.199A-4(c)(1) and (2)

- Once aggregated must consistently report as such in all future years
- If failed to aggregate on an original return, can't aggregate on an amended return except for 2018 tax year.
- May add newly created or acquired (including by non-recognition transfers) trades or businesses.
- If in the future the aggregation no longer meets the aggregation qualification, then the aggregation ceases to apply, and the taxpayer may reapply qualifications to determine if a new aggregation is permissible.
- _In the case of an individual_ – The individual must report aggregated trades or businesses of RPE in which the individual holds a direct or indirect interest.
- _In the case of an RPE_ – The RPE must report aggregated trades or businesses of a lower-tier RPE in which the RPE holds a direct or indirect interest.

Disclosure - For each year, the individual or RPE must attach a statement to the return that includes:

- A description of each trade or business;
- The name and EIN of each entity in which a trade or business is operated;
- Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;
- Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest.

Example #1 - Jack wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. Jack maintains a website and print advertising materials that reference both the catering business and the restaurant. He uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

Because the restaurant and catering business are held in disregarded entities, Jack will be treated as operating each of these businesses directly and thereby satisfies paragraph 199A-4(b)(1)(i) of the qualification. With regard to meeting 2 of the 3 requirements of **199A-4 (b)(1)(v)(A), (B) and (C)**Jack satisfies the following factors:

(b)(1)(v)(A) is met as both businesses offer prepared food to customers; and

(b)(1)(v)(B) is met because the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting.

Thus, Jack may aggregate the catering and restaurant businesses. (Reg Ex #1)

Example #2 – Same facts as example #1 except the catering and restaurant businesses are owned in separate partnerships and Jack and three of his friends each own a 25% interest in each of the two partnerships.

Because under paragraph (b)(1)(i) of this section Jack and three of his friends together own more than 50% of each of the two partnerships, they **may** each aggregate the catering business and the restaurant as a single trade or business. (Reg Ex #2)

Example #3 - Phil owns a 60% interest in each of four partnerships (PRS1, PRS2, PRS3, and PRS4). Each partnership operates a hardware store. A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses.

Phil owns more than 50% of each partnership, thereby satisfying paragraph (b)(1)(i). With regard to meeting 2 of 3 of the requirements of (b)(1)(v), Phil satisfies the following factors:

(b)(1)(v)(A) because each partnership operates a hardware store.

(b)(1)(v)(B) because the businesses share accounting and human resource functions.

Phil decides to only aggregate PRS1, PRS3, and PRS4 and report PRS2, which generates a net taxable loss, as a separate trade or business. Phil's decision to aggregate only PRS1, PRS3, and PRS4 into a single trade or business is permissible. The loss from PRS2 will be netted against the aggregate profits of PRS1, PRS3, and PRS4 pursuant to Sec. 1.199A-1(d)(2)(iii). (Reg Ex#4)

NOTES

Example #4 - George owns 80% of the stock in an S corporation (S1) and 80% of two partnerships organized as limited liability companies. Thus, George meets the ownership requirements of (b)(1)(i). LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1's widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store.

(b)(1)(v)(A) is met for LLC1 and LLC2 because they sell the same product.

(b)(1)(v)(B) is met for S1, LLC1 and LLC2 because they share significant centralized business elements and are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group.

(b)(1)(v)(C) S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. Thus, S1 operated in coordination with, or reliance on, other businesses in the aggregated group.

Thus, each entity meets 2 of the 3 requirements of (b)(10(v) and they may be aggregated. (Reg Ex #8)

Example #5 – Same as example #4, except George owns 80% of the stock in S1 and only 20% each of LLC1 and LLC2. George's son owns a majority interest in LLC2, owns no stock in S1 and has no interest in LLC1. George's mother owns a majority interest in LLC1, owns no stock in S1 and has no interest in LLC2. Since the same group of persons, including George, own a majority interest in LLC1 and LLC2 George is considered to have met the ownership requirements of (b)(1)(i). (Reg Ex #9)

Example #6: Clive owns 60% of PRS1, a partnership, that sells non-food items to grocery stores. He also owns 55% of PRS2, a partnership, which owns and operates a distribution trucking business. The predominant portion of PRS2's business is transporting goods for PRS1. Clive meets the (b)(1)(i) ownership test. With regard to meeting 2 of the 3 requirements of (b)(1)(v), Clive only satisfies one of the factors:

(b)(1)(v)(C) - The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group.

Clive does not meet either (b)(1)(v)(A) – provide the same products, property or services or (b)(1)(v)(B) – Share the same centralized business elements. Thus, Clive cannot aggregate the wholesaler and trucking company. (Reg Ex#12)

Example #7: PRS1, a partnership, owns 60% of a commercial rental office building in state A, and 80% of a commercial rental office building in state B. Both commercial rental office building operations share centralized accounting, legal, and human resource functions. PRS1 satisfies the ownership requirements. With regard to meeting 2 of the 3 requirements of (b)(1)(v), PRS1 satisfies the following factors:

(**b)(1)(v)(A) -** provide products, property and services that are the same.

(**b)(1)(v)(B) -** share significant centralized business elements (accounting, legal, and human resource functions).

Thus, PRS1 may aggregate its commercial rental office buildings. (Reg Ex #16)

Example #8: S, an S corporation owns 100% of the interests in a residential condominium building and 100% of the interests in a commercial rental office building. Both building operations share centralized accounting, legal, and human resource functions.

S satisfies the ownership requirements. With regard to meeting 2 of the 3 requirements of (b)(1)(v), S satisfies the following factor:

(b)(1)(v)(B) - share significant centralized business elements (accounting, legal, and human resource functions)

S does not meet either (b)(1)(v)(A) – provide the same products, property or services (commercial vs residential) or (b)(1)(v)(C) – operate in coordination with or reliance on the others. Thus, S cannot aggregate the commercial and residential businesses. (Reg Ex #17)

Precautionary Note: The regulations are taking the position that the commercial and residential activities do not provide the same products, property and services so cannot use (b)(1)(v)(A) for one of the two out of three requirements to group. So, they can only be aggregated together if they meet the requirements of (b)(1)(v)(B) and (b)(1)(v)(C).

NOTES

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SECTION 199A AGGREGATION WORKSHEET

Use this worksheet to compare the sum of the 199A deductions for several QTBs figured separately to the results of aggregating them.

A	B	C	D	E	F	G	H	I	J	K
QTB	QBI	20% of B	Wages	UBIA	50% of D	20% of D	2.5% of E	G Plus H	Greater of F or I	199A Deduction (Lesser of C or J)
The combined 199A Deductions for the trade or businesses figured separately (Sum of Column K):										**Total** $__________
Aggregated QTBs	**------------------ Total entries from each column above ------------------**									
										Aggregation $__________

Instructions:

1. *Precautions:*
    a. *The taxpayer's taxable income is assumed to be such that without benefit of the wage limitation the 199A deduction would be zero.*
    b. *Do not include any SSTBs, as they are not allowed to be aggregated.*
    c. *If any entity is showing a loss, the allocation of the negative QBI among the positive QBIs must be completed before using this worksheet.*
2. *Enter the IDs of the QTBs to be aggregated in Column A, the QBIs from the businesses in column B, the wages in column D and the UBIAs in column E.*
3. *Next, complete the calculation indicated for columns C, F, G, H, I, J and K for each QTB and enter the results in the box for that QTB.*
4. *Next, total the amounts in column K and enter results in the "total" box.*
5. *Next, In the "Aggregated QTBs" row, total the amounts in columns B, D and E.*
6. *Next, for the "Aggregated QTBs" row, complete the calculations indicated for columns C, F, G, H, I, J and K.*
7. *The benefit from aggregation is the excess of the amount in the "Aggregation" box over the amount in the "Total" box.*
8. ***CAUTION:*** *Just because this worksheet indicates the aggregation provides a benefit does not mean the QTBs aggregated in this worksheet qualify to be aggregated. That is a separate determination. This worksheet does not take the place of Schedule B of Form 8995-A.*

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TRUSTS, ESTATES, AND BENEFICIARIES

- **Grantor Trust** - Where the trust is a grantor trust, the owner will compute its QBI with respect to the owned portion of the trust as if that QBI had been received directly by the owner.
- **Non-grantor Trust** – In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries.

  Distributable Net Income (DNI) – A beneficiary's share of the DNI deemed to be distributed for the year is used to determine the beneficiary's share of QBI and W-2 wages from the trust for the year. Where part of the DNI is not deemed distributed, that amount shall be used to proportionally determine the QBI and W-2 wages for the trust or estate. Where there is no DNI for the year, all QBI and W-2 wages are allocated to the trust or estate. (Reg §1.199A-6(d)(3)(ii))

  UBIA - To the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportion as DNI of the trust or estate is allocated.

  Trust's TI Threshold - is determined at the trust level without taking into account any distribution deductions.

  Anti-Abuse Provisions - Trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A.

  Multiple Trusts - In the case in which two or more trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of Federal income tax, then such trusts will be treated as a single trust for Federal income tax purposes. (Proposed §1.643(f)-1)

Now let's examine the issue of what rentals qualify for 199A

RENTAL PROPERTY AND SEC 199A

Regrettably, the most currently misunderstood issue for preparing taxes could be the most significant - the issue of when a rental activity is a trade or business qualified for the Sec 199A deduction. The final regulation (§1.199A-1(b)(14)) defines a trade or business as being the same as trade or business under Code Sec. 162. Whether a taxpayer is engaged in a trade or business under section 162 requires an examination of all the facts and circumstances. (*Higgins v. Commissioner, 312 U.S. 212 (1941)*)

The courts have laid out two conditions necessary for an activity to be a trade or business. The first requires the taxpayer to carry on the activity with the intent of making a profit. (See *Ferrell v. Commissioner, 90 T.C. 1154 (1988)* and *Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), aff'd without opinion 702 F.2d 1205 (D.C. Cir. 1983))* The second requires the scope and level of taxpayer activity to be considerable, regular, and continuous. (See *Groetzinger v. Commissioner (U.S. Supreme Court) 480 U.S. 23, at 32, 35 (1987))*.

Applying these two conditions to Rental Real Estate **-** The Treasury/IRS regulation writers received a number of requests for "bright line rules" to help taxpayers and tax preparers determine whether a rental real estate activity is a trade or business. In response Treasury/IRS issued Notice 2019-07, followed by Rev Proc 2019-38, creating a safe harbor to address this issue.

Preparer Trap and Pitfall – To quote a close friend of mine, "dealing with rentals and Sec 199A for 2018 is like sitting in the front seat between Bonnie and Clyde." Making the ultimate decision that a rental activity is a trade or business solely on the basis of the Notice 2019-07 and RP 2019-38 safe harbor can lead to big problems. The 199A deduction takes into account both positive (net profit) and negative (net loss) qualified business income (QBI) and negative QBI reduces the positive QBI from other activities, and in doing so, reduces the 199A deduction. Thus, if a **loss** activity qualifies under Sec. 162 and it is not treated as a trade or business because it did not meet the 250-hour safe harbor, that does not preclude the IRS from determining it is a trade or business based upon Sec 162. The best way to look at the safe harbor is the IRS will not challenge your position that the rental IS a trade or business, BUT it is not a safe harbor that a rental is NOT a trade or business.

Rental Property Safe Harbor - On January 18, 2019, the IRS issued Notice 2019-07 which provided the language of a proposed revenue procedure – ultimately Rev Proc 2019-38 - for "safe harbor" conditions under which a rental real estate activity will be treated as a trade or business for purposes of the 199A deduction.

TAKE NOTE - NOTICE 2019-07 & REV PROC 2019-38 ARE ONLY A SAFE HARBOR RENTALS GENERALLY STILL QUALIFY UNDER SEC 162

Failure of the taxpayer to satisfy the requirements of this safe harbor **does not preclude** a taxpayer from **otherwise** establishing that a "rental real estate enterprise" is a trade or business for purposes of section 199A.

The tax code itself does not provide a definition of a trade or business. Regulation Section 1.199A-1(b) (14) defines "trade or business as a trade or business under Section 162". This means that the taxpayer may rely on the large body of court cases involving the question of rental real estate being a trade or business or investment.

Our research finds that virtually all court cases, except in the 2nd Circuit, refer to real estate rental activities as a trade or business with one notable exception for triple net leases. Thus, it is our considered opinion that most rental activities will qualify as a trade or business even if they do not meet the safe harbor requirements of Notice 2019-07 or Rev Proc 2019-38.

It's important to note that there are three "safe harbor" conditions that if met for a rental real estate enterprise (enterprise is a tax term introduced by the IRS in Notice 2019-07), the rental real estate enterprise (RREE) will be deemed to be a trade or business and eligible for the section 199A 20% deduction. For purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties.

IMPORTANT: Do not mix up the grouping of rentals into a single rental enterprise to meet the 250-hour requirement with the Sec 199A aggregation rules that allow taxpayers to aggregate business entities. They are two entirely different issues.

All for the following requirements must be satisfied for the safe harbor:

1. Separate books and records must be maintained for each rental real estate enterprise;

Observation: It is our opinion that if the rentals are not combined into a single rental enterprise, then each requires its own books and records (and bank account, although neither the Notice nor the Rec Proc mentions bank accounts) to meet the safe harbor requirements. If combined into a single rental enterprise, only a single set of books or bank account would be required but Rev Proc 2019-38 says that the income and expense information for each property may be maintained separately and then the results consolidated.

   a. A real estate enterprise can consist of a single or multiple real estate rentals.
   b. Commercial and residential rentals **cannot** be combined in the same real estate enterprise.

Observation: The rules for aggregation of rental real estate trade or businesses under regulation section 1.199A-4 are similar but not the same as the rules for selecting a rental real estate enterprise under Notice 2019-07. **Both** aggregation under Reg Sec 1.199A-4 and rental real estate enterprise groupings under Notice 2019-07 are optional.

2. For RREEs in existence less than 4 years, at least 250 hours of rental services must be performed for the year in question with reference to RREE. For RREEs that have been in existence for at least 4 years, in any 3 of the 5 consecutive taxable years that end with the taxable year, the 250-hour requirement must be met.
3. The taxpayer must maintain *contemporaneous* records, including time reports, logs, or similar documents, to document the following:
   a. hours of all services performed;
   b. description of all services performed;
   c. dates on which such services were performed; and
   d. who performed the services?

Observation: Contemporaneous is a difficult standard to meet, especially if the landlord is expecting his management company, gardener, pool person and other service providers to keep "contemporaneous records".

Special Relief: Because the safe harbor requirements were issued after the close of 2018, Notice 2019-07 said that the requirement for contemporaneous records for 2018 does not apply. Rev Proc 2019-38 states that the contemporaneous records requirement won't apply to taxable years beginning prior to January 1, 2020, but cautions taxpayers that they bear the burden of showing the right to any claimed deductions in all taxable years.

Rental services – Rental services that may be counted toward the 250 hour requirement include: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in tenant applications; (iv) collecting rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials for operation such as repairs; and (viii) supervision of employees and independent contractors.

However, rental services do NOT include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; ***or*** _hours spent traveling to and from the real estate_.

Rental services counted toward the 250-hour requirement may be performed by owners or employees, agents, and/or independent contractors working for the owners.

Observation: Many landlords compensate their tenants for performing maintenance and repair services. It appears that rental services performed by a tenant will count towards the 250-hour requirement provided:

1. The tenant, **if compensated,** does so as an employee or independent contractor (if the qualification for independent contractor can be met). However, neither N 2019-07 or RP 2019-38 includes a requirement that a tenant, or anyone for that matter, be compensated for the rental services provided.
2. A contemporaneous record of hours worked should be kept by the person responsible for keeping such records, in this case presumably the tenant. Records must be credible.
3. The services could be performed by the property owner's child, even if the child is not compensated for the work done.

Triple net leases are not eligible for safe harbor**.** Notice 2019-07 and Rev Proc 2019-38 specify that real estate rented or leased under a triple net lease agreement is not eligible for this safe harbor. A triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, ***and*** to be responsible for maintenance activities for a property in addition to rent and utilities. Also ineligible for the safe harbor is a property leased under an agreement that

requires the tenant or lessee to pay ***a portion*** of the taxes, fees, and insurance, **and** to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

Vacation rentals are not eligible for safe harbor **-** Real estate used as a residence by the taxpayer for **any** portion of the taxable year is not eligible for the safe harbor rules (see converted homes below).

Converted homes are not eligible for safe harbor - Real estate used by the taxpayer (including an owner or beneficiary of a relevant passthrough entity relying on this safe harbor) as a residence for any part of the year under section 280A is not eligible for this safe harbor.

Statement must be attached to the tax return **-** A statement by the taxpayemust be attached to the timely filed original return (or an amended 2018 return) for each year the safe harbor is used and must include the following information:

(1) A description (including the address and rental category*) of all rental real estate properties that are included in each rental real estate enterprise;

(2) A description (including the address and rental category*) of rental real estate properties acquired and disposed of during the taxable year; and

(3) A representation that the requirements of Rev Proc 2019-38 have been satisfied.

*residential or commercial

If an individual with more than one rental REE is relying on the safe harbor, a single statement may be submitted but the statement must list the required information separately for each rental REE.

Year-to-year consistency required **-** The revenue procedure states that taxpayers may not vary this treatment (i.e., treating each rental as a separate enterprise or grouping rentals as an enterprise) from year-to-year.

Double edged sword - The 199A deduction is 20% of a taxpayer's qualified business income from all of the taxpayer's trades or businesses subject to certain limitations. Many rentals do not show a profit and a rental that is treated as a trade of business that shows a deductible loss for the year will reduce the qualified business income of other trades or businesses of an individual, and as a result, reduces the 199A deduction of that individual.

This raises a serious due diligence question for tax preparers. Suppose a client does meet the safe harbor rules or qualifies as a trade or business under IRC Sec 162 and ends up with a deductible rental loss. Can this loss be omitted from the QBI calculation? The answer is obvious: if it meets the definition of a trade or business, of course it must be included in the computation of the Sec 199A deduction. To make matters more complicated, just because a rental does not meet the safe harbor rules does not mean it is not a trade or business under IRC Sec 162. The safe harbor criteria only means the IRS won't challenge the presumption that it is trade or business, nothing more.

CAUTION – Interest paid as part of a trade or business rental real estate activity is subject to the section 163(j) limitation on business interest UNLESS the rental real estate activity elects under section 163(j)(7)(B) to be an "electing real property trade or business." The effect of this election is that the rental activity, though a trade or business, is not subject to the section 163(j) limitation. It's important to note, however, that there is a small business gross revenue exception from the section 163(j) limitation for any section 162 trade or business, whether or not it is a rental activity, where in the 3 prior years the gross annual revenues are less than $25M ($26M for 2019 and 2020). See Big Book of Taxes chapter 3.25 for further details. The $26M (2019) section 163(j) interest limitation will not apply to most rentals.

Next let's look at Sec 162 which the final Sec 199A regulations say to follow when a rental is trade or business for purposes of the 199A deduction.

Rental Determination Using Sec 162 - The final regulation (§1.199A-1(b)(14)) defines a trade or business as being the same as a trade or business under Code Sec. 162. However, Code Sec. 162 is based on a myriad of court cases and IRS rulings that require the tax preparer to make a subjective determination which can be challenged by the Service. The catch-22 here is that IRS can determine a rental is a trade or business under Sec 162 even if it did not meet the safe harbor of Notice 2019-07. (You'll notice in the court cases we've cited that the IRS will sometimes argue that a rental is a trade or business, and in other cases will take the position that a rental is not a trade or business.) With regard to the Sec 199A deduction, a rental activity with a net profit benefits the taxpayer if it is a trade or business, but if the rental has a net loss it is a disadvantage since a net loss will offset any net profit from other business activities. You can't arbitrarily make those decisions to help a client; the decisions have to be based on facts and circumstances.

We see two problems facing tax practitioners:

- Explaining this very difficult determination to their client so the client (a) understands the determination is subjective, and can be challenged by the IRS, and (b) joins in the decision.
- Understanding the numerous tax court cases and how they might tie into their client's particular circumstances. For that we have developed a **checklist of facts and circumstances** that will help a practitioner determine if a rental is a trade or business under Sec 162 and have tied those facts and circumstance to particular court cases in a summary of **court cases and other guidance** that we have developed. The summary includes over 25 court cases related to rentals as trade or business.

COURT CASES & OTHER GUIDANCE For use in DETERMINATION OF RENTAL REAL ESTATE TRADE OR BUSINESS

This is a compilation of court cases and other guidance, each concerning the rental real estate trade or business issue. This is to assist in determining whether a rental activity rises to the level of a trade or business. It may be appropriate to review the entire court case or other guidance if used in making a determination of trade or business. We suggest you use the checklist to gather information from your client to help you make an informed decision as to whether or not your client's rental real estate activity is a trade or business. You will notice that after the name of the case or other guidance there is a short description intended to capture the essence of the cited authority as to the rental real estate trade or business determination. We suggest you share your evaluation with your client and keep this evaluation in the client's file. Remember rental real estate trade or businesses with losses **reduce** QBI and the 20% Sec 199A deduction. Rental real estate trades or businesses with net profits increase QBI and the Section 199A deduction.

(I) THRESHOLD ISSUE - PROFIT MOTIVE REQUIRED & FACTS CONTROL

(1) HIGGINS v. COMMISSIONER, 25 AFTR 1160 (61 S. Ct. 475), (S Ct), 02/03/1941

Commentary – "whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case." 312 U.S. at 217. Taxpayer must have a profit motive. Most rental real estate activities are a for profit activity. Vacation rentals, rental for less than fair rental value and hobby properties are examples of not-for-profit activities.

(II) LEVEL OF ACTIVITY REQUIRED

(2) COMMISSIONER V. GROETZINGER, 480 U.S. 23 (1987)

Commentary – Activities must be "beyond the scope of mere ownership of property" **and** must be **considerable, regular, and continuous activity.** See generally Commissioner v. Groetzinger, 480 U.S. 23 (1987) for "regular and continuous" requirements.

(3) FINAL REGS SUMMARY OF COMMENTS & EXPLANATION OF REVISIONS – Sec 1.199A (Pg 22)

As discussed in part II.A.3.a. of this Summary of Comments and Explanation of Revisions, generally under Section 162, to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. Commissioner v. Groetzinger, 480 U.S. 23, 35 [59 AFTR 2d 87-532] (1987).

Commentary: Final regulations require a taxpayer to be involved in a rental activity with continuity and regularity and the primary purpose to be for income or profit.

[4] GENERAL COUNSEL MEMORANDUM (GCM) 38779

The memorandum says the Tax Court requires only a *"relatively small amount of activity"* for trade or business. The Tax Court has repeatedly ruled that one real estate rental activity managed by the owner, including an agent or manager, meets the Groetzinger standard of activities, which are "beyond the scope of mere ownership of property" and were deemed to be **considerable, regular, and continuous activity.**

(III) CASES INVOLVING A SINGLE RENTAL PROPERTY

[5] LELAND HAZARD, 7 TC 372, Code Sec(s) 23, 07/16/1946

Taxpayer occupied his property as a personal residence until such time as the TP relocated, at which point he rented the personal residence property and at the same time listed it for sale. The property was continuously rented for a period of about 3.5 years at which time it sold. The property was sold for $18,500 for which the taxpayer reported an ordinary trade or business loss of $6,844. No other activity was identified.

The IRS took the position that the home was a capital asset on the grounds that the rental was not a trade or business. The Tax Court found it to be a trade or business. The IRS subsequently acquiesced to this decision.

Commentary – A single rental, formerly a personal residence, was a trade or business – no specific other activity discussed.

[6] ANDERS I. LAGREIDE, 23 TC 508, 12/22/1954

"Taxpayer inherited a residence which she then rented out. The Commissioner there argued the rental of this single piece of residential property amounted to the operation of a trade or business regularly carried on by the taxpayer. The Tax Court agreed, saying: "It is clear from the facts that the real estate was devoted to rental purposes, and we repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used. We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used. It is clear, also, that the business was 'regularly' carried on, there having been no deviation, at any time, from the obviously planned use."

Commentary – A single residence was a trade or business – no specific other activity discussed as being required.

[7] CURPHEY 73 T. C. 766(1980)

TP managed 6 units, but the Tax Court made this remarkable statement regarding a single rental property being sufficient for trade or business. "This Court (Tax Court) has held repeatedly in cases subsequent to the Supreme Court

decision in Higgins that the rental of even **a single piece of real property** for production of income constitutes a trade or business." See also *Fegan*, 71 T.C. 791, 814 (1979); *Elek*, 30 T.C. 731 (1958), acq. 1958-2 C.B. 5; *Noble*, 7 T.C. 960 (1946), acq. 1946-2 C.B. 4, supra; *Hazard*, 7 T.C. 372 (1946), acq. 1946-2 C.B. 3.

Commentary –Single rental is a trade or business & husband agent OK.

(IV) CASES WHERE TAXPAYER TRIED TO RENT BUT FAILED

(8) GEORGE S. JEPHSON., 37 BTA 1117, Code Sec(s) 23, 06/24/1938

A taxpayer, who purchased a house for renting, listed it for rent with a broker and showed it to prospective tenants but failed to rent it, was engaged in a business, and is entitled to deductions for care and maintenance expenses and depreciation on the property.

Commentary – Taxpayer attempted to rent but was not successful, ruled to be a **trade or business.**

(9) JACKSON V COMMISSIONER 34 T.C.M. 1139 (1975)

"But the record here, while shedding little light on what affirmative steps may have been taken to rent the property, makes clear those measures that were not pursued. Petitioner did not employ a rental agent nor advertise in newspapers his willingness to rent the El Cajon property despite the fact that at times, similar measures were among those used in efforts to sell the property. Moreover, although the property was no longer suitable for occupancy by the time he reluctantly expressed a willingness to accept a tenant, he did not undertake to make any of the repairs that were required to put the property in rentable condition. Such inaction certainly raises doubts about the earnestness with which petitioner tried to rent the property"

Commentary – Purchased for sale-Attempt to rent not serious enough – **Not Trade or Business**

(10) CAMPBELL v. COMMISSIONER 5 TC 272 (1945)

Facts from evidence indicated that TP's "only purpose in buying the property … was to rent it and that he tried to do so by listing it with a broker and showing it to prospective tenants, and that later he bought (another piece of property next door) …as a step in assembling property on which to build an apartment house".

Commentary – Attempt to rent was serious – **Trade or Business found**

(11) ESTATE OF MARIA ASSMANN, 16 T.C. 632 (1951)

Minimal unsuccessful efforts to rent not good enough. (See *Jackson* TCM 1965-275, to the same effect; also see *Redisch* TCM 2015-95, converted second home - unsuccessful attempt to rent - not a trade or business.)

Commentary: Minimal unsuccessful attempts to rent – **NOT a trade or Business.**

(V) LEVEL OF ACTIVITY REQUIRED TO BE HIGHER IN 2ND CIRCUIT BUT AGENT ACTIVITY COUNTS

(12) **2ND CIRCUIT** (covers the states of Connecticut, New York & Vermont)

Activities must be "beyond the scope of mere ownership and the receipt (collection) of income and these activities must be "continuous" rather than sporadic, "regular" rather than irregular, and "considerable" rather than minimal." (*Keefe* below; *See Alvary v. United States, 302 F.2d 790, 796-797 (2d Cir. 1962); Gilford v. Commissioner, 201 F.2d at 736; Pinchot v. Commissioner, - 17 - [*17] 113 F.2d 718, 719 (2d Cir. 1940); Balsamo v. Commissioner, T.C. Memo. 1987-477; Grier, 120 F. Supp. 395 at 398)*. Courts found that minimal activities with respect to the house as compared to the length of ownership, the lack of activity to rent or re-rent, and the absence of employees hired to regularly maintain or repair the premises did not rise to a trade or business - lack of "regular and continuous activity of management" under a facts and circumstances analysis.

Commentary: 2nd circuit requires the taxpayer's rental activities to be "continuous" rather than sporadic, "regular" rather than irregular, and "considerable" rather than minimal. *Grier, 120 F. Supp.* ***395*** *at 398* is the seminal 2nd Circuit case)

(13) **GILFORD v. COMMISSIONER, 43 AFTR 221 (201 F.2d 735), (CA2), 02/05/1953**

Although it does not appear that the petitioner did anything herself in connection with the management of eight buildings, **an appreciable amount of time and work** was necessarily required on the part of the managing agent. And if such management was a "trade or business," the petitioner was so engaged although she acted only through an agent.

Commentary – Taxpayer's involvement in the rental was entirely through an agent, and the tax court ruled it to be a **trade or business**.

(14) **DAVID KEEFE, ET UX., TC MEMO 2018-28**

Maintenance and repairs supplied by the taxpayer or an agent of the taxpayer; the taxpayer's employment of labor to manage the property or provide services to tenants; the purchase of materials; the collection of rent; and the payment of expenses. *See also* Alvary v. United States, 302 F.2d 790, 796-797 [9 AFTR 2d 1633] (2d Cir. 1962); Gilford v. Commissioner, 201 F.2d at 736; Pinchot v. Commissioner, 113 F.2d 718, 719 [25 AFTR 447] (2d Cir. 1940); Grier, 120 F. Supp. 395 at 398. The totality of the facts and circumstances surrounding the use of the property must support a conclusion that the alleged rental activities were sufficient, continuous, and substantial enough to constitute a trade or business with respect to the rental of the property.

Commentary: More activity needed since this case was in the 2nd Circuit. "This Court will "follow a Court of Appeals decision which is squarely in point where

appeal from our decision lies to that Court of Appeals and to that court alone." Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971). Court determined the taxpayer's efforts were sufficient, continuous, and substantial enough to constitute a **trade or business**.

(15) FACKLER 45 BTA 708, (19) aff'd 133 F2d 509, 30 AFTR 932 (CA-6, 1943)

TP was responsible for expenses such as heat, light, water, insurance, real estate commissions, real estate taxes, miscellaneous expenses and repairs. **Trade or business found**. The sixth Circuit emphasized the importance of "rendering personal services to tenants" but did not elaborate on what those "personal services" were or are.

(16) PETER S. ELEK, 30 TC 731, 06/26/1958

The taxpayer, a Hungarian who relocated to the U.S., had his father take over managing his apartment building in Budapest. The court determined the rental and management of an apartment building or residential property amounted to a trade or business of the owner, and this is true where an agent, in this case his father, acts for the owner.

Commentary – Agent did the management - Taxpayer's involvement in the rental was entirely through an agent, his father, and the tax court ruled it to be a **trade or business**.

(VI) AGRICULTURAL LAND LEASE CASES

(17) BYRON K. ANDERSON, TC MEMO 1982-576, CODE SEC(S). 280A, 09/30/1982

Taxpayer owned 80 acres of farmland which he leased to tenant farmer. The court agreed if the taxpayer had personally farmed the 80 acres it undoubtedly could constitute a trade or business. However, he leased it to a tenant farmer, thereby relieving himself of virtually all of the day-to-day responsibilities of farming and thus was not a trade or business.

Commentary – Farmland leased to a tenant farmer who did all of the day-to-day work, court ruled **NOT a trade or business**

(18) GOOD V COMM 16 T.C. 906 (1951)

For several years' petitioner rented 20 acres of land to tenants who raised hay and grain, the rent being in the form of a quarter share of the profits. For the remainder of the time petitioner rented the property as pasture for $50 per year, and during two or three years a 2-acre portion of it was rented for the storage of lumber, also for $50 a year. When petitioner rented it for both pasture and as a lumber yard the total annual rental of $100 exceeded the property taxes."

Commentary – Farmland leased to a tenant farmer - partially crop share and partially land lease - ruled a **trade or business.**

(VII) MISCELLANEOUS ISSUES

[19] JACKIE H. ROBINSON, ET UX., TC MEMO 2014-120

The Robinsons claimed **losses** for 2007 and 2008 derived from rental real estate expenses and depreciation on their Magnolia house. Though the Robinsons rented out the Magnolia house from 1995 through 1999 and again in December 2009, they received no rents in 2007 or 2008. The property was not held out for rent from 1999 until 2009, a 10-year period, and the Robinsons made no effort to sell the property. The tax court determined the Robinsons did not engage in a real estate trade or business or hold the Magnolia house out for the production of income. They failed to make any significant attempt to sell the property during the years at issue, and the house went unrented for the 10-year period encompassing the tax years at issue.

Commentary – Treatment as a rental was inconsistent, rented for 4 years, unrented for 10 years, then sold. Court ruled **NOT a trade or business**.

[20] EDGAR PERRY, ET UX. V. COMMISSIONER, TC MEMO 2018-90 - RENTAL AT LESS THAN FRV

The court found that the taxpayers failed to carry their burden of establishing that they rented petitioners' second house to petitioners' relatives at fair rental.

Commentary – Taxpayer rented the home for less than fair market to relatives. Thus, **NOT a trade or business**.

[21] VICTORIA BALSAMO, TC MEMO 1987-477, 09/21/1987 - EVIDENCE NOT CREDIBLE & ACTIVITIES ALMOST NONEXISTENT

Petitioner's activities with respect to the premises as rental property were almost nonexistent. Petitioner testified that the lessee, Economopoulos, pointed out to her a dead rat, a bee's nest, and several leaks during her single visit, yet petitioner presented no evidence that she attempted to remedy these problems during her period of ownership.

Commentary: Testimony and other evidence not credible, records incomplete, taxpayer activity almost nonexistent - very short rental period. The court found it was **NOT a trade or business**.

[22] HAJOS 23 T.C.M. 2015 (1964) -PERSONAL RESIDENCE CONVERTED TO RENTAL

Private personal residence for about 1½ years converted to rental for 1 ½ years till sold. Court found it to be a trade or business.

Commentary: Personal residence converted and sold within 1½ years was a **trade or business**.

[23] **STRATTON V. COMMISSIONER, T.C. MEMO 1962-218 - IRS ARGUED ONE RENTAL WAS A TRADE OR BUSINESS**

IRS argued "the mere renting of the house for the (three-year period) constituted the carrying on of a trade or business." Court determined it was a trade or business.

Commentary: In this case the IRS argued in favor of a trade or business. House rented for three years was a **trade or business**. The sole issue was whether the loss realized when the house was sold in 1951 was an ordinary loss deductible only in the year of the loss or a capital loss which can be carried forward to the years in question.

[23.1] **James B. and Joan E. Murtaugh v. Commissioner (1997-319) - 25% interest in two timeshare units rented** in a resort lodging facility were trade or business even though they lost money for two years and then were sold.

(VIII) OTHER GUIDANCE

[24] **NOTICE 2019-07**

This notice provides for 250 hours of rental services to achieve a safe harbor designation that a rental real estate enterprise is a trade or business. To qualify for the safe harbor contemporaneous records must detail (i) the hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. It also requires the taxpayer to attach a statement, signed under penalty of perjury, that all the safe harbor requirements have been satisfied.

Commentary: Keep in mind the regulations specifically state that rentals can qualify under Sec 162, and the taxpayer need not meet Notice 2019-07's requirements to be a Trade or Business (see cases above).

[25] **TRIPLE NET LEASES**

Notice 2019-07 excludes triple net leases from qualifying under the safe harbor. In addition, triple net leases do not appear to qualify under Sec 162 either since the taxpayer provides no meaningful rental services.

NOTES

SECTION 199A

RENTAL REAL ESTATE TRADE OR BUSINESS CHECKLIST:

This checklist is designed to help tax professionals determine the level of activity for the purpose of evaluating a rental activity's qualification for trade or business status under IRC section 162 for purposes of the pass-through deduction under IRC section 199A. The superscripted numbers refer to specific court cases or other guidance included in the "Court Cases & Other Guidance" to be used with this worksheet. This checklist does not provide a definitive determination, but rather assembles the information helpful to arrive at a decision based upon the facts and circumstances of the situation.

☐ [24] Check this box if the activity meets the 250-hour safe harbor requirements of Notice 2019-07. (If you have checked this box and documented the safe-harbor requirements, the activity is deemed to be a trade or business for purposes of the Sec 199A, and you don't need to use the checklist.)

The level of activity need not rise to the 250-hour safe harbor level of Notice 2019-07 to qualify as a trade or business under IRC Section 162, but there must be some level of activity above that of a triple net lease, [25] which is specifically excluded from the definition of a trade or business under Sec 199A. (See prologue to the final Sec 199A regulations, page 17, section II.A.3.b. & Notice 2019-07, section 3.05). The courts (particularly the Tax Court confirmed by GCM 38779), have found that only "a relatively small amount of activity" is indicative of a trade or business. Use this worksheet to gather the facts and circumstances to help determine if the rental activity meets the Sec 162 definition of a trade or business.

A. Describe rental property
   Commercial, Residential, Land lease, [17] [18] Farm land [17]
   Other (describe):___________-
____

B. How many other rental activities does the taxpayer own? _____

C. How long has this rental property been owned: _____

D. Has its use always been a rental? Yes No [2] [19] [22]

E. If no, explain: ____

F. Is it rented at less than FRV? Yes No [1] [20]

G. Did owner attempt to rent it but fail to do so? Yes No [8] [9] [10] [11]
   If yes, how long did owner attempt to rent? ___________________

H. Describe efforts to rent & conditions that hindered rental:
   ____

I. Has it been continuously rented or available for rent? Yes No [3] [10] [11] [12]
   If no, explain: ____

J. Check the boxes of the following expenses the owner or owner's property manager or other agent paid on behalf of the taxpayer: [6] [15] [16]
   Mortgage P & I Taxes Insurance Utilities Fees
   Homeowner assessments Other (describe) _____________________

K. Was the taxpayer or the taxpayer's property manager or other agent responsible for the repairs and maintenance for the rental? Yes No [4] [13] [14] [15] [16]

L. Check the boxes and give cost for the repairs and maintenance actually completed by the taxpayer or the taxpayer's property manager or other agent during the year: [8] [14] [15] [16]
   Gardening $_______ Landscaping $_______ Tree service $_______ Pool maintenance $_______ Painting $_______ Roof repairs $_______ Appliance repair/replacement $_______
   Electrical $_______
   Plumbing $_______ Other (description):
   ____ $_______

M. Management activities performed by the taxpayer, property manager, or taxpayer's other agent during the year: [9] [13] [16]
Showed property Prepared, negotiated and/or renewed leases Presided over evictions
Maintained the books and records Supplying furnishings Cleaning & preparing unit(s)

*Rental activities that are specifically not trades or businesses:
- Triple net lease [25]
- Home rented to a related individual or entity at less than fair rental value [20]
- Vacation home rental [20]

Conclusion

It is our opinion that the determination of trade or business for rental activities should be based on Sec 162, and the safe harbor used sparingly and only where there is doubt under Sec 162, if at all. Our research of court cases upon which Sec 162 is based indicates most rental real estate activities are trades or businesses.

Consideration should be seriously given to the proper treatment of each activity under relevant case law with the conclusion that, except for exceptions outlined above, a rental real estate activity will be a trade or businesses. Consistency for both net profit and net loss activities is appropriate.

But of course, how you handle this mess is entirely up to you. Court rulings are certainly in our future but that will take a number of years to play out.

WORKSHEETS & NEW IRS FORMS

Blank ClientWhys worksheets are available in the Big Book of Taxes.

For 2019 the IRS has developed two new forms that take the place of the worksheets that were available for 2018 in the 1040 instructions and Publication 535. According to drafts, these forms are:

- Form 8995 - Qualified Business Income Deduction Simplified Computation
- Form 8995-A - Qualified Business Income Deduction (plus a separate Sch A to handle SSTBs, a separate Sch B for aggregation of business operations, a separate Sch C for loss netting and carryforward, and a separate Sch D to deal with farming cooperatives)

At the time this material was updated, a draft of the instructions for Form 8995 (5 pages) was posted on the IRS web site, but those for the 8995-A and its schedules weren't available so we don't know how many pages they will be. The forms drafts are available on the IRS web site, https://apps.irs.gov/app/picklist/list/draftTaxForms.html - enter 8995 in the search box.

CA does not conform to the Sec 199A deduction

3.25 EXCESS BUSINESS LOSSES

Under pre-TCJA law (IRC Sec 461(j)), if a non-corporate taxpayer in the farming business received an applicable government subsidy, including a Commodity Credit loan, for the tax year, the taxpayer's "excess farm loss" for that year wasn't allowed. The amount of loss that could be claimed was limited to a threshold amount of $300,000 ($150,000 for MFS taxpayers).

Under TCJA the IRC Sec 461(j) limitation on "excess farm loss" for non-corporate taxpayers no longer applies after 2017 and through 2025. Instead all non-corporate taxpayers' business loss deductions are limited to a threshold amount *(IRC Sec. 461(l) as modified by TCJA Sec. 11012(a)).*

An "excess business loss" is the excess (if any) of the taxpayer's aggregate deductions for the tax year that are attributable to trades or businesses of the taxpayer (determined without regard to whether or not the deductions are disallowed for that tax year) over the sum of:

(i) the taxpayer's aggregate gross income or gain for the tax year, which is attributable to those trades or businesses, plus

(ii) $250,000 (200% of that amount for a joint return (i.e., $500,000)). This amount is adjusted for inflation after 2018, and for 2019, these amounts are $255,000 and $510,000, respectively.

APPLICABLE EXCESS BUSINESS LOSS			
Year	2018	2019	2020
Excess Business Loss			
MFJ	$500,000	$510,000	518,000
Others	$250,000	$255,000	259,000

Example: *A single taxpayer, in 2019, has gross income from his business of $200,000 and deductions of $550,000 resulting in a net loss of $550,000. He also had W-2 wages of $50,000 from a side job resulting in a net loss of $300,000. This limit for a single taxpayer is $250,000 so he ends with $50,000 excess loss. The excess loss is treated as "other" income on 1040 Schedule 1 line 8 and the $50,000 is also added to the taxpayers NOL carryover. The net result is the loss is $250,000 ($300,000 less $50,000) and he has $50,000 NOL carryover.*

Coordination with Passive Loss Rules – Passive loss limitations apply before the excess business loss rules (Code Sec 461(l)(6)). Presumably, if a loss is disallowed under the passive activity loss rules, any deductions or income from that passive activity would not be considered in the determination of whether a taxpayer has an excess business loss.

Commentary: However, Code Sec. 461(l)(3)(A) language does not limit losses used in determining excess business losses to "active" trades or businesses, so some additional guidance is needed from the IRS.

Commentary**:** TCJA also modified the NOL deduction for losses incurred after 2017 so there is no carryback and the carryforward is indefinite. But the deduction of post-2017 NOLs can only offset 80% of a taxpayer's income in any year. (See Big Book of Taxes chapter 03.16 for more detail and an issue about effective date.)

Excess Business Losses –

CA does not conform to the IRC Sec 461(j) limitation on "excess farm loss."

- **2018** - CA does not conform to the limitation on excess business losses.

- **Post-2018** - In AB 91 (signed by the governor 6/27/2019), California adopted the TCJA change relating to the limitation on excess business losses of noncorporate taxpayers, **with the following exceptions:**
    - California law says that any loss which is disallowed under this provision is to "be treated as a carryover excess business loss for the following taxable year" instead of as a net operating loss carryover as it is for federal. This means the carryover amount is used in determining if there's an excess loss in the carryover year for California.
    - The federal provision applies only for years 2018 through 2025, while the California law is effective for taxable years beginning after December 31, 2018 and continues indefinitely.
    - California's, rather than the federal's, passive activity loss provisions are used in determining any excess loss.

3.25 - DISALLOWANCE OF BUSINESS INTEREST

Effective beginning in 2018, TCJA gets rid of the special and complicated "earnings strippings" rules that were put in place to prevent a U.S. corporation from borrowing money from a foreign subsidiary in a lower tax bracket and then deducting interest on the U.S. corporate return. We won't get into that big business tactic other than to provide a little understanding why this provision was passed. Regardless of business form, the interest expense is limited to the sum of:

1. The taxpayer's business interest income for the tax year;
2. 30% of the taxpayer's adjusted taxable income for the tax year; plus
3. The taxpayer's floor plan financing interest (certain interest paid by vehicle dealers) for the tax year.

The net interest expense disallowance is determined at the taxpayer level. *IRC Sec 163(j)(1) as amended by TCJA Sec. 13301(a)*

For purposes of this limitation, the following definitions and rules apply:

- **Adjusted Taxable Income** - For 2018 through 2021, adjusted taxable income is determined without regard to depreciation, amortization or depletion deductions. In addition, adjusted taxable income means taxable income computed without regard to:
  - Any item of income, gain, deduction, or loss which is not properly allocable to a trade or business;
  - Any business interest income or business interest expense;
  - The amount of any net operating loss deduction;
  - The amount of any qualified business income deduction allowed under section 199A; and
  - Adjustments described in published guidance.
- **Small Business Exemption** – An exemption from the rules applies to taxpayers (other than tax shelters) with average gross receipts for the three prior years of $25 million or less. This amount is inflation-adjusted for years after 2018, so for 2019 the exemption amount is $26 million or less.

SMALL BUSINESS EXCEPTION		
2018	2019	2020
$25 Million	$26 Million	$26 Million

Commentary: Most small businesses are below the threshold so the interest deduction limitation generally will not apply.

- **Rental Real Estate Activities** – A rental real estate activity is not subject to the limitation on business interest **unless the rental real estate activity is a trade or business**. If the rental real estate activity is a trade or business, and the small business exception does not apply the Form 8990 must be filed to deduct any interest expenses for that rental real estate activity unless one of the filing exceptions listed in the instructions for Form 8990 is met, which include:
  - Those meeting the small business average gross receipts exception,
  - Providing services as an employee,
  - An electing real property trade or business,
  - An electing farming business, or
  - Certain utility business.
- **Real Property Trades or Businesses Election** – Can elect out of this provision by using the alternative depreciation system (ADS) to depreciate the real property used in a trade or business. For this purpose a real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. (Form 8990 instructions)

Commentary: The ADS recovery period was reduced for residential real estate from 40 to 30 years by TCJA.

- **Farming Businesses** - 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. For this purpose, a farming business includes livestock, dairy, poultry, fish (includes an area where fish and other marine animals are grown or raised and artificially fed, protected, etc., but not an area where they are merely caught or harvested), fruit, nuts, and truck farms. It also includes plantations, ranches, ranges, and orchards. A plant nursery is a farm for purposes of deducting soil and water conservation expenses. (Form 8990 instructions)

See Rev Proc 2019-08 for an explanation how electing real property trades or businesses or farming businesses change to the ADS for property placed in service before 2018. This revenue procedure provides that it is not a change in accounting method.

- **Automobile, Boat, Farm Machinery Dealers –** Interest on debt secured by the inventory is exempt from the limitation.
- **Partnerships and S Corporations** - There are special rules for partnerships and sub-S corporations not covered here, since this course is related to small business and the $25 million gross receipts should effectively provide an exemption for most small businesses. See Form 8990 and its instructions or proposed regulations for additional information.
- **Carryover** - Any business interest that isn't deductible because of the business interest limitation is treated as business interest paid or accrued in the following tax year, and may be carried forward indefinitely, subject to the restrictions applicable to partnerships. If a partnership or S corporation is subject to the business interest deduction limitation, the limitation is applied at the entity level and any disallowed business interest expense (excess business interest expense) is not carried over by the partnership but is allocated to the partners. In contrast, disallowed business interest expense is carried over by an S corporation and the S corporation treats it as business interest expense paid or accrued in the following year.
- **Application of Limitations** - Section 163(j) applies before the application of the at-risk rules (§ 465), passive activity loss provisions (§ 469), and the § 461(l) limitation on excess business losses of noncorporate taxpayers discussed above. (Prop Reg 1.163(j)-3)

IRS Guidance – In Notice 2018-28 (April 3, 2018) the IRS announced its intention to produce regulations addressing various issues related to this new provision, and that in the meantime, taxpayers could rely on the rules described in sections 3 through 7 of the notice. In late December 2018, the IRS issued the promised proposed regulations (NPRM REG-106089-18) that provide general rules and

definitions and are organized into eleven sections, proposed §§1.163(j)-1 through 1.163(j)-11.

Disallowance of Business Interest - CA has no similar provision, and it is unlikely the legislature will pass any conforming legislation.

3.29 REASONABLE COMPENSATION

Determining a reasonable shareholder salary for an S corporation is required and may be one of the most difficult tasks related to S corporation accounting and tax preparation.

S corporation shareholders enjoy tax advantages that other entity types don't offer. Only the portion of their cash distributions that is characterized as reasonable compensation (W-2 wages) is subject to payroll taxes while the profits passed through on the K-1 are not subject to SE tax. Compare that to a partnership where the entire profits are subject SE tax.

Note: if a partnership's "business" is rental of real estate, none of the profits would be subject to SE tax and limited partners don't pay SE tax on profits. But guaranteed payments would be subject to SE tax.

Related IRC and IRS Publications and Forms

- IRS Fact Sheet 2008-25
- Pub 535 (2018) Page 8
- IRC Sec 162
- Reasonable Compensation – Job Aid for IRS Valuation Professionals – An IRS Publication (see below) Link:

https://www.irs.gov/pub/irs-utl/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf

The Internal Revenue Code establishes that any officer of a corporation, including S corporations, is an employee of the corporation for federal employment tax purposes. S corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages.

Who's an employee of the corporation? - Generally, an officer of a corporation is an employee of the corporation. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer be treated as wages. Courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive or are entitled to receive payment are employees whose compensation is subject to federal employment taxes.

The Treasury Regulations provide an exception for an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration. Such an officer would not be considered an employee.

What's a reasonable salary? - The instructions to the Form 1120S, U.S. Income Tax Return for an S Corporation, state:

"Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

The amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go to the shareholder, a salary amount must be determined, and the level of salary must be reasonable and appropriate.

There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.

Factors - Some Factors Considered by the Courts in Determining Reasonable Compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

The problem here, of course, is that it is easy for the IRS to list contributing factors used by the courts in determining reasonable compensation and leave it to the corporation to quantify these factors into a reasonable salary, and still have the ability to challenge the selected amount later if an auditor, off the top of their head, decides the compensation is unreasonable. The IRS has a long history of examining S corporation tax returns to ensure that reasonable compensation is being paid, particularly so if no compensation is shown being paid to employee-stockholders.

IRS Publication – Reasonable Compensation - The IRS, in 2014, released a 26-page publication titled "Reasonable Compensation – Job Aid for IRS Valuation Professionals." However, the publication specifically indicates that it is not an official pronouncement of law and like the Internal Revenue Manual cannot be used, cited, or relied upon as such.

In the Publication's "Background" it States: The Reasonable Compensation issue usually involves a determination of whether the amount of compensation paid is reasonable so that it is deductible under section 162 of the Internal Revenue Code for income tax purposes. In some cases, the Reasonable Compensation issue comes up when the amount of compensation paid may be lower than reasonable to avoid the payment of employment taxes.[1] For tax-exempt entities, the issue involves the application of section 4958, taxes on excess benefit transactions, and reflects a concern that excessively high compensation may unduly enrich officers, directors, trustees or key employees of the tax-exempt entity at the expense of the qualified charitable purpose.

> [1] *According to Treas. Reg. § 1.162-7(a), "The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services."*

Valuation Approaches – The publication includes three approaches to determine reasonable compensation:

- **Market Approach** – How much compensation would be paid for this same position, held by a non-owner in an arms-length employment relationship, at a similar company.
- **Income Approach** - Is based on an "Independent Investor Test," which seeks to determine whether an independent investor would be satisfied with his/her return on investment when looking at the financial performance of the taxpayer's business in conjunction with the subject employee's level of compensation.
- **Cost Approach** – Is based on the hours spent by the employee down to the various duties performed, quantifies the amount of time devoted to the different responsibilities, and compares the employee's salary to market compensation for comparable positions.

The valuations approaches require access to local labor statistics and may be best left to professionals who provide reasonable compensation evaluation services.

IRC Sec 199A Deduction

> *Qualified business income (QBI) does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business, and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services" (199A Committee Reports)*

The advent of the Sec 199A deduction beginning in 2018 adds an additional level of complexity to reasonable compensation for the following reasons.

- The S corporation's employee-stockholder's wages are NOT included in qualified business income (QBI) when computing the employee-stockholder's

199A deduction. Thus, the larger the wages the smaller the K-1 flow through income (QBI) and thus the smaller the 199A deduction, which is 20% of QBI (or 20% of the individual's adjusted taxable income if less). In this case it would be the tendency of an S corporation to pay the stockholder a smaller salary in order to maximize the flow through income and as a result the 199A deduction.

- Where married taxpayers filing a joint return have taxable income that exceeds a threshold amount of $321,400 ($160,725 for married filing separate and $160,700 for other statuses) for 2019 ($315,000 (other filing statuses $157,500) for 2018), the 199A deduction begins to be subject to a wage limitation, and once the taxable income for married taxpayers filing a joint return exceeds $421,400 ($210,725 for MFS and $210,700 for other statuses) for 2019 ($415,000 (other filing statuses $207,500) for 2018), the 199A deduction becomes the lesser of 20% of the QBI or the wage limitation. For these high-income taxpayers there is a tendency for the S corporation to pay stockholders less wage income in order to benefit from the Sec 199A deduction.
- Where an S corporation is a specified service trade or business (see chapter 3.24) the Sec 199A deduction phases out for married taxpayers filing a joint return with taxable income between $321,400 and $421,400 ($160,725 and $210,725 MFS, $160,700 and $210,700 other statuses) for 2019 ($315,000 and $415,000 (other filing statuses $157,500 and $207,500) for 2018). And, although the wage limitation is used in computing the phase out, once the taxpayer's taxable income exceeds $421,400 (MFS $210,725, other filing statuses $210,700) for 2019 ($415,000 MFJ and other filing statuses $207,500 for 2018), the taxpayer receives no benefit from the wage limitation and therefore would again want to minimize their reasonable compensation in order to minimize FICA taxes.

Of course, taxpayers cannot pick and choose a reasonable compensation to minimize taxes or maximize deductions. There-in lies a trap for tax practitioners who do not take into consideration the factors related to reasonable compensation. There are firms that have the data necessary to determine reasonable compensation, and in **JD & Associates, Ltd. v. United States,** the IRS used Risk Management Association (RMA), an expert in the field of reasonable compensation, for data to determine reasonable compensation.

Commercial Sources - We searched the Internet for services that provide the needed data in report form to determine reasonable compensation. A major source in the field seems to be RC Reports. **We have no experience with them so cannot vouch for them**, but they do have an impressive website with some high-powered references. https://rcreports.com/ They charge a membership fee.

Tax Cuts & Jobs Act - Don't overlook the fact that in the early stages of tax reform (TCJA) the bill included a safe harbor definition of reasonable compensation of 70% compensation and 30% flow-through income. It also allowed a larger (more

taxpayer favorable) allocation to flow through income where a taxpayer could prove investment in the business justified a larger allocation. That provision did not make the cut and was not included in the final bill, although it provides some insight into Congressional thinking on the subject.

Guaranteed Payments (Partnership) - There has been substantial concern in the tax industry after the passage of the TCJA that Congress might be trying to apply the rules of reasonable compensation to partnership guaranteed payments. This concern was prompted by the fact that guaranteed payments are excluded from a partnership's QBI for purposes of computing the Sec 199A deduction, the same as shareholders' wages (reasonable compensation) are excluded from the QBI of an S corporation, since there was not a modifier included in Sec 199(c)(4) that limits the application of reasonable compensation to S corporations. Here is that section of the Code:

> **199A(c)(4)** Treatment of reasonable compensation and guaranteed payments — Qualified business income shall not include—
>
> > **199A(c)(4)(A)** reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,
> >
> > **199A(c)(4)(B)** any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and
> >
> > **199A(c)(4)(C)** to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

However, at an American Bar Association Section of Taxation meeting in San Diego on February 9, 2018, Dana Trier, Treasury deputy assistant secretary for tax policy, said the lack of a modifier to reasonable compensation has raised concerns that the government may broaden reasonable compensation to other entities. "From where I sit . . . that reference to reasonable compensation is not an indication to redo the law of reasonable compensation."

Despite those assurances, Trier noted that section 199A(c)(4) was "written as it's written," and Treasury has the power to issue guidance expanding reasonable compensation beyond subchapter S corporations. Treasury will exercise that power "if someone above me makes that decision," he said.

IRS Revenue Rulings & Court Cases:

> **IRS Revenue Ruling 74-44** – Dividends (dividends in this context means distributions) that two sole shareholders of an electing small business corporation arranged to receive instead of reasonable compensation in the same amounts for services they performed constituted "wages" for which the corporation was liable for the taxes imposed by the FICA and the FUTA and the withholding of income tax.
>
> **Spicer Accounting v. United States, 918 F.2d 90 – 66AFTR 2nd 90-5806 (1990)** – Taxpayer accounting corporation sought a refund for FICA and FUTA taxes paid

to the IRS on behalf of Mr. Spicer. Taxpayer contends that payments paid to Mr. Spicer were dividends, since payments made to stockholders in a subchapter S corporation are not wages. The court found that because payments received by Mr. Spicer were for substantial services rendered, these payments are "wages" subject to FICA and FUTA. Taxpayer asserts, in the alternative, that it was not liable for FICA and FUTA because Mr. Spicer was an independent contractor, not an employee. The Court denied Taxpayer's claim finding that there is no evidence that Mr. Spicer was an independent contractor. Finally, the Court held that Sec. 530 of the Revenue Act of 1978 does not relieve Taxpayer from FICA and FUTA liability for the years at issue (1981 and 1982), because Taxpayer's treatment of Mr. Spicer as a stockholder, not as an employee, was unreasonable. Therefore, the Court affirmed the district court's decision.

Watson v. U.S. 107 AFTR 2nd 2011-311 (DC IA) 12/23/2010 - The IRS recharacterized dividend and loan payments from David E. Watson, P.C. to its sole shareholder and employee, David E. Watson as wages. In light of this recharacterization, Watson was assessed additional employment taxes, interest and penalties for each of the eight calendar quarters in 2002 and 2003. He paid the fourth quarter 2002 assessment of $4,063.93 and filed a claim for refund of that amount on or about June 27, 2007 and the IRS subsequently denied his request for a refund.

Watson filed an action contending that the assessments were illegal, and requesting a refund of the amount paid. The IRS filed an Answer and Counterclaim resisting Watson's request for refund, and requesting Judgment against Watson in the amount of $44,457.39 for additional assessments, penalties, and interest for the seven additional quarters in 2002 and 2003 for which Watson did not make payment. Although Watson received a minor adjustment in the amount owed, the IRS prevailed.

California conforms to federal treatment of reasonable compensation (but California does not conform to the Sec 199A deduction).

4.22 CALSAVERS RETIREMENT SAVINGS PROGRAM

The state of California has been trying for a few years to set up a retirement savings program for employees who aren't covered by an employer's 401(k) or other retirement plan. The initial plan was called the California Secure Choice Retirement Program and was to be tied into the federal *my*IRA program. Due to lack of participation, *my*IRAs were discontinued. Then there was a court case, *Howard Jarvis Taxpayers Association v. The California Secure Choice Retirement Savings Program,* challenging whether the state's retirement savings program was legal under the federal ERISA law. The court ruled that it doesn't violate ERISA, but also allowed the plaintiff to file an amended complaint, so the case may not be over.

New program - California has created a new retirement savings program called CalSavers that is being implemented over a 3-year period. The law creating this program **requires most California employers that don't offer an employer-sponsored retirement plan to participate.**

The program is administered by a private-sector financial services firm (Ascensus College Savings Recordkeeping Services, LLC) and overseen by the California Secure Choice Retirement Savings Investment Board (the Board) chaired by the State Treasurer.

Registration of employers opened July 1, 2019, and the state is encouraging eligible employers to join the program any time prior to their registration deadline. Employers can register on the CalSavers web site: https://www.calsavers.com. The staggered deadlines for registering with the state, based on employer size, are:

Number of Employees	Registration Deadline
More than 100	June 30, 2020
51 to 100	June 30, 2021
5 to 50	June 30, 2022

Employer's responsibility - Employers have a limited role in the program, mainly to sign up employees, disseminate information about CalSavers, and submit participating employees' contributions that come from payroll deductions. Employers cannot make contributions to the program and there are no fees for employers. Since CalSavers is not sponsored by the employer, the employer is not responsible for the program or liable as a program sponsor. Employers are not permitted to endorse the program or encourage or advise employees on whether to participate, how much (if any) to contribute or provide investment help.

Employees' accounts – Each participating employee's CalSavers account is an after-tax Roth IRA, and the employee is responsible for their investment choices, which initially include a money market fund, target retirement date funds, bond fund, global equity fund, and environmentally and socially conscious fund. If the employee hasn't made an investment selection, the first $1,000 contribution will go into the money market fund and thereafter contributions will be put into a Target Retirement Date Fund. Investments in CalSavers are not guaranteed or insured by the Board, the State of California, the Federal Deposit Insurance Corporation (FDIC), or any other organization. Depending on the investment selected by the employee, the annual asset-based fee ranges from 0.80% to 0.95%, according to the 48-page 2019 program disclosure booklet available online at: https://cdn.unite529.com/jcdn/files/CAER/pdfs/program_description.pdf

Eligible participants and contribution rates - To participate the employee must be at least 18 years old and have either an SSN or an ITIN. (A sole proprietor or partner in a

partnership that is an eligible employer also qualifies to participate.) The default contribution rate for each employee is 5% of gross pay but employees can opt out of the program or change their contribution rate at any time. The minimum contribution rate is 1% and the maximum is 100% of available compensation up to the federal annual IRA contribution limits. An employee who doesn't opt out will be enrolled automatically after 30 days. The contribution percentage automatically increases by 1% each year starting January 1, 2020, up to a maximum contribution rate of 8%, but the employee can choose to opt out of automatic escalation.

Employees can join the program on their own if they do not have access to a retirement savings plan through their employer. Those who choose to self-enroll in CalSavers separate from an employer arrangement need to link their bank account to their CalSavers account through the CalSavers website.

Participating employees should be mindful of the AGI limitations for contributing to Roth IRAs and the annual IRA contribution limitations to avoid over-contributions that could result in tax and penalty liabilities.

5.05 - SEC 529 DISTRIBUTIONS

Distributions from a Sec 529 follow the Code Sec. 72 annuity rules meaning that distributions are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account. So, the part of the distribution representing the amount paid or contributed to the QTP doesn't have to be included in income, because that part is a return of the investment in the plan.

Kindergarten through grade 12 - The limit for the post 2017 special allowance for kindergarten through grade 12 (high school) is $10,000 per beneficiary. See details later.

Computation of Earnings **-** Under prior law for purposes of applying section 72, all Sec 529 qualified tuition programs of which an individual was a designated beneficiary were treated as one program. The PATH Act eliminated the aggregation requirement for distributions after December 31, 2014.

Refunds & Recontribution of Funds - The PATH Act created a new Sec 529(c)(3)(D) to address situations in which Sec 529 qualified tuition program funds are distributed for a beneficiary's qualified higher education expenses, but some portion of those expenses subsequently are refunded to the beneficiary, for example, when the beneficiary drops a class mid-semester. Now the portion of a distribution refunded to a Sec 529 beneficiary is not subject to income tax to the extent that, within 60 days of the date of the refund, it is recontributed to a Sec 529 qualified tuition program of which the individual is a beneficiary.

Designated Beneficiary - A "designated beneficiary" in a qualified tuition program is:

1. The initially named individual who receives benefits;
2. In the case of a change in beneficiaries within the same family, the new beneficiary, and
3. A scholarship recipient under a qualified state tuition program as part of a scholarship program operated by a state or local government or exempt organization. *(Sec 501(c)(3))*

Qualified Expenses - Qualified expenses under a Sec. 529 plan are the costs required for a beneficiary's enrollment at an eligible higher educational institution and include:

- **Higher Education Tuition**
- **Elementary and Secondary School Tuition Expenses** – TCJA added withdrawals for elementary or secondary school tuition expenses but limits the annual withdrawal for each beneficiary to $10,000 (regardless of the number of 529 plans in the beneficiary's name)[1]. **Note: this special amount is for tuition only**. Elementary or secondary means kindergarten through grade 12 as determined under State law, consistent with the definition applicable for Coverdell education savings accounts. This special $10,000 amount applies for tuition paid to public, private or religious schools. [1] Per IRS Notice 2018-58.
- **Fees,**
- **Books,**
- **Supplies,**
- **Equipment**,
- **Computers** - Effective beginning in 2015, the PATH Act provides that Sec 529 qualified higher education expenses also include expenses for the purchase of computer or peripheral equipment (as defined in section 168(i)(2)(B)), computer software (as defined in section 197(e)(3)(B)), and Internet access and related services, if such equipment, software, or services are to be used primarily by the Sec 529 plan beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution. Computer software designed for sports, games, or hobbies is qualified only when the software is predominantly educational in nature. (Amended Sec 529(e)(3)(A)(iii))
- **Reasonable room and board costs** - by a student enrolled at least half-time (generally limited to the school's posted room and board charge, or $2,500* per year for a student living off-campus and not at home)**, and
- **Expenses of a special needs beneficiary** that is necessary in connection with his or her enrollment or attendance at the eligible educational institution.
  **§472 of the Higher Education Act of 1965*

  *** Code Sec 529(e)(3)(B) references Sec 25A(b)(3) in defining students whose room and board costs are eligible expenses, and Sec 25A(b)(3) says the student must meet certain requirements of the Higher Education Act of 1965; therefore, room and board expenses of elementary and secondary school students would not qualify.*

Timing of Reimbursement - Apparently reimbursements can be made in a year other than the year of the expenses since the code and publications are all silent on the issue. However, the taxpayer had better have documentation to prove this is not a double benefit (reimbursing for expenses used as a deduction or credit in a prior year and not exceeding the annual $2,500 off-campus room and board expenses - tough documentation requirements should the distribution be challenged).

Recontribution of Refunded Qualified Higher Education Expenses - When qualified higher education expenses are refunded (for example, when a student drops a class mid-term), the regs IRS plans to issue will:

- Permit the entire recontributed amount to be treated as principal, thus eliminating the need to determine the earnings portion, and allowing the entire refund to be tax-free if recontributed to the plan within 60 days of the refund;
- Provide that the recontributed amount won't count against the Sec 529(b)(6) limit on contributions on behalf of the designated beneficiary (related to contributions in excess of those necessary to provide for the qualified higher education expenses of the beneficiary); and
- Specify that the recontributed amount must be to the Sec 529 plan for the benefit of the beneficiary who received the refund but the recontribution doesn't have to be into the same plan from which the original distribution was made.

Rollover from a QTP to an ABLE Account - QTP distributions made Dec. 23, 2017 through Dec. 31, 2025, to the ABLE account of the designated beneficiary or a family member of the beneficiary won't be taxable if:

(1) The distributed funds are contributed to the ABLE account within 60 days of the withdrawal from the QTP and

(2) That distribution plus all other contributions to the ABLE account for the year that are subject to the annual gift tax exclusion do not exceed that limitation.

A direct transfer or rollover that would result in the gift tax limitation being exceeded would be subject to income tax plus a 10% penalty, so the regs IRS plans to issue will require the QTP to prohibit the direct transfer amount.

This rollover provision is only available 2018 through 2025. The amount of the rollover is limited, when combined with other contributions, to the annual ABLE account maximum.

NOTES

Generally, CA conforms to the changes relating to Sec 529 plans made by the TCJA and the Consolidated Appropriations Act of 2016, including the following:

- A distribution is not taxable, if, within 60 days of distribution, it is transferred to the credit of another beneficiary who is a "member of the family" as defined in IRC Sec 529(e)(2) or is rolled into an ABLE account for the same beneficiary or a family member.
- Refunded amounts re-contributed to the plan within 60 days will not be taxable.
- Distributions used to purchase computers, computer software, internet access and related services are qualified education expenses and thus not taxable.
- California **did not conform** to the TCJA provision allowing tax-free distributions from 529 plans for amounts used to pay Kindergarten through grade 12 tuition expenses. Therefore, these distributions are taxable for California and subject to a 2.5% penalty.

SEC 529 PLAN COMPARISONS – FEDERAL/CALIFORNIA		
ACTION	**FEDERAL**	**CALIFORNIA**
Distribution to transfer funds to another family member's 529 plan within 60 days.	YES	YES
Distribution to transfer funds to an ABLE account within 60 days.	YES	YES
Refunded amounts re-contributed to the plan within 60 days will not be taxable.	YES	YES
Allows tax-free distributions from 529 plans for amounts used to pay Kindergarten through grade 12 tuition expenses.	YES	**NO**
Distribution to pay tuition expenses at a public, private or religious elementary, middle, or high school.	YES	**NO**
Distributions used to purchase computers, computer software, internet access and related services are qualified education expenses.	YES	YES

5.06 ABLE ACCOUNT CONTRIBUTION LIMITS

Eligible individuals are limited to one ABLE account, and for years after 2017 the annual limit by all individuals (including the beneficiary) to any one ABLE account continues to be limited to no more than the gift tax exclusion amount, which is $15,000 for 2018 and 2019.

However, beginning in 2018 and through 2025, TCJA added a provision allowing the beneficiary of the ABLE account to contribute a maximum **additional amount** equal to the lesser of:

- The beneficiary's taxable compensation for the year, or
- The prior year's poverty level for a one-person household.

The 2018 poverty level for a one-person household was $12,140, which means for 2019, the beneficiary can contribute an additional amount equal to the smaller of the beneficiary's taxable compensation or $12,140.

CAUTION: Even if a contributor limits his or her contributions to an ABLE account to no more than the annual gift tax exclusion amount, if the contributor has made other gifts (other than direct gifts to providers for medical or schooling) to the ABLE account beneficiary during the year, the gift tax return filing requirement will be triggered.

AB 91 generally conforms CA law to the changes relating to qualified ABLE accounts made by the TCJA and the Consolidated Appropriations Act of 2016. Thus, California conforms to the TCJA provision allowing ABLE account beneficiaries to contribute their own earnings, up to an amount equal to the federal poverty level amount, to their own account. No effective date was included in the legislation.

6.02 – HIGHER EDUCATION INTEREST

AB 91 conforms California law to the TCJA provision that certain student loan debt cancelled upon the death or disability of the student is not taxable, effective for loans cancelled after December 31, 2018.

6.03 - COMBAT-ZONE CONTRACT WORKERS MAY QUALIFY FOR FOREIGN EARNED INCOME EXCLUSION

Certain U.S. citizens or resident aliens, specifically contractors or employees of contractors supporting the U.S. Armed Forces in designated combat zones, may now qualify for the foreign earned income exclusion.

The Bipartisan Budget Act of 2018 changed the tax home requirement for eligible taxpayers, enabling them to claim the foreign earned income exclusion even if their "abode" is in the United States. The new law applies for tax year 2018 and subsequent years.

This means that these taxpayers, if eligible, will be able to claim the foreign earned income exclusion on their income tax return for 2018 when they file. Under the exclusion, taxpayers can choose to exclude their foreign earned income from gross income, up to a certain dollar amount. For tax year 2019, that dollar amount limit is $105,900.

The foreign earned income exclusion is not automatic. Eligible taxpayers must file a U.S. income tax return each year with completed Form 2555 (Form 2555-EZ has been discontinued) attached.

Foreign earned income is the income a taxpayer receives for performing personal services in a foreign country or countries during a period in which he or she meets both of the following requirements:

- His or her tax home is in a foreign country, and the individual
  - Meets the bona fide residence testor
  - The physical presence test – present for 330 full days during any period of 12 consecutive months. A period can include parts of two calendar years and periods can overlap.

Under prior law, many otherwise eligible taxpayers who lived and worked in designated combat zones failed to qualify because they had an abode in the United States. The new law makes it clear that contractors or employees of contractors providing support to U.S. Armed Forces in designated combat zones are eligible to claim the foreign earned income exclusion if they otherwise qualify.

The rule that the foreign earned income exclusion is not available to federal employees or members of the military is unchanged by this law revision (see pages 13 and 14 of the 2018 Pub 54).

6.03 FOREIGN EARNED INCOME EXCLUSION

U.S. citizens or resident aliens of the United States who live abroad are taxed on their worldwide income. However, they may qualify under IRC § 911 to exclude from income foreign earnings not to exceed an annual maximum amount. In addition, taxpayers may be able to exclude or deduct certain foreign housing cost amounts.

- To qualify for this exclusion, a taxpayer must:
  - Have foreign earned income,
  - Have a "tax home" in a foreign country, and be one of the following:
    a. A U.S. citizen who is a ***bona fide resident*** of a foreign country for an uninterrupted period that includes an ***entire tax year***, or
    b. A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a ***bona fide resident*** of a foreign country or countries for an uninterrupted period that includes an ***entire tax year***, or

c. A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least ***330 full days during any period of 12 consecutive months***.

Bona Fide Residence **-** Determine bona fide residence based on facts of each individual case. The IRS considers intent and nature of the trip and its length. The Tax Court has adopted a general set of factors, which are frequently used to help determine bona fide residency:

- Intention as to the duration of the foreign residence;
- Assimilation into the foreign country;
- Payment of foreign taxes;
- Status as resident of the foreign country;
- Establishment of a foreign home;
- Nature and extent of absences from the foreign country;
- Employer's view of taxpayer's status;
- Location of family;
- Good faith intentions of the taxpayer;
- Nontransient nature of stay in the foreign country.

The taxpayer must reside in a foreign country for **an uninterrupted period that includes an entire tax year**. However, once the taxpayer has met the uninterrupted period qualification, he/she will qualify as a bona fide resident for the period starting with the date actual residence began and ending with the date of abandonment of the foreign residence. Temporary trips to the U.S. are acceptable.

Physical Presence Test - Taxpayer must be physically present in a foreign country *330 full days (a day being defined as a 24-hour period which begins at midnight, not counting time over international waters) during a consecutive 12-month period*.

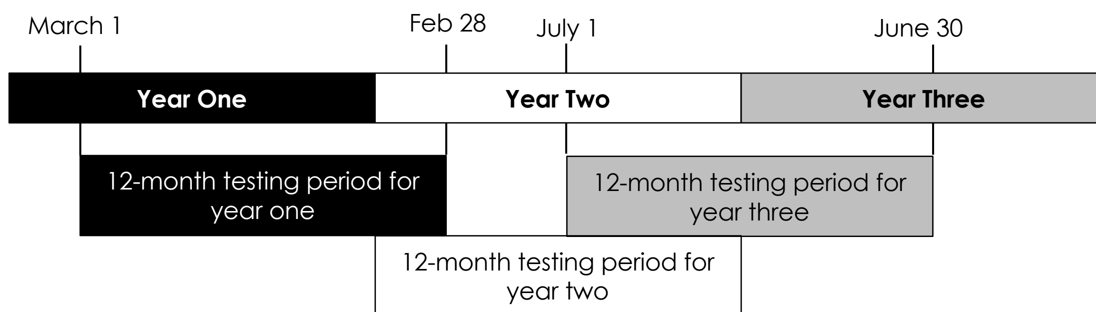
> ***Example:*** *Flying Hi left the U.S. on June 10, arriving in France at 9:00 a.m. on June 11. Hi's first full day in France is June 12.*

The 12-month period can start with any day of any calendar month, ending the day before the same calendar day 12 months later.

Waiver of Minimum Time Requirements - Minimum time requirement for both bona fide residence test and the physical presence test can be waived if a taxpayer must leave the foreign country due to war, civil unrest, or other adverse conditions. In the first quarter of each year the IRS provides a list of affected countries for the prior tax year and only countries included on that list qualify.

> **NOTE:** Meeting the requirements of bona fide resident can be difficult, and most often taxpayers will qualify under physical presence test. Below is an example of how the physical presence test will apply to a partial year.

Example: Taxpayers physical presence in a foreign country began on March 1, year #1 and continued through June 30, year #3.



Year One: Since the taxpayer cannot meet the bona fide resident requirement of one year of uninterrupted residence in the foreign country, the physical presence test must be used. Thus, in our example, for year one the testing period began on March 1 of year one and ends on February 28 of year 2. Therefore, the annual exclusion must be prorated for the partial year. Since the taxpayer was physically present in the foreign country for 306 days out of 12 months (365 days), the annual exclusion amount is prorated and the taxpayer only qualifies for 83.84% (306/365) of the exclusion amount provided the taxpayer meets the 330 days requirement.

Year Two: Since the taxpayer was physically present in the foreign country for the entire year, he or she gets the benefit of the full amount of the annual exclusion amount provided the taxpayer meets the 330 days requirement. If the taxpayer qualifies as a bona fide resident, he or she does not have to meet the 330-day requirement.

Year Three: Like year one, the taxpayer was not present for the full calendar year and must use the physical presence test and prorate the exclusion. In this case we use the 12-month period ending on the final full day of presence in the foreign country. In our example the taxpayer's last full day in the foreign country was June 30 of year 3. Thus, to establish the 12-month testing period we must look back 12 months and the testing period becomes July 1 of year 2 through June 30 of year 3. January 1 through June 30 of year 3 is 181 days so the taxpayer only qualifies for 49.59% (181/365) of the annual exclusion amount assuming the taxpayer meets the 330 days requirement.

Source of Earned income – Earned income subject to the exclusion can be from a foreign or domestic company and includes salaries, wages, commissions, bonuses, professional fees and tips. Earned income also includes allowances or reimbursements for cost of living, overseas differential, family, education, home leave, quarters, and certain moving expenses. Income received for work in a foreign country, is considered as from a foreign source, even if it is paid by an employer located in the U.S.

Foreign earned income doesn't include:

- any amounts paid by the U.S. government or its agencies to its employees.
- Previously excluded value of meals and lodging furnished for the convenience of the taxpayer's employer.
- Pension or annuity payments, including social security benefits.
- Amounts included in a taxpayer's income because of an employer's contributions to a nonexempt employee trust or to a nonqualified annuity contract.
- Recaptured unallowable moving expenses.
- Payments received after the end of the tax year following the tax year in which the services were performed to earn the income.

Exclusion Limits - The following is a table of the annual limits for this exclusion for recent years.

EXCLUSION LIMITS			
Tax Year	**2018**	**2019**	**2020**
Maximum Exclusion	103,900	105,900	107,600
Housing Daily Base Amount	45.55	46.42	47.04[1]
Housing Annual Base	16,624	16,944	17,216
Housing 30% Cap [1]	31,170	31,770	32,280
Max Housing Exclusion [3]	14,546	14,826	15,064
High Cost Area Listings – Notice #[2]	2018-44	2019-24	

If any amount or Notice number is not shown, it was not available at publication date

The amounts shown (other than the Housing Daily Base Amt.) are for a full year. These amounts must be prorated by the day for taxpayers who only qualify for a partial year.

(1) Leap Year (366 days)

(2) The IRS is authorized to adjust limitations for high cost areas. The Code allows the 30% cap amount to be replaced by higher amounts based on geographic differences in housing costs relative to housing costs in the U.S. Accordingly, Notice 2019-24 identifies locations within countries with high housing costs and provides an adjusted limitation on housing expenses to be used for these localities for tax year 2019.

Tax Home - Tax home is the general area of a taxpayer's main place of work (as employee or self-employed), regardless of where the taxpayer maintains his/her family home. A taxpayer is not considered to have a tax home in a foreign country for any period in which his/her abode is in the U. S. "Abode" has been defined as one's home, habitation, residence, domicile, or place of dwelling. "Abode" has a domestic rather than a vocational meaning and does not mean the same thing as "tax home." The location of abode often depends on where a taxpayer has economic, family, and personal ties.

***Example - Abode vs. Tax Home:** Ima Way is employed on an offshore oil rig in the territorial waters of a foreign country and works a 28-day on/28-day off schedule. She returns to her family home in the United States during off periods. Ima is considered to have an abode in the United States and does not satisfy the tax home test in the foreign country. She cannot claim either of the exclusions or the housing deduction.*

Exception **-** The Bipartisan Budget Act of 2018 changed the tax home requirement for contractors or employees of contractors supporting the U.S. Armed Forces in designated combat zones. This was discussed previously.

Foreign Country - The term foreign country usually means any territory (including the air space and territorial waters) under the sovereignty of a government other than that of the U. S. It doesn't include Puerto Rico, Guam, Commonwealth of the Northern Mariana Islands, Virgin Islands, or U.S. possessions such as American Samoa.

Cuba and Guantanamo Bay – Individuals working in Cuba in violation of U.S. travel restrictions are not eligible to exclude income earned in Cuba, housing expenses incurred in Cuba are not qualified housing expenses, and the time spent in Cuba cannot be used in determining if the bona fide residence or physical presence test is met. However, the IRS stated that the U.S. Naval Base at Guantanamo Bay is not located within a restricted country and that qualified individuals who are performing services at the U.S. Naval Base there are eligible for the income and housing exclusion under Code Sec. 911. *Notice 2006-84, 2006-41 IRB*

Other Exclusions, Deductions or Credits - Taxpayers choosing the foreign earned income exclusion cannot take advantage of any other exclusion, deduction or credit related to the excluded income. This includes any expenses, losses or other items that would have been deductible had the exclusion not been claimed. In addition, taxpayers claiming the exclusion are not eligible for EITC (Sec 32(c)(1)(C)) or the refundable portion of the child tax credit (Sec 24(d)(5)). A taxpayer who excludes foreign earned income from gross income under Sec 911 may not make an IRA contribution based upon the excluded compensation (Prop. Reg. §1.219(a)-1(b)(3)).

Federal Employees – The foreign income exclusion is not available to federal employees or members of the military.

Both Spouses Have Foreign Earnings - If both taxpayer and spouse qualify, each can choose the foreign earned income exclusion. The maximum exclusion applies individually to the earnings of a husband and wife. Ignore any community property laws when figuring the limit on the exclusion. Special rules apply if taxpayer and spouse live apart and maintain separate households. Both may be able to claim the foreign housing exclusion or the foreign housing deduction (discussed later). This can be done if the spouses have different tax homes that are not within reasonable commuting distance of each other. Otherwise, one spouse only can exclude or deduct a housing amount.

Foreign Housing Exclusion or Deduction - When a taxpayer qualifies for the foreign earned income exclusion under either the bona fide residence or physical presence tests, he/she can also claim an exclusion or a deduction *from gross income for housing expenses.*

The ***housing exclusion*** applies only to amounts considered paid for with employer-provided amounts. If a taxpayer has no self-employment income, the entire housing amount is considered paid for with employer-provided amounts.

The ***housing deduction*** applies only to amounts paid for with self-employment earnings. With the exception of higher-cost locations, **the housing amount is the** *total of a taxpayer's housing expenses* **for the year** *minus a base amount***.**

From the table above we find that the annual exclusion for 2019 is $14,826 and the annual housing base is $16,944.

> ***Example:*** *Bill Howser qualified for the foreign earned income exclusion under the physical presence test for all of 2019. During the year, he spent $26,400 for housing. Bill's housing amount is the lesser of the deduction cap of $14,826 or $9,456 ($26,400 less 16,944). Thus, exclusion (if an employee) or deduction (if self-employed) is $9,456.*

Both Self-employed and Employer-provided Amounts **-** If a taxpayer is both an employee and a self-employed individual during the year, deduct part of the housing amount and exclude part of it. To find the part that qualifies as a housing exclusion, multiply the housing amount by the employer-provided amounts and then divide the result by the taxpayer's foreign earned income. The balance of the housing amount can be deducted (but the deduction can't be more than the taxpayer's foreign earned income less the total of: (1) The taxpayer's foreign earned income exclusion, plus (2) His/her housing exclusion, if any).

Housing expenses include - reasonable expenses paid or incurred for housing in a foreign country for taxpayer, spouse and dependents. These include rent, the fair rental value of housing provided in kind by an employer, and other expenses for housing. Other expenses include repairs, utilities (other than telephone charges), real and personal property insurance, nondeductible occupancy taxes, nonrefundable fees for securing a leasehold, rental (but not the purchase) of furniture and accessories, and residential parking.

Housing expenses ***do not*** include expenses that are lavish or extravagant under the circumstances. They also do not include deductible interest and taxes (including deductible interest and taxes of a tenant) or the costs of buying property, including principal payments on a mortgage. Nor do they include the cost of domestic labor (maids, gardeners, etc.), pay television subscriptions, improvements and other expenses.

Form 2555 - Is used to claim the foreign earned income exclusion plus the foreign housing exclusion or deduction, if applicable. The computed exclusion amount is carried from Form 2555 to the other income line of the tax return (draft 2019, line 8, Schedule 1) and entered as a negative amount. The IRS has phased out Form 2555-EZ, which is no longer available for use after 2018.

NOTES

California does not have an equivalent to the Federal foreign income exclusion provision. Residents of California are taxed on ALL income, including income from sources outside California; the key is whether or not the taxpayer is a resident.

A safe harbor is available for certain individuals leaving California under employment-related contracts. The ***safe harbor*** provides that an individual domiciled in California who is ***outside California under an employment-related contract for at least 546 consecutive days (18 months) will be considered a nonresident*** unless:

- The individual has intangible income exceeding $200,000 in any taxable year during which the employment-related contract is in effect; or
- The principal purpose of the absence from California is to avoid personal income tax.

CAUTION: The safe harbor only applies to employment related income. Thus, other non-exempt CA source income would continue to be taxable to CA as a non-resident, except for CA source pension income, which is not taxable to CA when received by a non-resident

Spouse Issues: The spouse of the individual covered by this safe harbor rule will also be considered a nonresident while accompanying the individual outside California for at least 546 consecutive days. Return visits to California that in the aggregate do not exceed 45 days during any taxable year covered by the employment contract are considered temporary. However, if the spouse of the taxpayer who meets the safe harbor rule does not also meet the safe harbor rule (e.g., remains in California), then he or she would continue to be a California resident, and generally 50% of the taxpayer's income would not meet the safe harbor and would be taxable to CA. FTB Pub 1031, page 3 includes examples of this situation filing both jointly and separately.

Individuals not covered by this safe harbor must determine their residency status based on their facts and circumstances. The determination of residency status cannot be solely based on an individual's occupation, business, or vocation. Instead, all activities must be considered in the determination of residency status.

California Residents: Taxpayers, who by the facts and circumstances are determined to be California residents, may be able to deduct away-from-home business related travel expenses (for travel, meals, and lodging) on their California tax return while earning income in a foreign country.

7.04- SALT LIMITATION FINAL REGULATIONS

The IRS has released final regulations related to the SALT limitation imposed by TCJA and the attempts by various states, most notably NY, NJ and CT, to skirt the $10,000 ($5,000 MFS) limitation on the deductibility of state and local taxes. The technique these states attempted to use to get around the limitation was by offering their residents the ability to make a charitable contribution in return for a credit against their state or local taxes, thus converting a limited tax deduction into a fully deductible charitable contribution.

Background for the IRS' Position:

- Section 170(a)(1) generally allows an itemized deduction for any "charitable contribution" paid within the taxable year to a qualified charity which, under Section 170(c), includes a State, a possession of the United States, or any political subdivision of the foregoing, including the District of Columbia.
- Section 164(a) allows a deduction for the payment of certain taxes, including state and local, and foreign, real property taxes, and state and local income or sales taxes and personal property taxes.
- TCJA limited, for years 2018 through 2025, the itemized deduction for state and local taxes to $10,000 ($5,000 MFS) and does not allow a deduction for foreign real estate taxes.
- In 1986 the Supreme Court held that where the taxpayer receives something in return (quid pro quo) for a contribution, the contribution was not tax deductible.

The IRS proposed regulations in August 2018 that generally require a taxpayer that makes a payment or transfers property to or for the use of an entity described in Sec 170(c) for which the taxpayer receives or expects to receive a state or local tax credit in return for such payment, to reduce their charitable contribution deduction by the credit amount because the arrangement created a quid pro quo benefit. However, if the taxpayer received a state and local tax deduction instead of a credit, this would not be a quid pro quo unless the deduction exceeded the amount of the donor's payment or transfer.

The proposed regs also included the following de minimis exception: a state or local tax credit is not treated as a quid pro quo if the credit does not exceed 15% of the taxpayer's payment or 15% of the fair market value of the property transferred by the taxpayer.

The final regulations 1.170A-1(h)(3), released in June 2019, generally follow the proposed regulations. However, regarding the 15% exception the final regulations added that it applies only if the sum of the taxpayer's state and local tax credits received, or expected to be received, does not exceed 15% of the taxpayer's payment or 15% of the fair market value of the property transferred by the taxpayer.

In the preamble to the final regulations, the Treasury and the IRS indicated their concern that the regulations could create unfair consequences for some individuals who itemize their deductions and made a charitable contribution in return for tax credits. Consequently, simultaneously with releasing the final regs, the IRS published Notice 2019-12 saying they intend to publish a proposed regulation amending Treasury Regulation § 1.164-3 to provide a safe harbor for certain individuals who make a charitable contribution in return for tax credits. Under the safe harbor, an individual may treat as a payment of state or local taxes for purposes of Sec. 164 the portion of a payment for which a charitable contribution deduction is or will be disallowed under Regs. Sec. 1.170A-1(h)(3). To qualify for the safe harbor, taxpayers must itemize deductions for federal tax purposes and their total state and local tax liability for the year must be less than $10,000. Until the proposed regulations are issued, taxpayers may rely on Notice 2019-12.

The following examples are based on those in Notice 2019-12.

> **Example #1** – The taxpayer makes a payment of $500 to a local or state-run charity and receives a dollar-for-dollar credit against the taxpayer's state income tax credit. The taxpayer's state tax liability is $500 or more. For federal purposes the $500 contribution can be treated as a tax payment subject to the $10,000 SALT limitation.
>
> **Example #2** – The taxpayer makes a payment of $7,000 to a local or state-run charity and receives a dollar-for-dollar credit against the taxpayer's state income tax. Under state law the credit may be carried forward for three taxable years. The taxpayer's state tax liability for year 1 is $5,000. The taxpayer applies $5,000 of the credit against the year 1 state tax liability and carries the balance forward to year 2 where it is used against the taxpayer's year 2 state tax liability. The taxpayer's year 2 state tax liability exceeds $2,000. For federal purposes the contribution is treated as a tax payment, with the $5,000 treated as a year 1 tax deduction and the $2,000 treated as a year 2 tax deduction. Both the $5,000 and $2,000 are subject to the $10,000 SALT limitation.
>
> **Example #3** – The taxpayer makes a payment of $7,000 to a local or state-run charity. In return for the contribution, the taxpayer receives a real property tax credit of $1,750, which is 25% of the contribution, and applies it to his $3,500 property tax bill. For federal purposes the $1,750 is treated as a property tax payment subject to the $10,000 SALT limitation. The balance of the contribution, $5,250, can be deducted as a charitable contribution.

7.05 HOME ACQUISITION DEBT - Code Sec. 163(h)(3)(B)

Home acquisition debt is debt incurred to purchase, construct or substantially improve a taxpayer's principal home or second home. It must be secured by the home(s). *Combined home acquisition debt on the two homes can't be more than:*

- ***For Debt Incurred Before 12/16/17:*** *$1,000,000 ($500,000 for married separate).*
- ***For Debt Incurred After 12/15/2017:*** *$750,000 ($375,000 for married separate)* (IRC Sec 163(h)(3)(F)(i)(II)).

Commentary: *The TCJA did not change the rule that interest on acquisition debt of the taxpayer's primary and a second residence is deductible. What changed was the lowered cap on the amount of acquisition debt for debt incurred after December 15, 2017.*

Example #1 - *In January 2019, Jim and Donna, who file a joint return, take out a $500,000 mortgage to purchase a main home. The loan is secured by the main home. In February 2019, they take out a $500,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages exceeds $750,000, only 75% of the total interest paid is deductible.*

Pre-Dec. 15, 2017 Binding Contract Exception - Taxpayers who entered into a binding written contract before Dec. 15, 2017 to close on the purchase of a principal residence before January 1, 2018, and who purchase such residence before April 1, 2018 are not subject to the $750,000/$375,000 limitations and instead are subject to the $1,000,000/$500,000 limitations. *(IRC Sec 163(h)(3)(F)(i)(IV) as amended by TCJA §11043*

Does the Acquisition Debt Limit Apply to Residence or Individual Co-Owners?

The Ninth Circuit Court of Appeals reversed an earlier Tax Court's decision and the IRS has announced its acquiescence with the Ninth Circuit's decision. Under this interpretation, unmarried co-owners are collectively limited to a deduction for interest paid on a maximum of $2.2 million, rather than $1.1 million, of acquisition and home equity indebtedness (Voss - IRB 2016-31, p. 193). This can have significant implications for unmarried co-owners of a home.

It is presumed this will also apply to the new $750,000 acquisition debt limit.

But consider the results if the unmarried co-owners get married. The limits revert to the $1M/$750K amounts.

HELOCs Can Be Home Acquisition Debt - Home equity lines of credit (HELOCs) can be home acquisition debt. The tax definition of home acquisition debt is debt used to acquire, construct or substantially improve the taxpayer's home or second home. Just because the lender's title is equity debt does not preclude a HELOC from qualifying as home acquisition debt.

Spousal Buy-Out Debt **- *Notice 88-74, 1988-2 CB 385*** states that, in divorce situations, secured debt incurred to buy out a former spouse's interest in a home is acquisition debt. This rule is applied without regard to Code Section 1041, which treats certain transfers of property between spouses incident to divorce as nontaxable events.

Secured Debt **-** A secured debt has three characteristics for purposes of the home mortgage interest rules:

1. It makes the taxpayer's interest in the home specific security for the loan;
2. If the taxpayer defaults on the loan, the home would provide satisfaction for the debt, as with a mortgage or deed of trust;
3. The debt must be recorded according to the applicable state law.

Refinancing Acquisition Debt - Prior to TCJA, taxpayers could refinance acquisition debt for the amount of the amortized balance with an unlimited extended term for the refinanced loan.

Pre-TCJA – Example #2 - After 15 years, an original 30-year term acquisition debt of $200,000 has an assumed amortized balance of $150,000. Under law prior to TCJA, a homeowner could refinance that loan for $150,000 for any number of additional years and the debt continued to be acquisition debt.

Under TCJA, the $1,000,000/$500,000 limits continue to apply to refinances of acquisition debt incurred before 12/16/2017. However, TCJA only allows the refinanced acquisition debt to be treated as acquisition debt for the remainder of time left under the terms of the original loan (see exception below).

The following table illustrates three situations where a pre-12/16/2017 loan was refinanced after 12/15/17 with some of the proceeds from the refinanced loans being used to make substantial home improvements.

	Original Loan Balance @ Refi	Refinanced Loan Amount	Refi Proceeds Used for Substantial Improvements	Amount Treated as Acquisition Debt	Amount not Acquisition Debt* (interest not deductible on this amt.)
Case #1	$800,000	$900,000	$100,000	$800,000	$100,000
Case #2	$700,000	$800,000	$100,000	$750,000	$50,000
Case #3	$600,000	$700,000	$100,000	$700,000	$0

*Because the acquisition debt limit was exceeded

Post-TCJA – Example #3 - After 20 years, an original 30-year term acquisition debt of $200,000 has an assumed amortized balance of $100,000. The homeowner refinances the original loan for a new one with a balance of $150,000 and a term of 20 years. $50,000 of the new loan is used to make substantial improvements to the home. Because of TCJA's limits on loan terms, the refinanced loan will only be treated as acquisition debt for the first 10 years (30 years – 20 years), while the interest on the $50,000 portion of the refinanced loan will be deductible for the entire term of the new loan.

If the principal of the original indebtedness was not amortized over its term, the loan's acquisition debt would continue to be treated as acquisition debt through the expiration of the term of the first refinancing of the indebtedness (or if earlier, the date that is 30 years after the date of the first refinancing). *(Code Sec. 163(h)(3)(F)(iii)(II)) as amended by TCJA §11043).*

Commentary: Where a home acquisition debt is refinanced for an amount more than the current amortized balance of the loan it will result in a loan that is part acquisition debt and part equity debt. When this occurs, you basically treat the debt as two loans, one being acquisition debt and the other equity debt. The interest is allocated, proportionally between the two debts, per Reg. Sec. 1.163-8T interest allocation rules, resulting in deductible acquisition debt interest and equity debt interest. See page 34 – Interest Tracing Rules.

Example #4 – Post-2017 Refinance: *Married taxpayers have an acquisition debt loan with a balance of $175,000. They refinance that loan for $400,000 and do not use any of the proceeds to make improvements to the home. As a result, the taxpayers have a mixed debt loan consisting of:*

Home Acquisition Debt…. $175,000
Home Equity Debt………….. 225,000
Total Refinanced Debt……$400,000

The interest on the $175,000 portion of the debt is deductible as home acquisition debt interest. The balance of the refinanced debt, $225,000, is excess debt and the interest on this portion of the loan is deductible only if its use can be traced to another deductible use.

Increasing Acquisition Debt – If a home mortgage debt is refinanced, to the extent the new debt replaces the prior acquisition debt and any additional loan proceeds are used to substantially improve the residence, the new debt continues to be home acquisition debt so long as the $1 Million/$750,000 acquisition debt limits are not exceeded.

Refinanced Debt Loan Term – If the term of home acquisition debt is extended beyond its original term, the following rules apply:

- *Refinanced before December 16, 2017* – Where a home acquisition debt was refinanced **before** December 16, 2017, the loan continues to be home acquisition debt for the term of the refinanced loan.

  Example #6: *In 2015, the taxpayer refinanced his home acquisition loan, which at the time had an unpaid balance of $835,000 and was amortized over a 25-year period ending in 2030. The new loan is amortized over a 30-year period ending in 2045. The interest on the loan continues to be qualified home mortgage interest until the loan is paid off in 2045.*

- _Refinanced after December 15, 2017_ - Where a home acquisition debt was refinanced **after** December 15, 2017, the loan only continues to be home acquisition debt for the term of the original loan.

  Example #7: *In 2019, the taxpayer refinanced his home acquisition loan, which at the time had an unpaid balance of $835,000 and was amortized over a 25-year period ending in 2030. The new loan is amortized over a 30-year period ending in 2049. However, the interest on the loan only continues to be qualified home mortgage interest until 2030, the date the original refinanced loan would have been paid off.*

Home Equity Debt - *Code Sec. 163(h)(3)(C)*

For Years Before 2018 - *Home equity interest was deductible for debt secured by a taxpayer's principal or second home. The total equity debt on the TWO HOMES couldn't be more than:*

- ***$100,000*** ($50,000 for married separate - Code Sec. 163(h)(3)(C)(ii)), or
- The difference between the acquisition debt on the home and the FMV of the home, if smaller.
- *Home equity debt was NOT deductible against the AMT.*

For years 2018 through 2025 - The deduction for home equity debt interest is suspended. This applies to both primary and second homes and includes home equity debt incurred prior to TCJA. _(IRC Sec 163(h)(3)(F)(i)(I)_

> ***Commentary:*** *This law change can have an adverse impact on individuals who used their home as a piggy bank for personal expense purposes. Where the home loans have been refinanced and are partially acquisition debt and partially equity debt, tax preparers will still have to determine what part of the interest is attributable to the acquisition portion of the loan and which part is attributable to the now non-deductible equity portion.*
>
> ***Commentary****: HERO (aka PACE) program loans are loans secured by the home via a property tax lien. The loans finance substantial energy-related improvements to the home and as such are acquisition debt, and thus the interest is acquisition debt interest, which continues to be deductible under TCJA up to the $1 Million/$750K acquisition debt limits.*

Determining & Tracing Excess Debt Secured By the Home - Interest on debt secured by the home must first be allocated to the home to the extent permitted, and any excess can be allocated to the use of the funds per the general tracing rules of Reg §1.163-8T (See page 34 - Interest Tracing). Per the tracing rules, where the use of the loan funds can be traced to another purpose, the interest on the excess debt can be allocated to that use.

> ***Example #8 – Allocating Refinanced Debt -*** *The original purchase money loan was refinanced with an average balance for the year of $300,000. The acquisition debt had declined to $150,000 at the time of the refinance and the interest on the refinanced debt was $10,000 for the year. The interest would be allocated as follows:*

Allocation	***Debt***	***% of Total***	***Interest***
1. Total Home Debt	*$ 300,000*	*100.00%*	*$10,000*
2. Allowable Acquisition Debt	*<150,000>*	*50.00%*	*$ 5,000*
3. Excess Debt	*$ 150,000*	*50.00%*	*$ 5,000*

The excess generally will not be deductible unless some portion of the loan proceeds could be traced to another tax-deductible purpose. If so, to the extent the proceeds can be traced to that other purpose, the excess can be allocated in accordance with the general interest tracing rule (See chapter 2.15). To illustrate how the interest on the excess debt might be allocated, consider the following situations:

***Example 8(a)** – **Proceeds Used for Business** - Because the taxpayer could obtain a lower interest rate on a home loan, he refinanced his home loan to obtain the $150,000 needed to finance the startup of a Schedule C business. Since the entire debt is secured by the home, the interest on the refinanced debt must first be allocated to home acquisition and home equity debt. And, since for years 2018 through 2025 equity interest is not deductible as home mortgage interest, the traceable excess debt is $150,000 ($300,000 - $150,000) and can be traced to the taxpayer's Schedule C business.*

***Example 8(b)** – **Proceeds Used for Mixed Uses –** Assume the taxpayer in example #8(a) used the additional $150,000 proceeds for the following purposes: $35,000 as a down payment on a rental property, $25,000 for his child's college tuition, $50,000 for a new car, and the balance-placed in a savings account. The taxpayer could choose to allocate the excess debt of $150,000 in any manner he chooses (Reg §1.163-10T(e)(4)(iii)) between the rental, higher education or investment purposes to maximize his interest deduction; he needs to keep in mind the passive loss, AGI and net investment income limitations that could also further limit the allocated interest deduction**. Caution:** In this scenario, none of the amount allocated to higher education loan interest is deductible because mixed-use loans are not qualified as education loans. (Reg § 1.221-1(e)(4), EX (6)*

<u>Any Reasonable Method OK In Determining Excess Debt</u> **-** Although the current law limiting the deduction of mortgage interest has been on the books since enactment of the Tax Reform Act of 1986, as amended by the 1987 Omnibus Budget Reconciliation Act, the proposed and temporary regulations issued in 1987 became effective before the OBRA amendment and have not been updated since. According to the IRS in a Chief Counsel Advice, until regulations are issued, taxpayers may use any reasonable method of allocating debt in excess of the acquisition and/or home equity debt limitation. This includes methods described in Reg. § 1.163-10T

Also, using any of these methods does not require making the debt-not-secured-by-residence election of Reg. § 1.163-10T(o)(5), but if the "not secured by" election is made, it applies to the entire amount of the debt, not just a part. When the election isn't made, only the part of the debt in excess of the limitation is traced to how the debt proceeds are used. *(CCA 201201017)*

California conforms to the Federal treatment of home mortgage interest, except that:

(1) California has not conformed to the TCJA reduction in the acquisition debt limit to $750,000 and continues to follow the pre-TCJA acquisition debt limit of $1 Million.
(2) California has not conformed to the TCJA disallowance of equity interest and continues to follow the pre-TCJA rules allowing equity interest deduction on the first $100,000 of equity debt on the taxpayer's first and second homes.
(3) California does not have a mortgage interest credit (MIC). The amount of mortgage interest that is required to be reduced on the federal return when the MIC is claimed is deductible for state purposes. Restore the amount on Schedule CA.
(4) Mortgage insurance premiums are not deductible for California.

7.05 ACQUISITION DEBT – TIMING

When must a home purchase, construction cost or home improvement expenditures be made in order for a loan to be treated as acquisition debt?

The answer can be found In Notice 88-74 and here is what the Notice has to say on the issue:

1. **Acquisition** - In the case of the acquisition of a residence, debt may be treated as incurred to acquire the residence to the extent of expenditures to acquire the residence made within 90 days before or after the date that the debt is incurred.

Construction or Substantial Improvement - In the case of the construction or substantial improvement of a residence, debt incurred prior to the time the residence or improvement is complete may be treated as being incurred to construct or improve the residence to the extent of any expenditures to construct or improve the residence which are made no more than 24 months prior to the date that the debt is incurred. Debt incurred after the residence or improvement is complete, but no later than the date 90 days after such date, may be treated as being incurred to construct or improve the residence to the extent of any expenditures to construct or improve the

residence which are made within the period beginning 24 months prior to the date the residence or improvement is complete and ending on the date the debt is incurred.

The Notice goes on to say regulations will be issued, but that has never happened. Notices can be relied on and cited as precedent by taxpayers. IRS is bound to what it says in an announcement or notice to the extent it would be with a Revenue Ruling or Revenue Procedure.

California conforms to the provisions of Notice 88-74 and the timing of home purchase, construction cost or home improvement expenditures.

7.11 - DISASTER LOSSES

An itemized deduction for personal casualty losses is limited in years 2018 through 2025 to losses attributable to federally declared disasters, although a taxpayer may still claim personal casualty losses not attributable to federally declared disasters to the extent of personal casualty gains during this period.

Federally Declared Disaster – This is a disaster that occurred in an area declared by the President to be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. A list of the designated areas is available on the Federal Emergency Management Agency (FEMA) web site: *www.fema.gov*. Taxpayers in these areas are eligible for special tax breaks as well as non-tax related assistance.

Per Event & AGI limitations

1. Reduce the casualty amount by $100 for each event (Note: this amount is frequently increased by special legislation for major disasters).
2. After combining all personal casualty occurrences for the year, reduce the total by 10% of adjusted gross income (Note: this is frequently reduced to zero by special legislation for major disasters).

Election to Claim the Disaster Loss on Preceding Year's Return - The election must be made in writing no later than six months after the due date of the taxpayer's federal income tax return for the disaster year, without regard to any extension of time to file ((Reg Sec. 1.165-11T(f)); Rev Proc 2016-53).

Example: *A Federally-declared disaster occurred in Year 2. A calendar-year taxpayer who incurred a loss in that disaster can claim their casualty loss on either their Year 2 return or their Year 1 return. If the prior year (Year 1) return has already been filed, it can be amended by filing a Form 1040X. Either the original or amended prior year return must be filed no later than 6 months after the original due date of the Year 2 return. Thus, the due date will usually be October 15 of Year 3.*

An election statement indicating the taxpayer is making a §165(i) election must be included with the original or amended return. The election statement must contain the following information:

(1) The name or a description of the disaster and date or dates of the disaster which gave rise to the loss.

(2) The address, including the city, town, county, parish, State, and zip code, where the damaged or destroyed property was located at the time of the disaster.

For an election made on an original federal tax return, a taxpayer must provide the above information on Lines 1 or 19 (as applicable) of Form 4684. A taxpayer filing an original return electronically may attach a statement as a PDF document if there is insufficient space on Lines 1 or 19 of the Form 4684 to provide the required information.

For an election made on an amended return, a taxpayer may provide the information required by any reasonable means, such as writing the name or a description of the disaster, the State in which the damaged or destroyed property was located at the time of the disaster, and "Section 165(i) Election" on the top of the Form 4684 and providing the rest of the information as required in (1) and (2) above in either the Explanation of Changes on Form 1040X, or directly on the Form 4684, attaching a statement if there is insufficient room on the form.

Home Destroyed - When a home is destroyed in a casualty the outcome can be quite different than expected by taxpayers. The reason being that their loss is measured from the **lesser** of the home's adjusted basis or the FMV at the time of the loss. Since real property generally appreciates in value, for tax purposes a home that's destroyed will generally result in a casualty gain as opposed to a casualty loss once insurance payment is considered. However, the gain can be excluded under Sec 121 (home sale gain exclusion) if the taxpayer qualifies and any remaining gain (up to the basis of a replacement home acquired generally within 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized) can be deferred under the involuntary conversion rules of Sec 1033. This is best explained by example.

Example – A wildfire in a disaster area destroys Phil's home which had an adjusted basis of $125,000. Phil is single and has owned and used the home for over 10 years before it was destroyed. Phil's insurance company pays Phil $400,000 for the house. A tax loss is different from a financial loss in that a tax loss is measured from the **lesser** of the home's adjusted basis or the FMV at the time of the loss. So, in this case Phil does not have a tax loss, he has a gain.

The destruction of Phil's home is treated as a sale for tax purposes and since Phil meets the 2 out of 5 years ownership and use tests, the Sec 121 gain exclusion will apply. In addition, any gain in excess of the amount excluded can be deferred under Sec 1033. Here is how it all plays out for Phil…

Insurance company payment	$400,000
Phil's adjusted basis in the home	<125,000>
Realized Gain	275,000
Sec 121 Gain Exclusion	<250,000>*
Remaining Gain	25,000
Phil **elects** to defer gain into replacement	<25,000>**
Net taxable gain	0

* Since the casualty was treated as a sale, presumably Phil would be qualified for another $250,000 Sec 121 exclusion after owning and using the replacement property for two years.

** This amount reduces the basis of Phil's replacement home. This is an election and Phil could instead choose to pay the tax on the gain instead of deferring it. In addition, the deferral cannot reduce the basis of the replacement property below zero; thus, any amount not deferred would be taxable. See involuntary conversions – next.

Involuntary conversions - No gain is recognized when property is compulsorily or involuntarily converted into property similar or related in service or use. Where property is involuntarily converted into money or into property that isn't similar or related in service or use, a taxpayer can defer tax on any gain, if he so elects and he buys property that's similar or related in service or use. The cost of the replacement property must be equal to or more than the net proceeds from the converted property, and the replacement must generally be made within two years after the close of the first tax year in which any part of the gain is realized (IRC Sec. 1033(a)(1)). Gain is recognized only to the extent the amount realized on the conversion exceeds the cost of the replacement property (Code Sec. 1033(a)(2)(A)). The basis of the converted property carries over to the replacement property. (Code Sec 1033(b)(1))

Principal Residence & Contents - Special rules apply regarding a taxpayer's principal residence, or any of the residence's contents, that is compulsorily or involuntarily converted because of a disaster, and extend the replacement period to four years after the close of the first taxable year in which any part of the gain on the involuntary conversion is realized.

Debris Removal & Demolition Expenses - Generally, deductions are not allowed for the costs of demolishing structures, and the costs are, instead, charged to the capital account of the underlying land. The treatment of the cost of debris removal depends on the nature of the costs incurred. Sometimes the cost of debris removal is an ordinary and necessary business expense which is deductible in the year paid or incurred. However, if the debris removal costs are in the nature of replacement of part of the property that was damaged, the costs are capitalized and added to the taxpayer's basis in the property.

Reimbursement for living expenses - An exclusion from gross income is allowed for insurance proceeds received for the temporary increase in living expenses due to a casualty loss of a principal home. The exclusion amount is limited to the increased "actual", reasonable and necessary living expenses as compared to the "normal" living expenses that would be incurred by the taxpayer to maintain his/her customary living standard during the loss period. Living expenses include temporary housing, utilities, meals, transportation and miscellaneous items like laundry, etc. For this purpose, mortgage interest is not considered a living expense.

Example - Reimbursement of Living Expenses - *When fire damaged their home, Greg and Gretchen moved to a motel for a short time, then moved to a rented house. They stayed at the rental for about one month while they were having their home repaired. They incurred the following expenses during this period, compared to their normal household expenditures:*

Description of Expense	Actual Expense	Normal Expense	Taxable Difference
Rent	900	0	900
Motel Costs	1,000	0	1,000
Food	800	500	300
Laundry	50	20	30
Utilities	0	75	-75
Transportation	240	420	-180
TOTAL	**$2,990**	**$1,015**	**$1,975**

Greg and Gretchen received $2,990 in reimbursement from the insurance company. Of that amount, $1,015 is excludable from their income and $1,975 is taxable.

Note: The cost of living expenses incurred as the result of a casualty loss are not included in the deduction for a casualty loss. However, when the taxpayer receives reimbursement from their insurance company, the reimbursement is excludable to the extent that it covers increased "actual", reasonable and necessary living expenses as compared to the "normal" living expenses that would be incurred by the taxpayer to maintain his/her customary living standard during the loss period.

Forced Relocation or Demolition – Taxpayers who are forced to relocate or demolish a residence (not necessarily a principal residence), which is in a disaster area, may claim a casualty for the property, regardless of whether a casualty occurred to the residence, if the:

1. Area was declared a Federal disaster area,
2. Taxpayer was ordered by state or local officials to demolish or relocate the residence,

3. Order was made no later than 120 days after the date of the President's disaster declaration, and
4. Residence was determined to be unsafe because of (as a "proximate result of") surrounding conditions *(Sec 165(k))*.

<u>*Insurance Proceeds*</u> **-** A taxpayer whose principal residence (or its contents) is damaged in a disaster can qualify for special tax treatment regarding certain insurance proceeds received as a result of the casualty. To qualify, the locale of the residence must be in a Presidential-declared disaster area.

- **Personal Property** - The rules stipulate that no gain is recognized on the receipt of insurance proceeds for personal property that was part of the residence's contents, if such property was not scheduled under the insurance policy (scheduled property is property such as jewelry which is covered by a rider under the insurance policy).
- **Common Pool of Funds** - Other insurance proceeds received for the residence or its contents may be treated as a common pool of funds. If those funds are used to purchase property similar to the property lost, a taxpayer will need to recognize the gain only to the extent that the pool is more than the cost of the replacement property.

The replacement period for the damaged or lost property is extended to four years after the close of the first taxable year in which any part of the gain on the involuntary conversion is realized.

These rules are extended to renters as well. Renters who receive insurance proceeds related to disaster damage to their property in a rented principal residence also qualify for the disaster loss relief.

Rev Rul 95-22, 1995-12 IRB explains when gain doesn't have to be recognized on the receipt of insurance proceeds for the destruction of a principal home (or contents) in a disaster area. The ruling clarifies that gain recognition is avoided if the proceeds received for the residence and scheduled property are reinvested in a replacement residence and/or any kind of replacement contents, whether separately scheduled or not.

Example: *Earl's home and its contents were destroyed in an earthquake. The contents included furniture and appliances (not "scheduled" separately for insurance purposes). Also destroyed was jewelry and sterling silverware which were each separately scheduled for insurance purposes. Earl's adjusted bases at the time of the loss were: $250,000 – residence, $5,000 – jewelry and $2,000 – silverware. Earl has insufficient records to establish the cost basis for most of the general household items.*
Earl got the following from his insurance company as a result of his loss:

Loss on home	*$300,000*
Jewelry, silverware	*10,000*
Furniture & unscheduled property	*35,000*
Total	*$345,000*

In the following year, Earl spent the following:

Rebuild home	*$300,000*
Home furnishings, etc.	*40,000*
A painting hung in living room	*10,000**
Total	*$350,000*

**(scheduled prop. for insurance purposes)*

Earl didn't replace the jewelry and silver. Because of the IRS ruling, Earl recognizes no gain on the conversion of the furniture and unscheduled contents; this is true regardless of whether he bought any replacement property. Earl can defer gain recognition on the $310,000 (the common pool of funds) he received as reimbursement for loss of the home, jewelry and silver. This is due to the fact that he spent $350,000 to rebuild and refurnish the home and this exceeds $310,000.

Determining FMV **-** A qualified appraiser should be used to determine FMV of real property and scheduled personal property. The appraisal should cite values just before and after the casualty. In a disaster, it may be difficult to get an appraiser to "commit" to FMV until prices stabilize. Absent an appraisal, a possible alternative may be to get the written opinion of a real estate broker.

The question how to value trees, plants, etc., often comes up in casualty situations. For example, to value a mature tree, appraisers will often use historical data and estimate the overall loss of FMV in the property. A landscape firm could perhaps determine the cost of bringing landscaping back to its original state--this is a case where cost of repair work may be a good indicator of the amount of loss.

- **Use of estimates of repair** - Where the taxpayer relies on the cost of repairs, and not a competent appraisal, to measure the amount of a casualty loss, the repairs and associated expenditures must actually be made (*Abrams, Paul, (1981) TC Memo 1981-231)*. Thus, a taxpayer couldn't use the estimated costs of repairs where no repairs were in fact made (*Farber, Jack, (1972) 57 TC 714)* or where taxpayer did part of the repair work himself and had a contractor do some of the work (*Wheeler, Elvin, (1984) TC Memo 1984-42)*. If the taxpayer doesn't intend to have the repairs done, he should get a competent appraisal of the property which shows the decline in the value of the property as a result of the casualty. However, see "Safe harbor methods" below for situations where estimates of repairs will suffice.

  But, where a taxpayer uses a competent appraiser to establish the decrease in fair market value of the property resulting from the casualty, the appraiser is entitled to take into account the probable costs of repairing the damaged property, even though the repairs to the property are not, in fact, ever actually made. In computing the probable cost of repairs, however, the cost of repair immediately after the casualty is the relevant figure.

- **Safe Harbor Methods** – The IRS recognizes that taxpayers often have difficulty determining casualty losses based on the decline in fair market value which has frequently resulted in time-consuming and expensive litigation. So to provide certainty to both taxpayers and the IRS, in Rev Proc 2018-08, effective December 13, 2017, the IRS provides safe harbor methods, that a taxpayer may choose to use in determining the decrease in FMV of personal-use residential real property (which we sometimes shorten to "residence" in this discussion) and for personal belongings in lieu of the actual reduction in FMV.

CAUTION: Rev. Proc. 2018-8 can be quite misleading. The "purpose," part of the Rev. Proc. leads the reader to believe that the Rev. Proc. provides an alternate and more taxpayer-beneficial way of determining a casualty loss. The problem is the purpose of the Rev. Proc. is to provide safe harbors to determine fair market value of a property for casualty loss purposes, **NOT** the casualty loss itself. A casualty loss is still the lesser of the adjusted cost basis or the fair market value on the date of the casualty reduced by any insurance reimbursement.

- ***Definitions for this purpose***:
  - *Personal-use residential real property* – is real property, including improvements (such as buildings and ornamental trees and shrubbery), that is owned by the individual who suffered a casualty loss and that contains at least one personal residence, which can be a single family residence, or a single unit within a contiguous group of attached residential units (for example, a townhouse or duplex), and any structures attached to the residence or single unit. *Ineligible* property includes:
    - a condominium unit or cooperative unit,
    - mobile home or trailer,
    - property of which the taxpayer owns a fractional interest or no interest in the structural components, and
    - a personal residence where part is used as rental property or a home office used in a trade or business or transaction entered into for profit.
  - *Personal belonging* - is an item of tangible personal property that is owned by the individual who suffered a casualty or theft loss and that is not used in a trade or business or in a transaction entered into for profit, and *does not* include a boat, aircraft, mobile home, trailer, or vehicle, or an antique or other asset that maintains or increases its value over time.
  - *No-cost repairs* – these are repairs made for a de minimis or token cost, donation or gratuity, such as the repair or rebuilding of an individual's residence by volunteers.

- ***Estimated repair cost safe harbor method for residence casualty losses of $20,000 or less*** – To determine the decrease in the FMV of the personal-use residential real property, the lesser of two repair estimates prepared by two separate and independent contractors, licensed or registered in accordance with state or local regulations, may be used, provided the costs to restore the residence to pre-casualty condition are itemized. Costs that improve or increase the value of the residence above pre-casualty value must be excluded from the estimate. This safe harbor only applies if the loss is $20,000 or less before applying the per-casualty and percentage of AGI reductions.

- ***De minimis safe harbor method for residence casualty losses of $5,000 or less*** – Under the de minimis method, the cost of repairs required to restore the residence to pre-casualty condition may be estimated by the taxpayer. Costs that improve or increase the value of the residence above pre-casualty value must be excluded from the estimate. The estimate must be done in good faith, and the individual must maintain records detailing the methodology used for estimating the loss. This safe harbor only applies if the loss is $5,000 or less before applying the per-casualty and percentage of AGI reductions.

- ***Insurance safe harbor method for residence casualty*** - To determine the FMV decrease of the individual's residence, the estimated loss determined in reports prepared by the individual's homeowners' or flood insurance company may be used.

- ***Contractor safe harbor method (Federally declared disasters only)*** – The contract price for the repairs specified in a contract prepared by an independent and licensed contractor (or one registered in accordance with state or local regulations) may be used if the contract itemizes the costs to restore the residence to the condition existing prior to the disaster. Costs that improve or increase the value of the residence above pre-casualty value must be excluded from the contract price for purposes of this safe harbor. To use the Contractor Safe Harbor Method, the contract must be a binding contract signed by the individual and the contractor.

- ***Disaster loan appraisal safe harbor method (Federally declared disasters only)*** – Under this method, to determine the decrease in FMV of the individual's residence, an appraisal prepared for the purpose of obtaining a loan of Federal funds or a loan guarantee from the Federal Government may be used. The appraisal should include the estimated loss the individual sustained as a result of the damage to or destruction of their residence from the Federally declared disaster.

- ***De minimis safe harbor method for casualties or thefts of $5,000 or less of personal belongings*** – The rev proc allows an individual to make a good faith estimate of the decrease in the FMV of the individual's personal belongings, provided the individual maintains records describing the personal belongings affected and detailing the methodology used for estimating the loss. This safe

harbor only applies if the loss is $5,000 or less before applying the per-casualty and percentage of AGI reductions.

- ***Replacement cost safe harbor method for personal belongings in Federally declared disasters*** – This method may be used to determine FMV of most personal belongings located in a disaster area immediately before the disaster in order to compute the casualty or theft loss. If used, this method must be applied to all eligible personal belongings for which a casualty loss is claimed. This method may **not** be used for the following: boats, aircraft, mobile homes, trailers, vehicles, and antiques or other assets that maintain or increase in value over time.

  Under this method, first determine the current cost to replace the personal belonging with a new one and reduce that amount by 10% for each year the personal belonging was owned, using the percentages in the Personal Belongings Valuation Table below. A personal belonging owned by the individual for nine or more years, will have a pre-disaster FMV of 10% of the current replacement cost.

Personal Belongings Valuation Table	
Year	Percentage of Replacement Cost to Use
1	90%
2	80%
3	70%
4	60%
5	50%
6	40%
7	30%
8	20%
9+	10%

Example: *Joe's uninsured furniture was destroyed in a hurricane. He purchased his couch 4 years prior to the hurricane for $800. It would cost $1,100 to replace it. Using the replacement cost safe harbor method, the fair market value of the couch just before the storm would be $660 ($1,100 x 60%). Since the couch was destroyed, its FMV after the hurricane is $0, so the decrease in FMV is $660, which is less than his basis of $800. Therefore, Joe's casualty loss for the couch is $660.*

- ***Effect of no-cost repairs*** – If any of the safe harbor methods provided in Rev Proc 2018-08 are used to determine the fair market value of or the amount of loss of an individual's residence or personal belongings, the loss must be reduced by the *value* of any no-cost repairs.

Generally, California law conforms to federal law regarding the treatment of casualty and disaster losses, including the safe harbor treatment for Ponzi schemes, with the following exceptions:

Tax Reform Changes – California has not conformed to the changes in the TCJA related to casualty losses but has belatedly and partially conformed to the NOL changes. Thus, for California:

- To be deductible, casualty losses do not have to be disaster-related.
- A casualty loss occurring prior to 2019 that results in a NOL can be carried back 2 years and any balance remaining can be carried forward for 20 years, or an election to forego the carryback can be made. The election to waive the carryback can be made separately for California and federal. For NOLS occurring in taxable years beginning after December 31, 2018, AB 91(signed by the governor 6/27/2019) repeals the 2-year carryback period. California continues to allow a 20-year carryover period and has not adopted the federal rule limiting the NOL deduction to 80% of the carryover year's taxable income. Thus, 100% of the unused CA NOL is carried over.

California Disaster Losses – SB-35, signed into law 9/1/15, allows the Governor to declare a state of emergency (disaster) for California purposes without action by the state legislature. Special legislation is no longer needed. For California purposes, a casualty loss becomes a disaster loss depending upon who declares a disaster:

- **President -** If the U.S. President declares a disaster the disaster loss rules apply for both the state and federal tax returns.
- **Governor -** If the Governor of CA declares a state of emergency, and the President does not, the governor's action only allows disaster treatment on the California return.

A Disaster Loss is Allowed If:

- The loss is sustained in an area declared a disaster for either state purposes or state and federal purposes, and.
- The loss occurs because of the declared disaster.

List of CA Disasters - A complete list of all California disasters declared by the President and/or the Governor is included in the instructions to FTB Form 3805-V. The list covers the disasters through the tax year of the form. A current list is also available on the FTB web site at: https://www.ftb.ca.gov/file/business/deductions/distaster-codes.html

9.02 YOUNG CHILD TAX CREDIT

Beginning for the 2020 tax year, California has added a refundable young child tax credit (child younger than 6)
See additional details below.

AB 91 added new R&TC Sec 17052.1 that, effective for years beginning on or after January 1, 2019, allows a refundable "young child tax credit." The credit is per taxpayer, not per child, and is $1,176 times the EITC adjustment factor, which is 85% for 2019. However, the credit cannot be greater than $1,000 for any year. Thus, the maximum credit for 2019 is $1,000 ($1,176 x .85 = $999.60 = $1,000).

The credit phases out when the taxpayer's earned income exceeds a threshold amount of $25,000. The phaseout rate is $20 per $100 or fraction thereof that the taxpayer's earned income exceeds $25,000. Therefore, the credit is fully phased out once earned income reaches $30,000 ($30,000 – $25,000 = $5,000/$100 = 50 x $20 = $1,000). The threshold amount will be annually adjusted beginning in the year after the year the minimum wage is set at $15 per hour, which is scheduled to be 2022 unless the scheduled increases are suspended by the governor (Labor Code Sec 1182.12).

To be eligible for the young child tax credit, the taxpayer must also be eligible for the CA EITC, have at least one qualifying child as defined for the EITC, and the child must be younger than 6 years old at the end of the tax year.

9.03 CA EITC

As of 2020, if a taxpayer's earned income is $30,000 or more, the phaseout will reduce the California EITC to zero. (AB 91, signed by the governor 6/27/2019) The bill also makes other changes in the phaseout calculation, which will be reflected in the table provided by the FTB in the Form 540 instructions.

The California EITC will generally follow the eligibility requirements of the federal EITC. Additionally, the earned income limitations for the California EITC (the amount where the CA EITC will be fully phased-out) will be lower than those for the federal EITC.

Beginning for tax year 2017, the limitation of only allowing EITC for wage earners has been lifted and self-employment income will be allowed. This includes domestic workers whose income is not subject to withholding. The phase-out ranges also were substantially increased. It is estimated this change will more than double the number of individuals qualifying for California EITC. (SB 106)

2018 EITC TABLE				
Number of Children	**Credit Rate**	**Phaseout Starts**	**Phaseout Complete**	**Maximum Credit**
None	7.65%	$3,580	$16,751	$232
One	34%	$5,376	$24,951	$1,554
Two	40%	$7,547	$24,951	$2,559
Three +	45%	$7,547	$24,951	$2,879

Eligible Individual Age Requirement – Beginning with tax year 2018, an individual (or if married, either the individual or their spouse) who does not have a qualifying child will be eligible for the California EITC if age 18 or older at the end of tax year. Previously, California followed the federal requirement that individuals without a qualifying child be age 25 through 64. (R&TC § 17052(c)(2), as amended by SB 855)

9.15 ELECTRIC VEHICLE CREDIT

The per-vehicle credit will be the sum of the following: (Code Sec. 30D(b)(1))

(1) $2,500; plus

(2) for a vehicle which draws propulsion energy from a battery with not less than 5 kilowatt hours of capacity, $417, plus an additional $417 for each kilowatt hour of capacity in excess of 5 kilowatt hours, but not in excess of $5,000. For this purpose, battery capacity, with respect to any battery is the quantity of electricity that the battery is capable of storing, expressed in kilowatt hours, as measured from a 100% state of charge to a zero percent state of charge.

Thus, the maximum credit is $7,500.

Important – In case you missed the underline above, this credit is a per vehicle credit not a per taxpayer credit. Thus, if a taxpayer purchases multiple electric vehicles the taxpayer is entitled to the credit for all of the vehicles subject to the non-refundable provisions for the personal credit and subject to the general business credit provisions for the business portion of the credit.

Credit Phase-Out – The credit phases out beginning in the second calendar quarter following that in which a manufacturer sells its 200,000th plug-in electric drive motor vehicle for use in the U.S. The applicable percentage phase-out is:

- 50% for the first two calendar quarters of the phaseout period,
- 25% for the third and fourth calendar quarters of the phaseout period, and
- 0% for each later calendar quarter.

Allocation Between Business and Personal Use – The credit is allocated between a personal credit (personal use) and general business credit (business use).

- **Personal Credit** – The personal portion of the credit is a non-refundable personal credit that will off-set the AMT. Thus, any excess not used in the year of purchase is lost.
- **Business Credit** – The business use portion of the credit becomes part of the general business credit (Form 3800) with its normal carryback and carryforward provisions.
- **Basis** – Both the personal and **depreciable basis of the vehicle** must be reduced dollar for dollar for the amount of the credit claimed for the purchase of the vehicle. No credit is allowed for any portion of the vehicle expensed under Sec 179.

YOU MUST GO TO THE IRS WEBSITE TO DETERMINE IF THE CREDIT IS PHASING OUT FOR A PARTICULAR VEHICLE

The IRS is tracking the cumulative sales by manufacturer on its web site: https://www.irs.gov/businesses/irc-30d-new-qualified-plug-in-electric-drive-motor-vehicle-credit

VEHICLES BEGINNING PHASEOUT IN 2019							
Date Acquired >>> VEHICLE	Before 2019	Jan - Mar 2019	Apr - June 2019	July - Sept 2019	Oct – Dec 2019	Jan – Mar 2020	After Mar 2020
Tesla*	$7,500	$3,750	$3,750	$1,875	$1,875	$0	$0
Chevrolet*	$7,500	$7,500	$3,750	$3,750	$1,875	$1,875	$0
Cadillac*	$7,500	$7,500	$3,750	$3,750	$1,875	$1,875	$0

*All qualifying models

9.11 BUSINESS ENERGY CREDITS

Business energy credits include solar, small wind energy, and fuel cell, all of which generally apply to big business. See Chapter 9.11 of the Big Book of Taxes for further details, However, one of those credits is a business solar energy credit that might apply to small trades or businesses.

Solar Energy Property - (Form 3468-Line 12b) This credit is for solar energy property (i.e., equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for) a structure, or to provide solar process heat, but not for heating a swimming pool), the construction of which begins before Jan. 1, 2022 subject to the phaseouts below. (Code Sec. 48(a)(3)(A)(i))

SOLAR ENERGY PROPERTY PHASE-OUT		
Date Construction Begins	Placed in Service	Credit
Before 1/1/2020	Before 1/1/2024	30%
1/1/20 - 12/31/20	Before 1/1/24	26%
1/1/21 - 12/31/21	Before 1/1/24	22%
Before 1/1/22	On or after 1/1/24	10%
On or after 1/1/22	Any	10%

Qualifications:

1. Meet the performance and quality standards, if any, that have been prescribed by regulations and are in effect at the time the property is acquired;
2. Be property for which depreciation (or amortization in lieu of depreciation) is allowable; and
3. Be property either:
   a. The construction, reconstruction, or erection of which is completed by the taxpayer; or
   b. Acquired by the taxpayer if the original use of such property commences with the taxpayer. Energy property doesn't include any property acquired before February 14, 2008, or to the extent of basis attributable to construction, reconstruction, or erection before February 14, 2008, that is public utility property, as defined by section 46(f)(5) (as in effect on November 4, 1990), and related regulations.

Other Requirements:

- The basis of energy property must be reduced by 50% of the energy credit determined.
- The basis of energy property used for figuring the credit must be reduced by any amount attributable to qualified rehabilitation expenditures.
- Energy property that qualifies for a grant under section 1603 of the American Recovery and Reinvestment Tax Act of 2009 isn't eligible for the energy credit for the tax year that the grant is made or any subsequent tax year.

Forms - A taxpayer can claim (on Form 3468) the business energy credits (in each case, the applicable percentage applies to the basis of eligible energy property placed in service during the year). The results from Form 3468 – Investment Credit are transferred to Form 3800 – General Business Credit (see chapter 3.00 of the Big Book of Taxes).

What About Rentals? Property that is eligible for the general business credit is tangible property for which depreciation is allowable (Sec. 48(a)(5)(D)). Solar panels installed on a residential rental would meet that requirement.

But, as noted in the Form 3468 instructions and per the code, business credits are generally not available for property that is used predominantly to furnish lodging (Sec. 50(b)(2)). However, there is an exception: Sec. 50(b)(2)(D) provides the restriction to property used predominantly to furnishing lodging does not apply to the energy credit. Thus, rental property would qualify.

One more hurdle: because rentals are considered passive activities for purposes of the Sec 48 energy credits, before the credit from the 3468 can pass onto the Form 3800, the credit must first pass through Form 8582-CR – Passive Activity Credit Limitations or Form 8810 – Corporate Passive Loss and Credit Limitations.

CA has no equivalent credit, but these repealed California energy credits have carryover provisions:

- Commercial Solar Energy – Credit Code 181
- Energy Conservation – Credit Code 182
- Solar Energy – Credit Code 180

10.03 2018 SPECIAL UNDERPAYMENT WAIVERS

The changes brought about by TCJA and the ensuing W-4 debacle and concerns that taxpayers may have under-withheld or under-prepaid estimated tax through no fault of their own prompted several members of Congress to apply pressure on the IRS to provide special relief from the penalty for underpayment of estimated taxes for 2018.

The IRS capitulated and initially provided an 85% safe harbor. This safe harbor, unlike the 90% quarterly statutory safe harbor only required that the taxpayer had made payments at any time during the year to satisfy the 85% requirement. However, because of the lateness of TCJA, the 2018 Form 2210 was already released and did not provide for the special 85% safe harbor. As a result, the IRS issued special instructions to check Box A in Part II of the 2210 and write "85% Waiver" next to Box A, and file page 1 of Form 2210 with the tax return to request the waiver.

However, after doing all this several Congressional leaders did not believe 85% was sufficient relief and urged the IRS to further reduce the safe harbor. The IRS subsequently, towards the end of February, reduced the safe harbor to 80% (Notice 2019-25).

> ***Example**: Susan's 2018 tax liability is $10,000; She had paid estimated tax installments totaling $8,100; no tax withheld. Thus, Susan was under paid by $1,900, so the $1,000* de minimis *exception did not apply. However, she had paid in 81% ($8,100/$10,000) of her tax liability, and since she prepaid more than 80% but less than 90%, the taxpayer is eligible for the penalty waiver due to tax reform. Had the taxpayer's ES payments been only $7,900 (79% of $10,000), neither the 90% safe harbor nor the 80% tax reform waiver would apply, and the taxpayer would be subject to a Form 2210 penalty.*

Bottom line is some taxpayers, depending upon when they filed their return may have paid too high of an underpayment penalty and are due a refund.

Automatic Penalty Refund - In mid-August 2019 the IRS announced that it is automatically waiving the estimated tax penalty for the more than 400,000 eligible taxpayers who already filed their 2018 federal income tax returns but did not claim the waiver. The IRS will apply this waiver to tax accounts of all eligible taxpayers, so there is no need to contact the IRS to apply for or request the waiver. The IRS will be sending out CP21 notices advising taxpayers that they qualify for the waiver, followed by a refund check about three weeks after the CP21 is sent. The whole process could take several months. (IR-2019-144)

Refund Not Received - If you later determine your client is due a refund of some part or all of the penalty and your client did not receive an automatic refund, they can claim a refund of estimated tax penalties paid by filing Form 843, Claim for Refund and Request for Abatement. Most of the lines of the form are self-explanatory with the exception of the following:

- **Line 3** – Check "income" tax
- **Line 4** - Enter IRC Sec 6654
- **Line 5** – Leave blank
- **Line 7** – Include the statement "80% Waiver of estimated tax penalty" on line 7 and if the entire penalty is not refundable explain the circumstances.

Form 843 can't be filed electronically.

Special Waiver for Farmers and Fishermen – Anticipating that tax reform changes that affect farmers and fishermen would mean that some farmers and fishermen would have difficulty accurately determining and paying their 2018 tax liability by March 1, 2019, the IRS provided relief to individual taxpayers who are farmers or fishermen by waiving the underpayment of estimated tax penalty for any qualifying farmer or fisherman if their 2018 income tax return was filed and tax due was fully paid by April 15, 2019 (April 17, 2019 for those living in Maine or Massachusetts) and Form 2210-F was attached to the return with box A in Part I checked.

12.02 NEW CALIFORNIA HEALTH INSURANCE ASSISTANCE

NOTE: California has decided to supplement the federal PTC for CA taxpayers with incomes up to 600% of the federal poverty level (federal only supplements up to 400%).

This does not take effect until 2020, so it is not something you need to be concerned about for over a year (i.e., for 2020 returns), and by that time the state should have the forms and procedures in place. **See additional details below.**

SB 78, signed by the governor 6/27/2019, created a California Individual Market Assistance program that is authorized to provide health care coverage financial assistance, including advanced premium assistance subsidies, to California residents with household incomes below 600% of the federal poverty level. The program will run from 2020 through 2022, after which it is repealed, and no new financial assistance or other subsidies are to be provided. (Gov Code Sec 100825(b))

A California individual taking advantage of the advanced assistance from the state will be required to file a California income tax return, even if their income is below the income-based filing requirement, to reconcile the advances with the actual amount allowed based on household income, family size, etc., and to repay any excess advances (up to a limit to be determined by the program) or receive a refund if the actual subsidy allowed exceeds the advances.

To be eligible for a premium assistance subsidy from the California program, a California resident must be eligible for the federal premium tax credit authorized under IRC Sec 36B, except that premium assistance subsidy shall not be subject to the income requirements of Sec 36B.

It is the Legislature's intent that the regulations promulgated under IRC Section 36B as of January 1, 2019, shall apply to the extent that those regulations do not conflict with CA law or regulations issued by the Exchange (Covered California) or Franchise Tax Board.

12.03 PENALTY FOR NOT BEING INSURED (shared responsibility penalty)

TCJA eliminated the shared responsibility payment effective in 2019. Congress didn't *actually* repeal this penalty; instead, it *effectively* repealed it by tweaking the law so that the percentage of household income used in the penalty calculation is 0%, and the flat dollar amount is $0, which causes the amount of the penalty to be $0.

12.03 NEW CALIFORNIA PENALTY FOR NOT BEING INSURED

NOTE: California has decided to pick up where the Feds left off with one intervening year. So, for 2019 neither CA nor the Federal return will include a penalty. But **beginning in 2020** CA will begin imposing an individual mandate on Californians, generally following the former Federal guidelines. **See the details below**.

While the TCJA essentially repealed the federal requirement for individuals to have health insurance coverage or be penalized, California's legislature enacted SB 78 (signed by the governor 6/27/2019) that created new Title 24 in the Government Code (sections 100700 – 100725) imposing an individual mandate on Californians. For each month beginning on or after January 1, 2020, a California resident must be enrolled in and maintain minimum essential coverage for that month for him- or herself, spouse, and dependents except in the situations listed below:

(1) An individual who has in effect a certificate of exemption for hardship or religious conscience issued by the Exchange (Covered California) for that month.

(2) An individual who, for that month, is a member of a health care sharing ministry defined the same as in IRC Sec 5000A(d)(2)(B) on January 1, 2017.

(3) An individual who is incarcerated for that month, other than incarceration pending the disposition of charges.

(4) An individual who is not a citizen or national of the United States and is not lawfully present in the United States for that month.

(5) An individual who is a member of an Indian tribe, as defined in IRC Sec 45A(c)(6), during that month.

(6) An individual for whom that month occurs during a period when the individual's tax home is in a foreign country (i.e., meets either the bona fide resident or substantial presence test of IRC Sec 911).

(7) An individual who is a bona fide resident of a possession of the United States, as determined under IRC Sec 937(a), for that month.

(8) An individual who is a bona fide resident of another state for that month.

(9) An individual who is enrolled in limited or restricted scope coverage under the Medi-Cal program or another health care coverage program administered by and determined to be substantially similar to limited or restricted scope coverage by the State Department of Health Care Services for that month.

Individuals, other than those listed above who fail to have minimum essential coverage, or who qualify for one of the exceptions noted below, will be subject to an individual shared responsibility penalty (new R&TC Sec 61015), calculated in much the same way as the federal penalty was. The penalty is the lesser of:

(a) The sum of the monthly penalty amounts (defined below) for months in the taxable year during which one or more of the failures occurred, or

(b) An amount equal to one-twelfth of the state average premium for qualified health plans that have a bronze level of coverage for the applicable household size involved, and are offered through the Covered California for plan years beginning in the calendar year with or within which the taxable year ends, multiplied by the number of months in which a failure occurred.

The monthly penalty amount is one-twelfth of the greater of (1) or (2) below:

(1) An amount equal to the lesser of either of the following:

(a) The sum of the applicable dollar amounts for all applicable household members who failed to enroll in and maintain minimum essential coverage. The applicable dollar amount is $695 ($347.50 for individuals under age 18 as of the beginning of the month) and is subject to inflation adjustment.

(b) 300% of the applicable dollar amount determined for the calendar year during which the taxable year ends.

(2) An amount equal to 2.5% of the excess of the responsible individual's

applicable household income for the taxable year over the amount of gross income that would trigger the responsible individual's requirement to file a state income tax return (the applicable filing threshold), for the taxable year.

If an individual who is subject to the state's shared responsibility penalty fails to timely pay it, the individual is not subject to a criminal prosecution or penalty with respect to that failure and the FTB may not place a lien on or levy any real property of the individual. (R&TC 61025(b)(1) and (2)) Otherwise, the individual would be subject to the usual FTB notice and collection actions.

Exceptions to the Penalty – No penalty applies if:

- The responsible individual's required contribution, determined on an annual basis, for coverage for the month exceeds 8.3% (as adjusted for inflation) of that responsible individual's applicable household income for the taxable year.
- The responsible individual's applicable household income for the taxable year containing the month is less than the amount of adjusted gross income or gross income specified for that taxable year for the return filing requirement.
- The last day of the month occurred during a period in which the applicable household member did not maintain minimum essential coverage for a continuous period of three months or less.

NOTES

SUPPLEMENTAL MATERIALS

4.14 EXCESS 401(K) CONTRIBUTIONS

It is not uncommon for individuals to have multiple employers, each with a 401(k) plan. This can possibly create a situation where the employee makes an excess elective deferred compensation contribution. The maximum annual contribution for 2019 is $19,000 ($25,000 if age 50 and over).

The limit does not just apply to each 401(k) plan to which the employee makes elective deferrals, but instead applies to the aggregate amount of all the elective deferrals made by the employee for the year to all plans which permit such contributions, including:

- Code Sec. 401(k) deferred compensation plans,
- Code Sec. 408(k) SEP IRAs,
- Code Sec. 408(p)(2) SIMPLE Plans, and
- Code Sec. 403(b) annuity plans (TSAs)

However, Code Sec. 457 plans (government plans) are not included in the overall deferral limitations.

To the extent taxable, the distribution of the excess deferral is taxable in the year distributed (Reg. Sec. 1.402(g)-1(e)(8)(i)). Thus, an excess deferral for 2018 distributed in 2019 would be taxable in 2019. Such a distribution would appear on a 1099-R for 2019 with a code 8. It is not subject to the early distribution penalty of Sec 72(t).

> ***Example:*** Sam is a 45-year-old individual who participates in employer Y's qualified cash or deferred arrangement. For January through July Sam deferred $12,800 into Y's qualified cash or deferred arrangement. Sam subsequently leaves employer Y's employment and begins working for employer Z. During the remainder of 2019, Sam defers an additional $6,500 under Z's qualified cash or deferred arrangement. Sam's elective deferral contributions for 2019 total $19,300. Since Sam is under age 50, Sam's maximum allowable contribution for 2019 is $19,000 and he has $300 in excess contributions.

Correcting Excess Contributions - After the close of the tax year, but not later than April 15 (or earlier as specified in the plan), the taxpayer may notify each plan under which elective deferral contributions were received by the plan for the year. The notification must also identify the extent, if any, the contribution consisted of designated Roth contributions (Reg. Sec. 1.402(g)-1(e)(2)(i)). No later than April 15 after the close of the taxable year, the plan may distribute the excess and any earnings associated with the excess contribution to the taxpayer (Reg. Sec. 1.402(g)-1(e)(2)(ii)).

the result of not correcting an excess 401(k) contribution before April 15 of the subsequent year is:

1. The excess is taxable in the year of the excess contribution (but not subject to the premature distribution penalty).
2. Whenever the excess is withdrawn it is taxable again (i.e. no basis is established by virtue of the excess being taxed).

3.17 POST DISASTER LOSS PASSIVE LOSS CARRYOVER

What becomes of passive losses on a rental property that was destroyed in a fire when it is unlikely that the property would be replaced? This question was raised in connection to the Paradise Fire in Northern California.

Passive losses are released **upon a total disposition of the property in a fully taxable event** (IRC Sec 469(g)). Thus, to release the passive loss carryovers a taxpayer needs to dispose of the land. Otherwise, the passive loss carryover continues to be attached to the property and can only be used to offset other passive income.

Tough situation, since the current value of the land is severely depressed. But, when and if the taxpayer decides to sell, the passive losses would be released at that time.

6.02 STUDENT LOAN INTEREST

Within the AGI limits for the year, up to $2,500 of interest on debt to finance higher education is deductible above the line. However, many perceive that to be limited to the interest paid on Government Student Loans which is not true.

Virtually any debt, including credit card (if used only for education expenses) and home equity debt may qualify provided the loan is single purpose and the purpose is to pay qualified education expenses.

Example #1 – Jack takes out an equity line of credit on his home and borrows $30,000 to finance a solar electric installation on his home and $10,000 to pay his daughter's qualified education expenses. Because this loan is not single purpose – he used it to borrow funds for more than education expenses – he cannot deduct a portion of the interest as above-the-line education interest. However, Jack can still deduct the prorated interest on the solar installation as home acquisition debt if the total debt does not exceed the acquisition debt limits. Had Jack only used the loan to pay for qualified education expenses, then up to $2,500 of the loan interest could have been deducted as above-the-line student loan interest.

Example #2 – Mark has a Visa card that he uses for a variety of purposes and he also uses it to pay his daughter's qualified education expenses. Because the credit card is not used exclusively to pay for qualified education expenses, none of the interest will qualify as student loan interest.

Caution: Although we use a credit card as an example of an alternate student loan, it is not practical to do so because of the high interest rates generally charged for credit card debt.

To qualify as an eligible loan, the loan must have been taken out solely to pay the costs of attending an eligible educational institution for an individual during a period in which the individual is a qualified student. Eligible costs include:

- Tuition
- Fees
- Room and board
- Books and equipment
- Other necessary expenses (including transportation)

The expense must be incurred within a reasonable time before or after the debt is incurred. The regulations provide that a loan is incurred with a reasonable period if:

- The expenses are paid with proceeds of a loan from a federal postsecondary education loan program; or
- The expenses relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within a period that begins 90 days prior to the start of, and ends 90 days after the end of, that academic period.

Such expenses must be reduced by the following:

1. Income excluded from ***employer-provided educational assistance***,
2. Income excluded from ***U.S. savings bonds*** used to pay higher education expenses,
3. Nontaxable distributions from ***Coverdell ESAs***, and
4. ***Scholarships, allowances, or other payments*** (such as distributions from Sec. 529 plans) that are excludable from gross income.

Eligible educational institution....includes colleges, universities, and vocational schools eligible to participate in the Department of Education student aid programs (in other words, virtually all accredited public and private post-secondary schools). In addition, institutions conducting internship or residency programs leading to degrees or certificates awarded by an institution of higher education, a hospital, or a healthcare facility which offers postgraduate training also qualify.

Eligible student....is one enrolled in a degree or certificate program and who is at least a half-time student. What constitutes half the normal course load will be determined by the definition of the school being attended. Generally, a full-time student is one carrying at least 12 units.

NOTES

2019 & 2020 INFLATION ADJUSTMENTS

Caution, some values are unofficial but are based upon generally reliable sources

	2019	2020
GENERAL TAX		
Standard Deductions		
Single	12,200	12,400
Head of Household	18,350	18,650
Married Filing Joint & SS	24,400	24,800
Married Filing Separate	12,200	12,400
Unmarried - 65 & Over / Blind	1,650	1,650
Married – 65 & Over / Blind	1,300	1,300
Dependent of Another	1,100/350	1,100/350
Kiddie Tax		
Base Amount	1,100	1,100
Earned Income Limit	2,200	2,200
Earned Income Extra Amount	350	350
AMT Exemption	7,750	7,900
AMT Exemptions		
Unmarried Individuals	71,700	72,900
Married Filing Joint & SS	111,700	113,400
Married Filing Separate	55,850	56,700
Estates & Trusts	25,000	25,400
Kiddie Tax	7,750	7,900
Phase Out – AMT Exemptions		
Unmarried Individuals	510,300 - 797,100	518,400 – 810,000
Married Filing Joint & SS	1,020,600 - 1,467,400	1,036,800 – 1,490,400
Married Filing Separate	510,300 - 733,700	518,400 – 745,200
AMT Tax Rates – 26% at or under, 28% above	$194,800	$197,900
Teachers Above-The-Line Deduction	250	250
Savings Bond Interest Exclusion Phase-Out		
Married Filing Joint	121,600 – 151,600	123,550 – 153,550
Others	81,100 – 96,100	82,350 – 97,350
Transportation Fringe Benefits		
Parking	260	270
Transit Passes	260	270
Education Loan Interest Phase-Out Range		
Married Filing Joint	140,000-170,000	140,000-170,000
Others	70,000-85,000	70,000-85,000
FOREIGN ISSUES		
Foreign Earned Income Exclusion	105,900	107,600
Annual Housing Base	16,994	17,216
Max Foreign Housing Excl (Ex High Cost Areas)	14,826	15,064
BUSINESS		
Section 179		
Annual Expense Limit (½ for MFS)	1,020,000	1,040,000
Annual Investment Limit	2,550,000	2,590,000
Bonus Depreciation	100%	100%

2019 & 2020 INFLATION ADJUSTMENTS - CONTINUED

	2019	2020
BUSINESS - Continued		
Automobile Expenses		
Business Miles	58.0	*
Depreciation Component	0.26	*
Moving/ Medical	0.20	*
First Year Luxury Auto Limit	10,100	*
Bonus Depreciation	8,000	8,000
Sec 199A Deduction Taxable Income Threshold		
Married Joint	321,400	326,600
Married Separate	160,725	163,300
Others	160,700	163,300
Excess Business Loss Threshold Amount		
Married Joint	510,000	518,000
Others	255,000	259,000
Small Business Exemption	$26,000,000	$26,000,000
MEDICAL & ACA		
Long-Term Care Premiums		
Age 40 or Younger	420	430
Age 41 to 50	790	810
Age 51 to 60	1,580	1,630
Age 61 to 70	4,220	4,350
Age 71 and Older	5,270	5,430
Per Diem	370	380
Medical Mileage	20.0	*
Health Savings Accounts (HSA)		
Minimum Annual Deductible – Self Only	1,350	1,400
Minimum Annual Deductible – Family	2,700	2,800
Max Annual Out of Pocket – Self Only	6,750	6,900
Max Annual Out of Pocket – Family	13,500	13,800
Max Annual Contribution – Self Only	3,500	3,550
Max Annual Contribution – Family	7,000	7,100
Premium Tax Credit – Limit on Repayment		
Under 200% of the FPL - Single	300	325
Under 200% of the FPL - Joint	600	650
200% but Less than 300% of the FPL - Single	800	800
200% but Less than 300% of the FPL - Joint	1,600	1,600
300% but Less than 400% of the FPL - Single	1,325	1,350
300% but Less than 400% of the FPL - Joint	2,650	2,700
Small Employer Insurance Cr.- Aver FT Wages	27,100/54,200	27,600/55,200
Qualified Small Employer HRA		
Max Reimbursement - Individual	5,150	5,250
Max Reimbursement - Family	10,450	10,600

2019 & 2020 INFLATION ADJUSTMENTS - CONTINUED

	2019	2020
MEDICAL & ACA - Continued		
Archer Medical Savings Account (MSA)		
Self Only Coverage – Min. Annual Deductible	2,350	2,350
Self Only Coverage – Max. Annual Deductible	3,500	3,550
Self Only Coverage – Out of Pocket	4,650	4,750
Family Coverage –Min. Annual Deductible	4,650	4,750
Family Coverage –Max. Annual Deductible	7,000	7,100
Family Coverage – Out of Pocket	8,550	8,650
Max Hlth FSA Salary Reduction – Cafeteria Plan	2,700	2,750
PENSION & RETIREMENT PLANS		
Defined Benefit Contribution Limit	225,000	*
Defined Contribution Limit (HR10/SEP)	56,000	*
Maximum Compensation Considered	280,000	*
SARSEP Elective Deferrals (Under Age 50)	19,000 Max	*
SARSEP Elective Deferrals (Age 50 and Over)	25,000 Max	*
Deferred Comp – 401(k) (Under Age 50)	19,000 Max	*
Deferred Comp – 401(k) (Age 50 and Over)	25,000 Max	*
TSA (Under Age 50)	19,000 Max	*
TSA (Age 50 and Over)	25,000 Max	*
TSA (15 Years Of Service – Added Amount	3,000	*
IRA Contribution Limits	6,000	6,000
IRA Contribution Additional Age 50 and Over	1,000	1,000
IRA Deductible Contribution Phase-Out - MAGI		
Married Filing Joint	103,000 - 123,000	104,000 - 124,000
Others	64,000 - 74,000	65,000 - 75,000
Married Filing Separate	0 - 10,000	0 - 10,000
Spouse – Non-participant	193,000 - 203,000	196,000 - 206,000
Roth IRA Allowable Contribution Phase Out		
Married Filing Joint	193,000 - 203,000	196,000 - 206,000
Others	122,000 - 137,000	124,000 - 139,000
Married Filing Separate	0 - 10,000	0 - 10,000
PENALTIES		
Failure to File 1040 Tax Return (Minimum)	215	330
Failure to File 1065 Tax Return $ Amount	205	210
Failure to File 1120-S Tax Return $ Amount	205	210
Failure to File Info Returns (Aver Gross < 5Mil)		
General Rule	270	280
Corrected within 30 Days of Due Date	50	50
Corrected after 30th Day but by August 1	110	110
Failure To Provide Payee Copy (Aver Gross < 5Mil)		
General Rule	270	280
Corrected within 30 Days of Due Date	50	50
Corrected after 30th Day but by August 1	100	110

2019 & 2020 INFLATION ADJUSTMENTS - CONTINUED

	2019	2020
GIFT & ESTATE		
Annual Gift Tax Exclusion	15,000	15,000
Annual Gift Exclusion, To Noncitizen Spouses	155,000	157,000
Reporting Foreign Gifts (Corps & Partnerships)	16,388	16,649
Unified Estate & Gift Tax Exclusion	11,400,000	11,580,000
Generation Skipping Transfer Tax Exclusion	11,400,000	11,580,000
SOCIAL SECURITY		
Maximum Taxable Earnings	132,900	137,700
Tax Rates – Employee/Self-Employed	7.65%/15.30%	7.65%/15.30%
Quarter of Coverage	1,360	1,410
Maximum SS Benefit – Retire At Full Retire Age	2,861	3,011
CREDITS		
EITC Disqualifying Income	3,600	3,650
EITC Maximum Credit		
No Qualifying Child	529	538
One Qualifying Child	3,526	3,584
Two Qualifying Children	5,828	5,920
Three or more Qualifying Children	6,557	6,660
EITC Earned Income		
No Qualifying Child	6,920	7,030
One Qualifying Child	10,370	10,540
Two Qualifying Children	14,570	14,800
Three or more Qualifying Children	14,570	14,800
EITC Phase-Out (Totally Phased Out)		
Married – No Children	21,370	21,713
Married – One Child	46,884	47,648
Married – Two Children	52,493	53,330
Married – Three or More Children	55,952	56,844
Unmarried – No Children	15,570	15,823
Unmarried – One Child	41,094	41,758
Unmarried – Two Children	46,703	47,440
Unmarried – Three or More Children	50,162	50,954
Child Tax Credit		
Per Child	2,000	2,000
Refundable	1,400	1,400
Non Qual Child Dependent (not refundable)	500	500
MFJ Phase-out Threshold	400,000	400,000
MFS Phase-out Threshold	200,000	200,000
S, HH, SS Phase-out Threshold	200,000	200,000
Education Credits Phase-Out Ranges		
AOTC-Unmarried	80,000 - 90,000	80,000 - 90,000
AOTC-Married Filing Joint (no credit for MFS)	160,000 - 180,000	160,000 - 180,000
LTLC-Unmarried	58,000 - 68,000	59,000 - 69,000
LTLC-Married Filing Joint (no credit for MFS)	116,000 - 136,000	118,000 - 138,000

2019 & 2020 INFLATION ADJUSTMENTS - CONTINUED

	2019	2020
CREDITS - Continued		
Adoption Credit & Expense	14,080	14,300
Credit Phase-Out Range	211,160 - 251,160	214,520 - 254,520
Saver's Credit – MAGI Brackets		
Joint – 50% of up to $2K rtmnt contribution	0 to 38,500	0 to 39,000
Joint – 20% of up to $2K rtmnt contribution	38,501 to 41,500	39,001 to 42,500
Joint – 10% of up to $2K rtmnt contribution	41,501 to 64,000	42,501 to 65,000
HH – 50% of up to $2K rtmnt contribution	0 to 28,875	0 to 29,250
HH – 20% of up to $2K rtmnt contribution	28,876 to 31,125	29,251 to 31,875
HH –10% of up to $2K rtmnt contribution	31,126 to 48,000	31,876 to 48,750
Others – 50% of up to $2K rtmnt contribution	0 to 19,250	0 to 19,500
Others – 20% of up to $2K rtmnt contribution	19,251 to 20,750	19,501 to 21,250
Others – 10% of up to $2K rtmnt contribution	20,751 to 32,000	21,251 to 32,500

* Indicates values were not available at press date.

2020 CAPITAL GAINS TAX RATES SCHEDULES

CAPITAL GAINS TAX RATES		
Joint, SS – 0% rate on net capital gains	0 – 78,750	0 – 80,000
Joint, SS – 15% rate on net capital gains	78,751 – 488,850	80,001 – 496,600
Joint, SS – 20% rate on net capital gains	488,851 & above	496,601 & above
HH – 0% rate on net capital gains	0 – 52,750	0 – 53,600
HH – 15% rate on net capital gains	52,751 – 461,700	53,601 – 469,050
HH – 20% rate on net capital gains	461,701 & above	469,051 & above
Single – 0% rate on net capital gains	0 – 39,375	0 – 40,000
Single – 15% rate on net capital gains	39,376 – 434,550	40,001 – 441,450
Single – 20% rate on net capital gains	434,551 & above	441,451 & above
MFS – 0% rate on net capital gains	0 – 39,375	0 – 40,000
MFS – 15% rate on net capital gains	39,376 – 244,425	40,001 – 248,300
MFS – 20% rate on net capital gains	244,426 & above	248,301 & above

2020 INDIVIDUAL & FIDUCIARY TAX RATES SCHEDULES

MARRIED INDIVIDUALS FILING JOINT AND SURVIVING SPOUSE						
If Taxable Income Is:				**The Tax Is:**		
Not Over	19,750			10% of Taxable Income		
Over	19,750	But not over	80,250	1,975.00	Plus 12% of the excess over	19,750
Over	80,250	But not over	171,050	9,235.00	Plus 22% of the excess over	80,250
Over	171,050	But not over	326,600	29,211.00	Plus 24% of the excess over	171,050
Over	326,600	But not over	414,700	66,543.00	Plus 32% of the excess over	326,600
Over	414,700	But not over	622,050	94,735.00	Plus 35% of the excess over	414,700
Over	622,050			167,307.50	Plus 37% of the excess over	622,050

INDIVIDUALS FILING SINGLE						
If Taxable Income Is:				**The Tax Is:**		
Not Over	9,875			10% of Taxable Income		
Over	9,875	But not over	40,125	987.50	Plus 12% of the excess over	9,875
Over	40,125	But not over	85,525	4,617.50	Plus 22% of the excess over	40,125
Over	85,525	But not over	163,300	14,605.50	Plus 24% of the excess over	85,525
Over	163,300	But not over	207,350	33,271.50	Plus 32% of the excess over	163,300
Over	207,350	But not over	518,400	47,367.50	Plus 35% of the excess over	207,350
Over	518,400			156,235.00	Plus 37% of the excess over	518,400

INDIVIDUALS FILING AS HEAD OF HOUSEHOLD						
If Taxable Income Is:				**The Tax Is:**		
Not Over	14,100			10% of Taxable Income		
Over	14,100	But not over	53,700	1,410.00	Plus 12% of the excess over	14,100
Over	53,700	But not over	85,500	6,162.00	Plus 22% of the excess over	53,700
Over	85,500	But not over	163,300	13,158.00	Plus 24% of the excess over	85,500
Over	163,300	But not over	207,350	31,830.00	Plus 32% of the excess over	163,300
Over	207,350	But not over	518,400	45,926.00	Plus 35% of the excess over	207,350
Over	518,400			154,793.50	Plus 37% of the excess over	518,400

INDIVIDUALS FILING AS MARRIED FILING SEPARATE						
If Taxable Income Is:				**The Tax Is:**		
Not Over	9,875			10% of Taxable Income		
Over	9,875	But not over	40,125	987.50	Plus 12% of the excess over	9,875
Over	40,125	But not over	85,525	4,617.50	Plus 22% of the excess over	40,125
Over	85,525	But not over	163,300	14,605.50	Plus 24% of the excess over	85,525
Over	163,300	But not over	207,350	33,271.50	Plus 32% of the excess over	163,300
Over	207,350	But not over	311,025	47,367.50	Plus 35% of the excess over	207,350
Over	311,025			83,653.75	Plus 37% of the excess over	311,025

ESTATES & TRUSTS						
If Taxable Income Is:				**The Tax Is:**		
Not Over	2,600			10% of Taxable Income		
Over	2,600	But not over	9,450	260.00	Plus 24% of the excess over	2,600
Over	9,450	But not over	12,950	1,904.00	Plus 35% of the excess over	9,450
Over	12,950			3,129.00	Plus 37% of the excess over	12,950

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EMPLOYEE OR INDEPENDENT CONTRACTOR GUIDE

(California AB5)

California Assembly Bill 5 (AB5) codifies the CA Supreme Court findings in the Dynamex case where the Supreme Court applied the ABC test used by other states to reach their decisions and sets out special circumstances where the Borello test factors are used instead of the ABC test**.**

HOW TO USE THIS MATERIAL – In all cases, the ABC test is applied (Dynamex applies) to determine whether an individual is an employee or an independent contractor **EXCEPT** for the occupations listed below for which special rules apply. Thus, if a particular occupation does not appear in the list, the ABC test will apply. If the occupation is included in the list below, then go to the appropriate flow chart to determine how to determine employee or independent contractor status.

CAUTION:
In order to condense the material into a more understandable format, the descriptions used in AB5 have been substantially abbreviated, and the full descriptions included in AB5 should be consulted before reaching any final conclusions.

OCCUPATION	FLOW CHART
Accountant	A
Architect	A
Artist, Fine	B1
Barber	B2
Business Service Provider	D
Cartoonist, Newspaper	B1
Contractor, Construction Trucking	E
Contractors	E
Court Ordered	A
Cosmetologist	B2
Dentist	A
Direct Salesperson	A
Editor	B1
Electrologist	B2
Engineer	A
Enrolled Agent	B1
Esthetician	B2
Fisherman, Commercial	A
Freelance Writer	B1
Grant Writer	B1
Graphic Design	B1
Administrator of Human Resources	B1
Insurance Agent	A
Investment Adviser	A
Lawyer	A
Manicurist	B2
Marketing	B1
Payment Processing Agent	B1
Photographer, Still	B1
Photojournalist	B1
Physician	A
Podiatrist	A
Private Investigator	A
Psychologist	A
Real Estate Licensees	C
Repo Agency (Licensed)	C
Salesperson, Direct Sales	A
Securities Broker-Dealer	A
Service Providers (referred by a referral agency)	F
Sub-contractors (construction)	E
Surgeon	A
Travel Agent	B1
Trucking Contractor	E
Veterinarian	A
Writer, Freelance	B1

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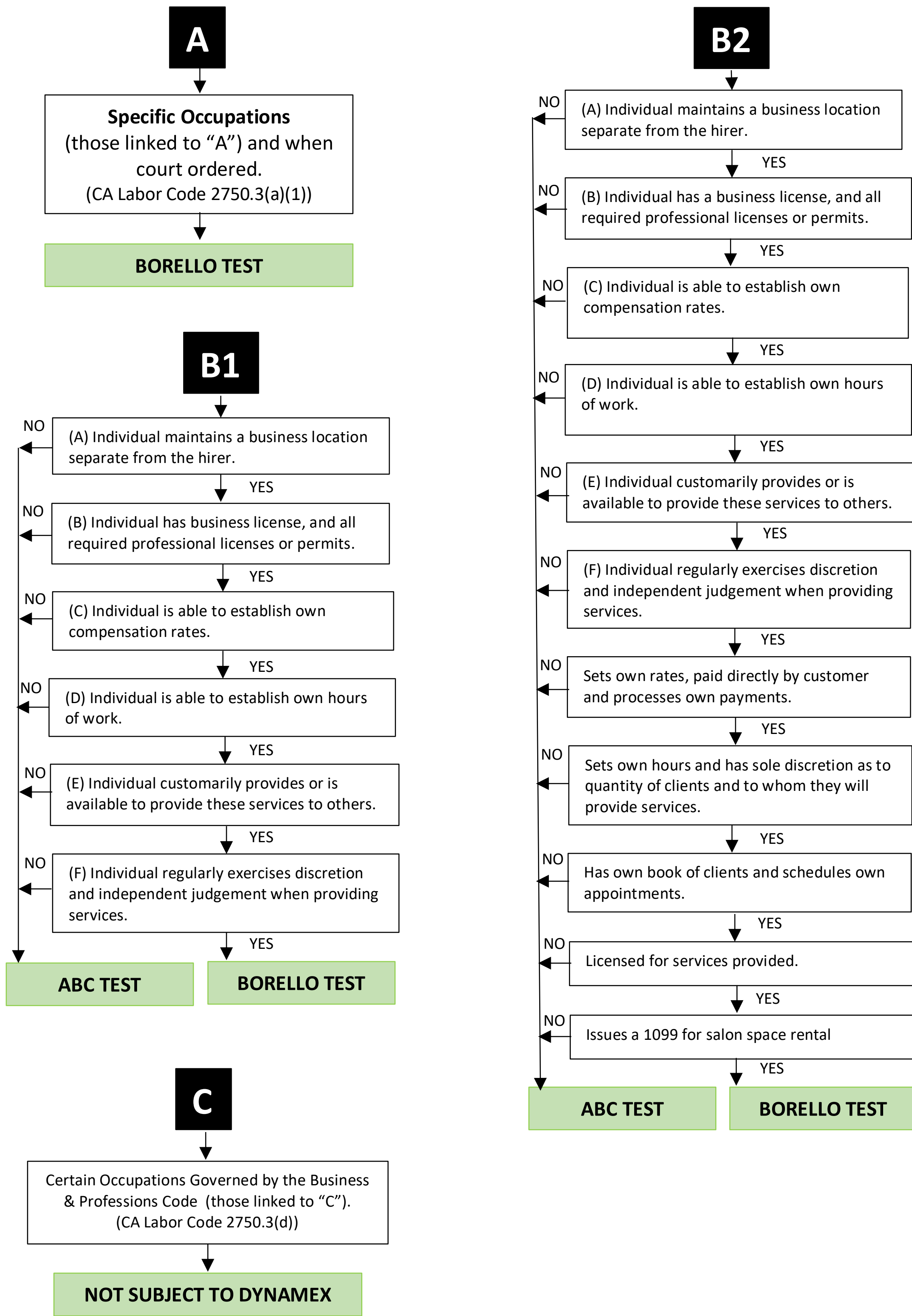

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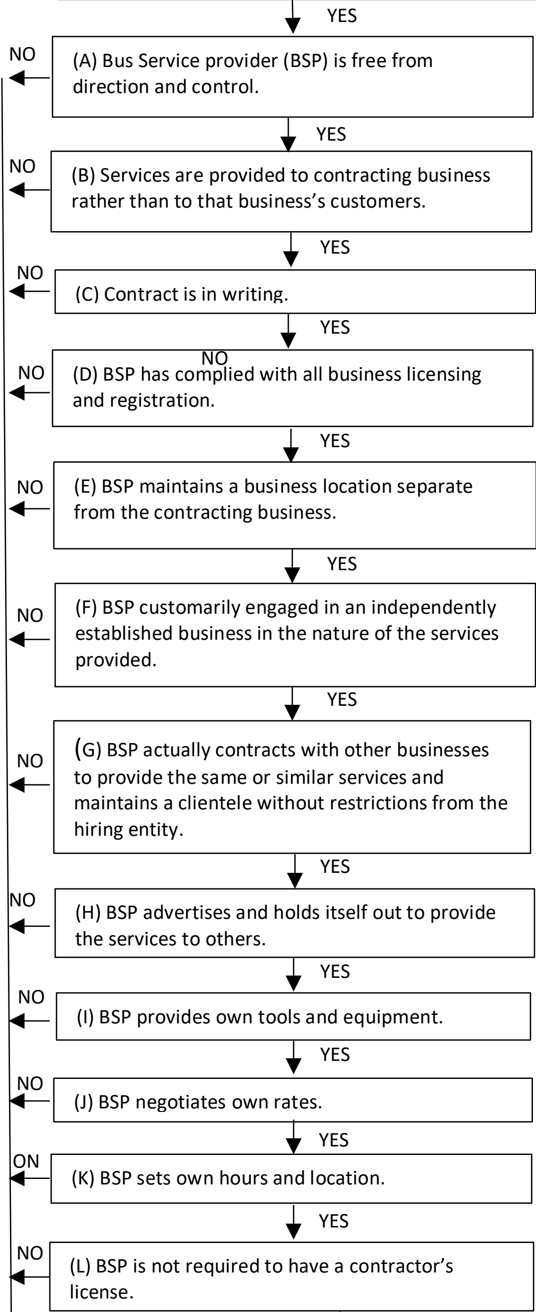

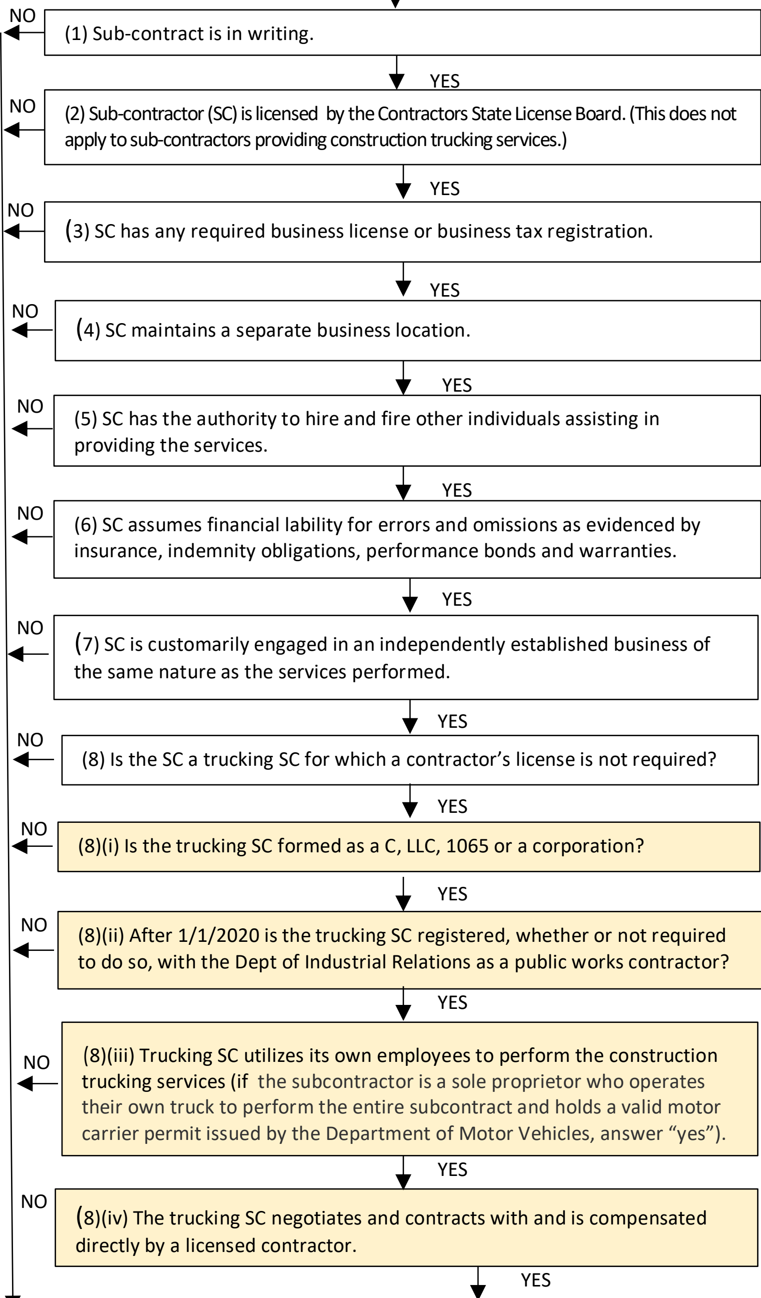

Special Requirements for Trucking SC

- Utilizing more than one truck shall be deemed to be the employer of all drivers of those trucks.
- Construction trucking services means contracting with a licensed contractor using vehicles that require a commercial driver's license to operate or have a gross weight rating of 26,001 pounds or greater.

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F

Referral Agency and Service Provider (CA Labor Code 2750.3(g)) where the entities are organized as a C, 1065, LLC or Corporation and provide services to clients through a referral agency.

(A) Service provider (SP) is free from direction and control. — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(B) SP has complied with all business licensing and registration. — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(C) SP has a contractor's license where required for services provided. — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(D) SP delivers services under SP's name not the agency's — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(E) SP provides own tools and equipment. — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(F) SP is customarily engaged in an independently established business in the nature of the services provided. — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(G) SP maintains a clientele without restriction from agency and is free to accept work from another referral agency. — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(H) SP sets own hours and terms or work and is free to accept or reject clients and contracts. — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(I) SP sets own rates without deduction by agency. — NO → NOT SUBJECT TO DYNAMEX; YES ↓

(J) SP is not penalized for rejecting clients or contracts. — NO → NOT SUBJECT TO DYNAMEX; YES → BORELLO TEST

NOT SUBJECT TO DYNAMEX

BORELLO TEST

ABC TESTS

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;

That the worker performs work that is outside the usual course of the hiring entity's business;

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.

BORELLO TEST FACTORS

The Borello test involves the principal factor of 'whether the person to whom services are rendered has the right to control the manner and means of accomplishing the result desired' as well as the following nine additional factors.

Right to discharge at will, without cause;

Whether the one performing the services is engaged in a distinct occupation or business;

The kind of occupation, with reference to whether in the locality the work is usually done under the direction of the principal or by a specialist without supervision;

The skill required in the particular occupation;

Whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;

The length of time for which the services are to be performed;

Method of payment, whether by the time or by the job;

Whether or not the work is part of the regular business of the principal;

Whether or not the parties believe they are creating the relationship of employer-employee.

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