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Accounting • Tax • Business Insight

# Strategize & Optimize

## Tax Planning Strategies for 2023

Barnes Dennig Signature Tax Event
November 16, 2022

# Agenda

- State & local tax compliance and the impact of recent changes
- Sunsetting tax provisions and what steps to take now
- Wealth management strategies for 2023
- Cost segregation – accelerating depreciation on your building project
- Maximizing the Employee Retention Tax Credit
- K-2 & K-3 – the international tax impact

# Today's Speakers

Scott Cress, CPA, CVA, CM&AA

Mary Dieble, CPA

Cheryl Ganim, CPA

Beth Germann, CPA/PFS

Mark Hamad, CPA

Lauren Huster, CPA, MBA

Natalie Young, CPA


Natalie Young, CPA

# State & Local Tax (SALT) Compliance Update

# Today’s Topics

- Ohio’s New Pass-Through Entity Tax
- Updated Ohio’s Business Income Deduction to include sale of a business
- State Tax Methodology Changes
- Tax Rate Changes in Ohio, Indiana, and Kentucky
- Increased interest rates for underpayments beginning in 2023
- Other current state and local tax updates

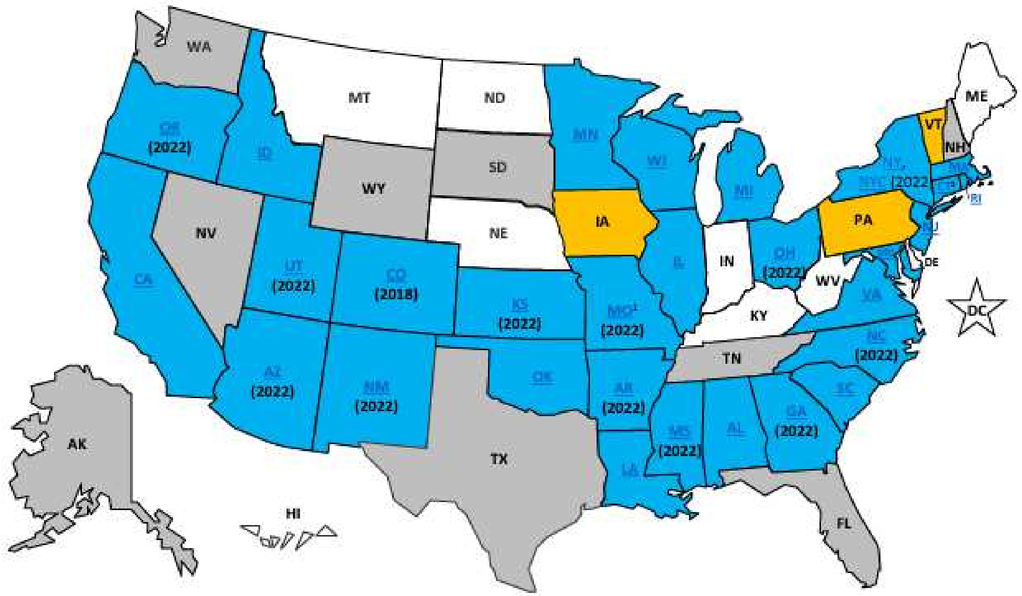
# Ohio PTE Tax

- Senate Bill 246 - Ohio's new Pass-Through Entity (PTE) Tax is effective for 2022
  - Allows a PTE owner to claim a refundable credit against the owner's Ohio income tax liability equal to the owner's proportionate share of the tax paid by the PTE
- Is considered a "workaround" to federal $10K SALT CAP
- Effective for tax year 2022 at 5% and 3% for 2023 forward
- Entity must make an annual irrevocable election by filing the IT 4738 by April 15th after the year in which the entity's taxable year ends
- All shareholders/investors/owners, both residents and non-residents must be included
- Awaiting guidance from the state of Ohio
- Draft version of Form 4738 & FAQ section are available
- Encourage planning with your CPA to determine if this election makes sense based on other states where you file, SALT addbacks, reciprocity, sales apportionments, etc.

# Ohio PTE Tax (cont.)

## States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax

As of August 31, 2022




29 states (& 1 locality) that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2021 (or earlier) unless noted:

AL, AR[1], AZ[1], CA, CO[2], CT[3], GA[1], ID, IL, KS[1], LA, MA, MI, MD, MN, MO[1], MS[1], NC[1], NJ, NM[1], NY, OH[1], OK, OR[1], RI, SC, UT[1], VA, WI, and NYC[1]

[1] Effective in 2022 or later – on map (2022) or (2023)
[2] Retroactive to 2018
[3] Mandatory

3 states with proposed PTE tax bills:
IA - HF 2087, session over, not enacted
PA – HB 1709, in committee
VT - H 0527 , session over, not enacted

9 states with no owner-level personal income tax on PTE income:

AK, FL, NH, NV, SD, TN, TX, WA, WY

10 states with an owner-level personal income tax on PTE income that have not yet proposed or enacted PTE taxes:

DE, HI, IN, KY, ME, MT, NE, ND, VT, WV

AICPA

# Ohio Business Income Deduction

- House Bill 515, effective 9/21/22 – clarified that Ohio residents who have a gain from the sale of an equity or ownership interest in a business is considered business income for Ohio income tax purposes
  - Why is this important?
    - Makes this income eligible for the Business Income Deduction (BID), which could wholly or partially exempt the sale from state taxation
    - $250k business income cap or 3% flat tax rate on excess over $250k
  - Must be considered an asset sale for Federal Income Tax Purposes
  - Must have materially participated in the business in two of the past five year
- HB 515 is intended to be remedial and clarify existing law – thus, changes should apply to audits, refund applications, reassessment petitions and appeals

# State Tax Methodology Changes

- States competing to attract & retain workers, residents, businesses & investors
- Many states shifting towards consumption-based tax systems (i.e. sales & use tax)
- States continue equalizing the tax treatment of goods versus services to increase tax revenue in an increasingly service-based economy
- States continue crafting limited-scope tax credits to encourage specific investment in their state
- PROS:
  - decreasing individual and corporate tax rates as states can recognize increased revenue from sales and use taxes
- CONS:
  - Additional complexity for service providers where sales & use tax law change frequently and are different from state-to-state
  - States continue to broaden their definition, or lower their thresholds of what constitutes nexus to capture more businesses & service providers

# Tax Rate Changes

- Indiana – House Bill 1002: tax reform to lower Indiana individual income tax rate from 3.23% in 2022 to 3.15% in 2023 & 2024. If certain government revenue thresholds are met, individual tax rates may be further reduced (3.1% 2025 & 2026, 3.0% 2027 & 2028, and 2.9% 2028 forward).

- Kentucky – individual income tax rate to lower from 5% in 2022, by .5%, to 4.5% in 2023.

- Ohio – has a graduated tax system, rather than a flat tax; tax rates and the number of tax brackets were reduced in 2021 with the top tax bracket being reduced from 4.797% to 3.990%. These rates and brackets are in effect through 2022. Business income is taxed at a flat 3%.

# SALT Underpayment Interest Rates

- Applicable to overdue personal income tax, corporate income tax and unpaid employer withholding tax
  - Interest on overpayments may not have the same rate structure
- As the federal interest rates continue to increase, so will interest rates charged by state and local taxing authorities that use the Applicable Federal Rates (AFR) as a component of their base rate
- Ohio interest rate - 3% for 2022 and 5% for 2023
- Ohio municipal interest rate - 5% for 2022 and 7% for 2023
- Ohio trust & estate - 0% in 2022 and 2% in 2023
- Kentucky interest rate – 5% for 2022 and 8% for 2023
- Indiana interest rates – 3% for 2022 and 2% for 2023
  - (Indiana rates based on the average investment yield on state money for the state's previous fiscal year, rounded to the nearest whole number)

# Ohio Municipal Update

- House Bill 519 – Municipal Extensions & Late Fees

  When a taxpayer receives an extension (including a federal extension), the bill prohibits the municipal tax administrator, or the Commissioner for state-administered local income tax collection from sending any inquiry or notice regarding the return until after either the taxpayer files the return or the extended due date passes. If a tax administrator sends a prohibited inquiry or notice, the municipality must reimburse the taxpayer for any reasonable costs incurred in responding to it. Notices may be sent if the municipality has actual knowledge that the taxpayer did not actually file for a federal or municipal income tax extension.

  Limits the penalty that may be imposed on a taxpayer for failing to timely file municipal income tax returns to a one time $25 penalty, rather than the $25 monthly, max $150 for each return currently in effect & the bill exempts a taxpayer's first failure to timely file penalty and requires the municipality (or Commissioner) to be refund or abate the penalty after the taxpayer files the late return

- For Tax Year 2022, municipal withholding requirements reverted to pre-pandemic rules

  Must withhold based on where the employee physically works beginning again in 2022

# Poll Question

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Mary Dieble, CPA

# Preparing for the Great Sunset

# Today’s Topics

- Sunset Provisions on the Horizon
- Sunset Provisions for Individuals
- Higher Tax Rates Looming
- Corporations and TCJA
- Review of the NOL rules post TCJA
- Sunset Provisions for Businesses

# Sunset Provisions on the Horizon

- With the Tax Cuts and Jobs Act (TCJA), Congress made certain provisions temporary to limit the revenue loss of the act and to get it passed under the 10-year Senate budget rules
- TCJA made significant changes to individual taxes and to estate and gift taxes and almost all these changes expire or “sunset” at the end of 2025
- Without additional policy changes, **2026** will be a big shock to many U.S. taxpayers

# Notable Sunset Provisions for Individuals:

## Personal & Dependent Exemptions:

TCJA repealed the deduction for personal exemptions but increased the standard deduction and the deduction has been adjusted annually for inflation. For 2022, the deduction is $25,900 for joint filers and $12,950 for single filers

TCJA replaced the dependent exemption with an increased child tax credit, doubling the maximum per child credit and extending it to higher-income families by increasing income thresholds

**Note:** The American Rescue Plan Act of 2021 increased the credit for one year for many taxpayers, with the intent to provide an income boost to assist low-income families

# Notable Sunset Provisions for Individuals:

## Itemized Deductions:

Limited the deduction for taxes (state, local, real estate) to $10,000 annually for single and joint filers with no indexing for inflation

For new mortgages after the effective date, TCJA limited this interest deduction to the first $750,000 vs the first $1M of mortgage debt

Suspended the home equity interest deduction unless the debt is used to buy, build or substantially improve the taxpayer's home rather than for any use – such as to pay off credit card debts, buy a car or for any other reason (Equity debt limit remained @ $100,000)

Removed the deduction for miscellaneous itemized deductions, such as tax preparer and investment advisor fees and unreimbursed business expenses

# Notable Sunset Provisions for Individuals:

## TCJA Changes to Itemized Deductions & AMT:

Removed the cap on overall allowable itemized deductions for filers with AGI above certain thresholds (known as the Pease limitation)

However, many taxpayers were forced to switch to the standard deduction due to the significant changes to itemized deductions

TCJA retained the AMT for individual taxpayers but raised the exemption levels and the income threshold at which the AMT exemption phases out to $1M for married individuals and $500,000 for others (both indexed for inflation)

TCJA changes to itemized deductions and the increase in the AMT exemption significantly decreased the number of taxpayers subject to AMT

# Tax Rates – reverting to tax rates of 2017?

## What if there are no new law changes before 2026?  Why does it matter?

TCJA added several lower tax rate brackets and increased the amount of taxable income subject to each bracket.  Unless made permanent, these changes will revert to the 2017 rates and income brackets

For example, the top federal individual tax rate will revert from the current rate of 37% for taxable income over $647,850 to the 2017 top rate of 39.6% for taxable income over $470,700

Net after-tax income will likely decline – and without inflation in check the impact will most likely be worse

# Thinking ahead to 2026

## What is the Likelihood of the TCJA Expiration?

Of course, there is no way to predict what will happen

Future scenarios depend on elections – will one party be in control or will government be split?

What economic factors will come in to play?  Recession?  Inflation? National Debt?

2024 is an election year – so anything could happen in 2025!

# Tax Planning for 2026

## For higher income taxpayers:

Roth conversions are ideal when tax rates are low – but only if a taxpayer has the funds to pay the tax outside of the IRA. Something to consider over the next three years. Remember the funds must remain in the Roth IRA for a five-year period for tax free withdrawal

Capital gain tax planning – accelerate recognition of gains prior to 2026 to avoid a possible increase in capital gain rates

Charitable gifts of stocks to reduce capital gain income

Accelerate income prior to 2026 if possible

- Best idea – consult with your financial and tax advisors since every taxpayer's situation is different – which presents different opportunities to reduce taxes!

# Corporations and TCJA

- Unlike almost all personal tax provisions of the TCJA which sunset in 2026, most corporate tax provisions are permanent (with some exceptions) noting:

  The corporate rate of 21% was made permanent by the TCJA

  The corporate alternative minimum tax was permanently repealed

# TCJA Changes to Net Operating Loss Rules

- In 2017, TCJA changed the NOL rules by:
  - Limiting the NOL deduction to 80% of taxable income
  - Disallowing NOL carrybacks, and
  - Lifting the 20-year limit on NOL carryovers

# Cares Act Changes to Net Operating Loss Rules

In 2020, the CARES Act temporarily and retroactively changed the NOL rules again:

- Under the CARES Act, an NOL from a tax year beginning in 2018, 2019 or 2020 can be carried back five years - noting that taxpayers could make an election to waive the carryback period and only carry NOLs from these years forward
- NOLs generated in 2018, 2019 and 2020 are not subject to the 80%-of-income limitation if exhausted during the five-year carryback period
- NOLs generated in 2018, 2019 and 2020 are still subject to the TCJA 80%-of-income limitation if they are carried forward to a year in which the limitation applies (generally tax years beginning after 2020)
- The five-year carryback provision expired for tax years beginning in 2021

# TCJA deduction for pass-through entities to sunset

- TCJA introduced a new but temporary deduction for pass-through businesses which allows a deduction of 20% of qualified business income – often referred to as the QBI deduction:

  The intent of this deduction was to lower the effective top individual tax rate on business income from 37 percent to 29.6 percent as the tax rate for businesses structured as pass-through entities will be almost double the C-corporation tax rate of 21%

  The QBI deduction is subject to taxable income thresholds and deductible loss limitations, with more specific income limitations for personal service firms

This provision will expire in 2026 absent a tax law change

# Expiring TCJA Provision for Businesses

A big tax benefit from the TCJA phase-out begins at the end of 2022!

- TCJA temporarily allowed 100% expensing for business property acquired and placed in service after 9/27/17 and before 1/1/23. This 100% bonus depreciation for qualifying property phases out as follows:

  2022 = 100%
  2023 = 80%
  2024 = 60%
  2025 = 40%
  2026 = 20%
  2027 = 0%

- For planning purposes – remember to be eligible for any of these bonus percentages, you must ensure that the assets are "placed in service" prior to the end of the year.

# Temporary Expiring Provision for Businesses:

**Review of the Meals & Entertainment Deduction:**

- *2017 Law:*

  A business could deduct up to 50% of meals and entertainment expenses directly related to the active conduct of the business if incurred immediately before or after a substantial and bona fide business discussion

- *TCJA Law Change:*

  Made business entertainment expenses entirely nondeductible and reduced the deduction for most meals to 50%

- *Temporary Expiring Provision:*

  In an effort to assist restaurants from the COVID-19 pandemic, the Consolidated Appropriations Act (CAA) of 2021 enacted a temporary provision for 2021 and 2022 allowing business to deduct 100% of meals when provided by a restaurant – with all other meals remain eligible for the 50% deduction

# Poll Question

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Beth Germann, CPA/PFS

# Wealth Management Strategies

# Today’s Topics

- Growth of Barnes Dennig Wealth Management (BDWM)
- Current market conditions
- Investment strategy
- Money Guide Pro
- Benefits of CPA advisors

# Current Market Conditions

- YTD performance of the market – S&P 500 down 18.76%
- Recall – 20-30% returns in 2021 (S&P 500 26.61%)
- Contributing factors:
  - Market correction
  - Inflation and federal interest rates
  - Global uncertainties

# Investment Strategy Planning

- Discipline in keeping the plan
  - Long term plan
  - All bear markets run their course
  - Avoid knee jerk changes
- Value investing
  - Review PE ratios
  - Watch for attractive buys
  - Evaluate timing to exit holdings
- Alternative investment options

# Risk Tolerance

- Bear market on a balanced, 5 on a 1-10 scale, portfolio

## Your Account Summary

| Date | Asset Value |
|---|---|
| November 2022 | $1,000,000 |
| November 2023 | $791,356 |
| Loss | -$208,644 |

# Risk Tolerance cont.

- Bear market on a growth, 7.5 on a 1-10 scale, portfolio

## Your Account Summary

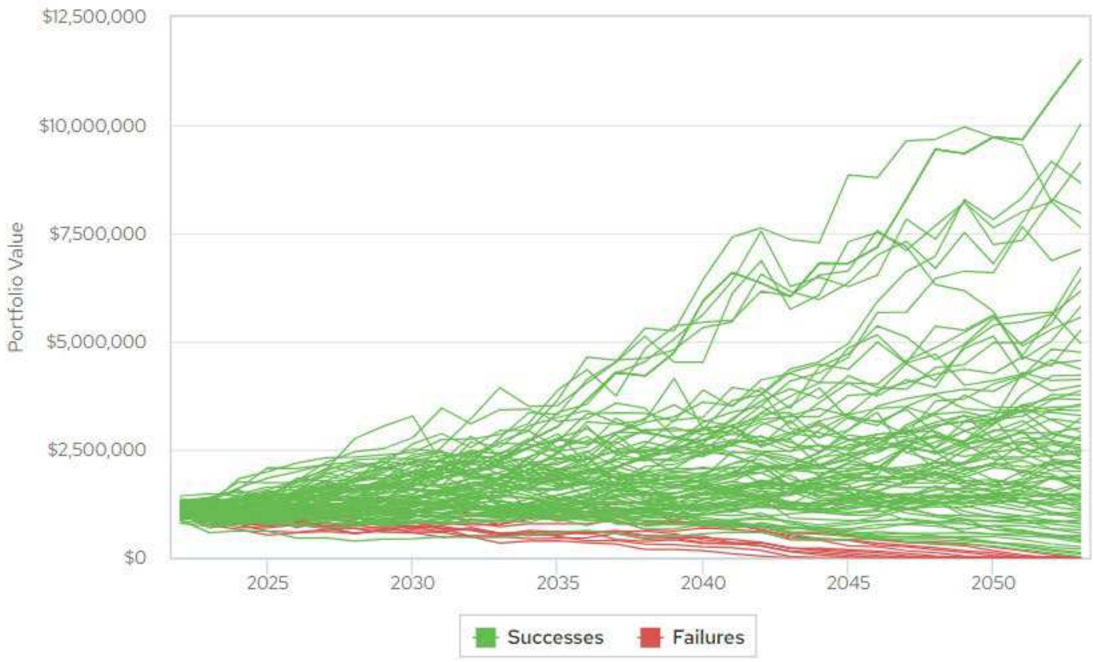
| Date | Asset Value |
|---|---|
| November 2022 | $1,000,000 |
| November 2023 | $672,878 |
| Loss | -$327,122 |

# MGP – Monte Carlo simulations

## Current Scenario

Unfortunately, because no one knows what the future returns will be, there's not a simple Yes or No answer.

That's why we run 1000 Trials of your plan using 1000 different return possibilities to calculate the probability your plan will be successful.




870 Successes
1000 Trials

=


In Confidence Zone

Explore

**Tip**

Is 87% a good result? Find Out

# Money Guide Pro

- Software used to model financial plan for retirement
  - Retirement expenses
  - Medical costs
  - Education planning
  - Extraordinary expenses
- Additional inputs – “what if” scenarios
  - Retirement year
  - Annual savings required for success
  - Proceeds needed from business sale for success
  - Returns required for success (risk assessment)

# What If….

## Solve Result

| | | Solve Result | | Enter Solve Assumptions |
|---|---|---|---|---|
| | |  | | Super Solve Method<br>Monte Carlo<br>Solve Target<br>Edit Willingness<br>SuperSolve®<br>Social Security |

## Retirement Age

Lock All Unlock All

| Name | Target Value | Solve Result | Changes | Lock |
|---|---|---|---|---|
| Mr. | 65 | 67 | 2 year(s) later | |

## Goals

Lock All Unlock All

| Description | Target Value | Solve Result | Changes | Lock |
|---|---|---|---|---|
| **Needs** | | | | |
| Retirement - Basic Living Expense | | | | |
| Both Retired | $120,000 | $67,500 | Decreased $52,500 | |
| Mrs. Alone Retired | $71,412 | $40,169 | Decreased $31,243 | |
| Health Care | | | | |
| Mr. Medicare / Mrs. Retired Before Medicare | $21,460 | N/A | Decreased $21,460 | |
| Both Medicare | $14,328 | $14,457 | Increased $129 | |
| Mrs. Alone Medicare | $8,841 | $8,841 | | |
| SUV | $50,000 | $6,250 | Decreased $43,750 | |
| **Wants** | | | | |
| Travel | $10,000 | $0 | Decreased $10,000 | |
| **Wishes** | | | | |
| Home Improvement | $45,000 | $0 | Decreased $45,000 | |
| **Total Spending for Life of Plan** | **$4,740,554** | **$2,553,530** | **Decreased 46%** | |

## Extra Savings

Show more ...

| Tax Category | Target Value | Solve Result | Changes | Lock | |
|---|---|---|---|---|---|
| Taxable | | $12,500 | Increased $12,500 | | $ 12,500 |
| Total Extra Savings | | $12,500 | Increased $12,500 | | |

# Benefits of a CPA/PFS

- Existing relationship with your personal philosophy and business operations
- Understand tax implications of transactions
- Make recommendations to manage both the tax burden and meet personal financial goals
- Under the same roof
- Held to high regulatory standards

# Poll Question


Mark Hamad, CPA

# Individual & Estate Planning Considerations

# Today's Topics

- Individual Year End Tax Strategies
- Charitable Gifting
- Tax Investment Plays
- Retirement and Other Individual Updates
- Estate and Gift Tax Exclusion Limits
- Estate and Gifting Strategies

# Individual Tax Planning

- Accelerate Deductions – Those that itemize have the most flexibility:

  - Prepay January Mortgage
  - Charitable Deductions

    Charitable Bunching
    Consider a Donor Advised Fund (DAF)
    Contribute Appreciated Securities
    If 70 ½ & older, consider Qualified Charitable Distribution (QCD)

# Individual Tax Planning

- Defer Income –
  - Investment Accounts
    - Tax Loss Harvesting
    - Watch out for Wash Sale Rules
    - See if you qualify for the 0% long-term capital gains rate
  - Be wary of buying mutual funds late in the year
  - Max out retirement accounts

# Retirement Updates

- 401(k)s, 403(b)s and other workplace retirement plans
  - You have until December 31st to contribute
  - 2022 max contribution limits – $20,500 (extra $6,500 for those over 50)
  - 2023 – Increases to $22,500 with $7,500 catch-up contributions

- IRAs
  - You have until April 18, 2023 to contribute
  - 2022 max contribution limits – $6,000 (extra $1,000 for those over 50)
  - 2023 – Increases to $6,500 and $1,000 catch-up remains the same

- Contribute to a Health Savings Account (HSA)
- Consider converting a traditional IRA to Roth IRA

# Required Minimum Distributions (RMDs)

- Individuals 72 and older must take annual withdrawals or pay 50% penalty
  - If 2022 is your first RMD year, you have until April 3, 2023 to take the RMD
- IRA
  - The RMD amount can be taken from any IRA you pick
- 401(k)
  - If you have multiple 401(k)s, an RMD must be taken from each account
  - People who work past 72 can generally delay taking RMDs from current employer's account
- QCD
  - People 70 ½ and older can transfer up to $100,000 yearly from IRAs directly to charity

# Other Individual Tax Highlights

- Standard Deduction
  - MFJ – $25,900 (each spouse 65 and older can add an additional $1,400)
  - Single – $12,950
  - HOH – $19,400
- Educator Expenses
  - If you are an eligible educator, you can deduct up to $300 of out-of-pocket classroom expenses
- Estimates and Withholdings
  - Safe Harbor Estimates vs. Actual
  - Avoid Underpayment Penalties
  - Consider bumping up W-2 or IRA withholdings

# Estate and Annual Gift Updates

| | 2022 | 2023 |
|---|---|---|
| Annual Gift Exclusion | $16,000 | $17,000 |
| Estate Lifetime Exemption | $12,060,000 | $12,920,000 |

- Lifetime Exemption amount set to be cut in half beginning in 2026 – down to ~$6M

# Estate and Gifting Strategies

- Use your annual gift tax exclusion before the end of the year
  - Both you and your spouse can give up to $16,000 to each person
- Example:
  - You are married with 4 children and 3 grandchildren
  - You and your spouse can give each person up to $32,000 this year
  - $224,000 ($32,000 x 7 kids/grandkids)
  - Out of your estate without using your lifetime exemption

# Estate and Gifting Strategies

- Help kids or grandkids with education:
  - Contribute to a 529 plan – Shelter up to 5 years in gifts
  - Pay tuition directly to the school

- Spousal Lifetime Access Trust (SLAT)
- Intentionally Defective Grantor Trust (IDGT)
- Grantor Retained Annuity Trust (GRAT)

# Other Year End Considerations

- Rebalance your retirement and investment portfolios
- Review and Update Beneficiaries
- Update Wills, Trusts and Estate documents
- Review your insurance coverage
    - Life Insurance
    - Long-Term Care Insurance

# Poll Question

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Scott Cress, CPA, CVA, CM&AA

# Cost Segregation and Depreciation

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# Cost Segregation – General Concepts

- Land is never expensed
- Buildings are expensed via depreciation – slowly
  - Commercial Buildings over 39 years
  - Residential Buildings over 27.5 years
- Goal of Study
  - Segregate cost into asset classes with shorter depreciation lives
    - 5 Year – electrical, millwork, appliances, specialized cost to support equipment
    - 7 Year – “built-in” furniture/fixtures, cabinets
    - 15 Year – Plumbing, Sitework, Land Improvements
    - 39 Year – HVAC, Roof; (while no immediate benefit segregate for easier disposal later)
- Study effective for new construction AND purchasing existing structures

# Cost Segregation – Typical Results

- Depreciable assets with class lives of 20 years or less are eligible for bonus depreciation
- Bonus depreciation phase out schedule:
  - 100% during 2022
  - 80% during 2023
  - 60% during 2024
  - 40% during 2025
  - 20% during 2026
  - 0% starting 2027
- The balance of cost not eligible for bonus depreciation normally depreciated over life of assets
- A study will accelerate (not create) depreciation deduction

# Cost Segregation – Typical Results

| | |
|---|---|
| • Apartment buildings | 20-35% |
| • Shopping center | 20-40% |
| • Warehouse | 10-25% |
| • Hotel | 25-45% |
| • Manufacturing | 25-60% |
| • Office | 10-30% |
| • Medical Facility | 30-50% |

The more specialized the structure – the better the result

# Cost Segregation Example

| Building ABC | | Year One Depreciation | |
|---|---|---|---|
| Original Cost | $1,000,000 | 100% | A = $12,820 |
| Reclass to 5 Years | $100,000 | 10% | $100,000 |
| Reclass to 15 Years | $150,000 | 15% | $150,000 |
| Remainder to 39 Years | $750,000 | 75% | $9,615 |
| | | Depreciation after reclassification | C = $259,615 |
| | | Difference (C – A) | $246,795 |
| | | Tax Rate | 42% |
| | | 1st Year Cash Savings | **$103,654** |

# Cost Segregation – Decision Tree

- Cost/Benefit Analysis of Study
  - Studies start at $5,000
  - Estimated 1st year deduction – tax/cash benefit
  - Exit plan – how long to you plan on holding the asset?
  - Passive income/loss considerations
  - Current vs future taxable income projections
  - Pending tax reform
  - 163(j) – real property trade or business election

- Plan properly to avoid surprises!


Cheryl Ganim, CPA

# The Employee Retention Tax Credit (ERTC)

# Determining if the organization qualifies is critically important

Qualification for the ERC hinges on **two tests**

- **Quantitative / Bright-line test:**

  Gross Receipts Decline Q2/3/4 2020, and/or Q1/2/3 2021 as compared to 2019 quarters

- **Qualitative test:**

  An essential business may be considered to have a partial suspension of operations if, under the facts and circumstances, more than a nominal portion of its business operations are suspended by a governmental order

# Who is an eligible employer?

- **The ERC is available to all eligible employers of any size that paid qualified wages to their employees, however different rules apply to employers with under 100 employees and under 500 employees for certain portions of 2020 and 2021.**

  US employers with 100 or fewer full-time employees in 2019 (to calculate the 2020 ERC)

  US employers with 500 or fewer full-time employees in 2019 (to calculate the 2020 ERC)

  US employers with more than 100/500 employees who paid employees to not work due to Covid-governmental orders restricting business operations

# Who is eligible for the Employee Retention Credit?

**Aggregated Groups of Employers:**

- Related entities are considered to be one employer for the purpose of the ERC tests for:
  - Small business (100/500 full time employees)
  - Gross receipts decline tests (20%/50% gross receipts decline)

# Who is eligible for the Employee Retention Credit?

Essential Businesses that were not closed due to Covid orders may qualify

More than a nominal portion of the Essential Business' operations were suspended by a government order, such that they are unable to perform their operations in a **comparable manner** as compared to 2019.

The employer operates in multiple locations and some locations are fully or partially suspended (more than a nominal portion).

# Who is eligible for the Employee Retention Credit?

## More than a nominal portion

Gross receipts from the suspended operations are 10% or more than total gross receipts (quarterly comparison of 2019 gross receipts), or

Hours of service performed by employees in the suspended operations are 10% or more than total hours of service of all employees (quarterly comparison of 2019 hours of service).

# Calculating the 2020/2021 ERC

- Maximum of $10,000 qualified wages per employee for a potential $5,000 credit per employee for 2020, increases to potential $7,000 per employee per qualifying quarter for 2021.

- Qualifying wages include employer/employee pre-tax health insurance premiums.

- Excludes wages used to calculate PPP loan forgiveness, and other wage-based tax credits.

# Claim the ERC on Payroll Tax Return

- Quarterly Forms 941X – amended payroll tax returns are used to claim the **refundable** employee retention credit.
- Advance ERCs were claimed on originally filed 941s using Form 7200.

# Substantiation Requirements

- Any records the employer relied upon to determine whether more than a nominal portion of its operations were suspended due to a governmental order.
  - Whether a governmental order had more than a nominal effect on its business operations.
- Qualifying wages.
  - How the employer determined allocable qualified health plan expenses.
- Gross receipts decline.
  - Documentation of aggregated group treated as a single employer for ERC and how aggregation impacts the determination and allocation of the credit.
- Copies of completed Forms 7200s and 941s submitted to IRS.
  - Records retained 4 years, 5 years for Q3 2021 ERCs.

# ERC Tax Impact

- The ERC is not includible in gross income, but it is subject to expense disallowance rules, which increase taxable income.
- The wages used to compute the ERC are not tax deductible for federal income tax in the tax year the wages were incurred.
- Generally, amended 2020 and 2021 income tax returns are necessary when claiming the ERC after those income tax returns were filed.
- State Income Tax conformity to federal tax code - Cares Act / CAA / ARPA. Some states may have differing conformity dates for corporate and individual tax.
  - Some states have fixed date/static conformity – OH, KY, IN. OH had post-Cares Act conformity
  - Changes to IRC are updated automatically, although the state may decouple
  - Selective conformity – adhere to some IRC changes but forgo using IRC as starting point.

# Poll Question

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Lauren Huster, CPA, MBA

# K-2 and K-3

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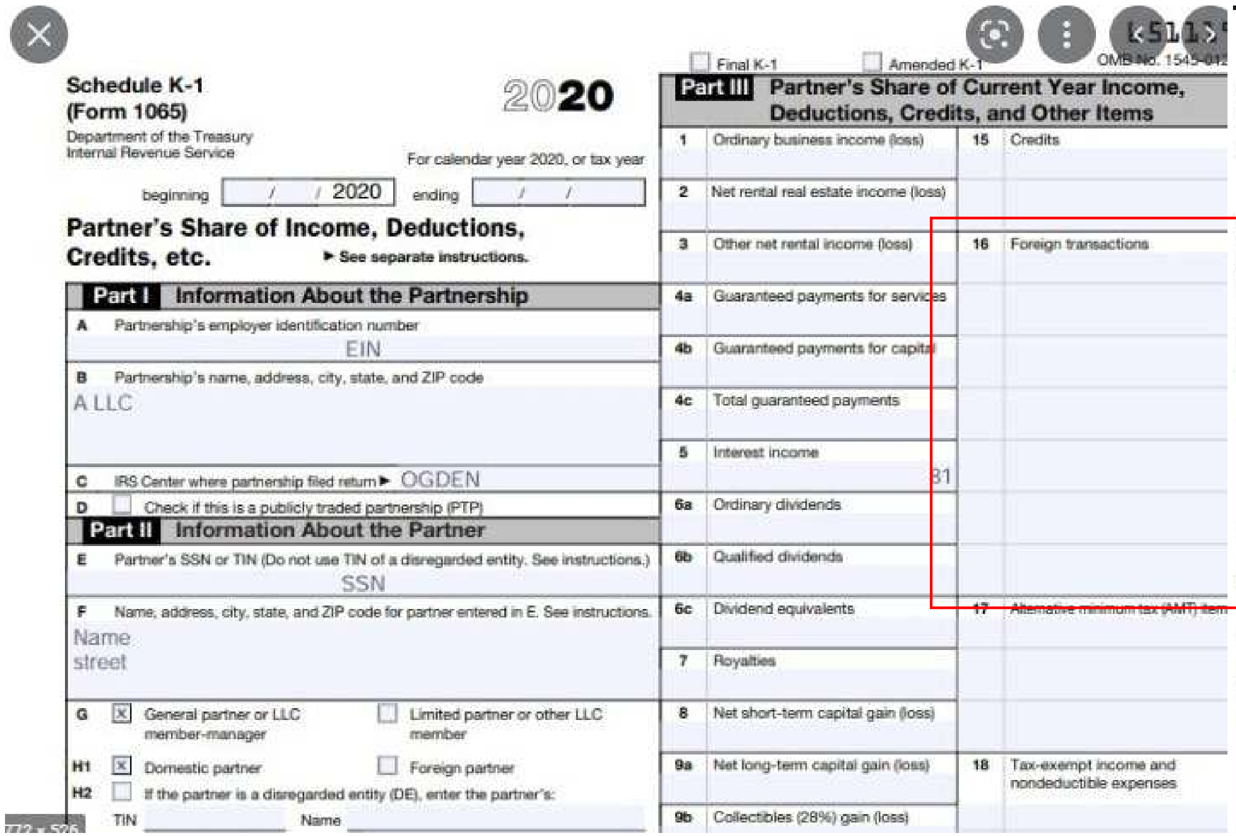
# Background

- Partnerships (Form 1065), S Corporations (Form 1120-S), and Foreign Partnerships (Form 8865) are flow through entities. These entities do not pay tax.
- Flow through entities file Form K-1s to provide the partner or shareholder's share of income, gains, losses, deductions, credits and other information from the operation of the partnership.
- Form K-1s are utilized to prepare the partner or shareholder's return

# Background

- Historically K-1s reported the foreign information in Box 16 for Form 1065 K-1 and Box 14 for Form 1120-S K-1.



Final K-1 Amended K-1 OMB No. 1545-012

Schedule K-1 (Form 1065) 2020

Department of the Treasury Internal Revenue Service

For calendar year 2020, or tax year

beginning / / 2020 ending / /

Partner's Share of Income, Deductions, Credits, etc. ▶ See separate instructions.

**Part I Information About the Partnership**

A Partnership's employer identification number
EIN

B Partnership's name, address, city, state, and ZIP code
A LLC

C IRS Center where partnership filed return ▶ OGDEN

D ☐ Check if this is a publicly traded partnership (PTP)

**Part II Information About the Partner**

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
SSN

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Name
street

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

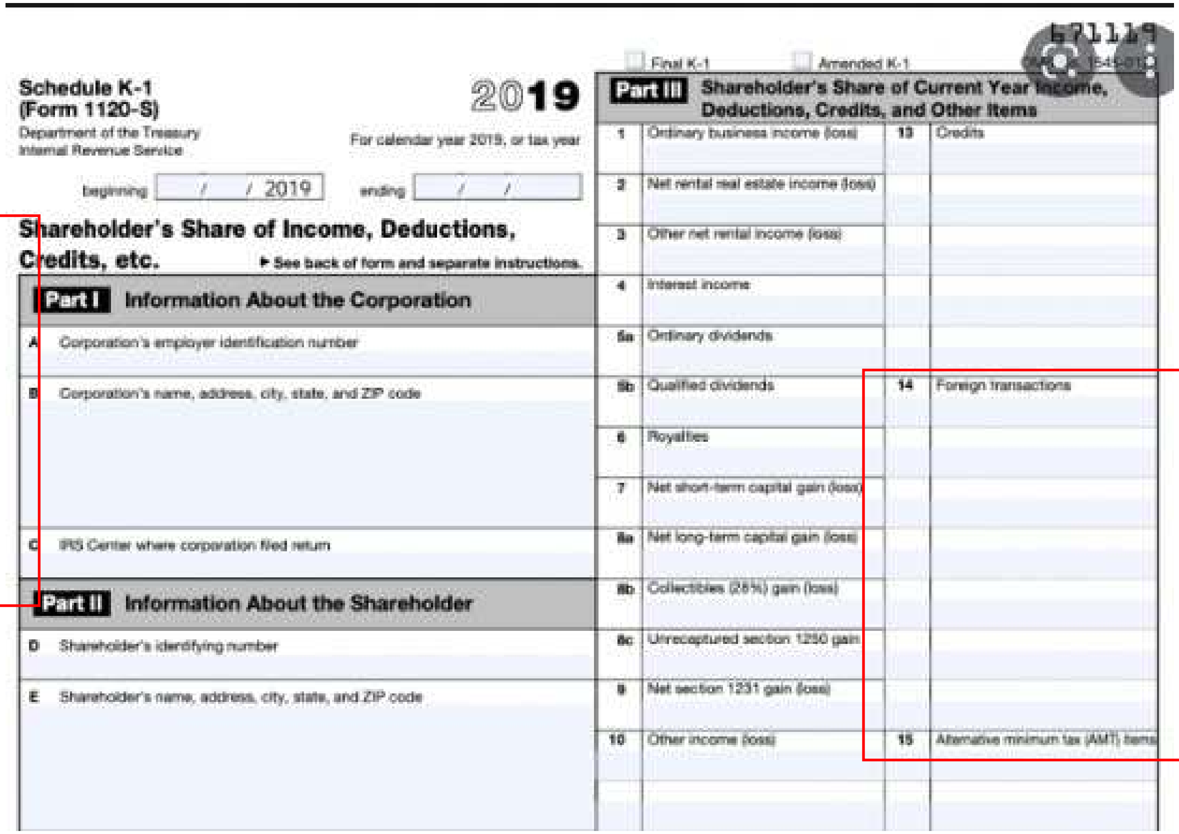
H1 ☒ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:

TIN Name

**Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items**

| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 15 | Credits |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | 16 | Foreign transactions |
| 4a | Guaranteed payments for services | | |
| 4b | Guaranteed payments for capital | | |
| 4c | Total guaranteed payments | | |
| 5 | Interest income | | |
| 6a | Ordinary dividends | | |
| 6b | Qualified dividends | | |
| 6c | Dividend equivalents | 17 | Alternative minimum tax (AMT) items |
| 7 | Royalties | | |
| 8 | Net short-term capital gain (loss) | | |
| 9a | Net long-term capital gain (loss) | 18 | Tax-exempt income and nondeductible expenses |
| 9b | Collectibles (28%) gain (loss) | | |



Final K-1 Amended K-1

Schedule K-1 (Form 1120-S) 2019

Department of the Treasury Internal Revenue Service

For calendar year 2019, or tax year

beginning / / 2019 ending / /

Shareholder's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

**Part I Information About the Corporation**

A Corporation's employer identification number

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return

**Part II Information About the Shareholder**

D Shareholder's identifying number

E Shareholder's name, address, city, state, and ZIP code

**Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items**

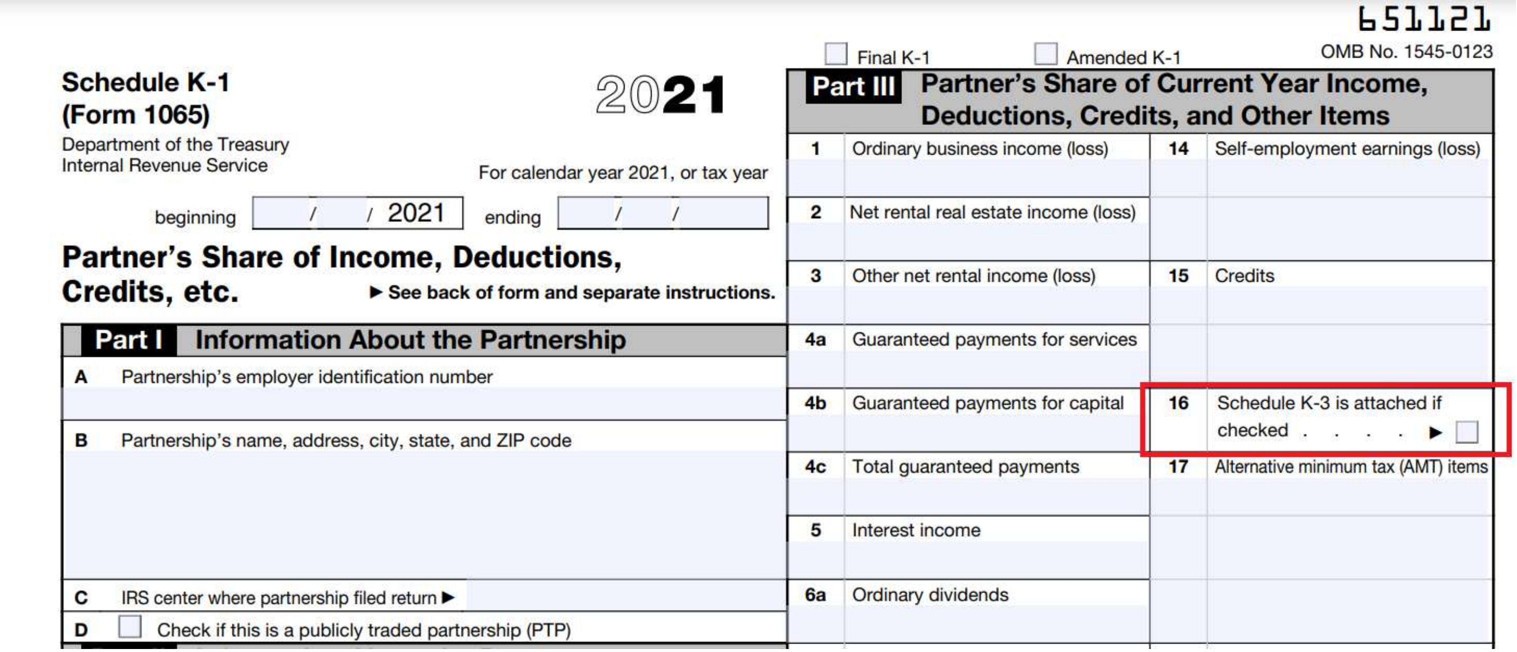
| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 13 | Credits |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | | |
| 4 | Interest income | | |
| 5a | Ordinary dividends | | |
| 5b | Qualified dividends | 14 | Foreign transactions |
| 6 | Royalties | | |
| 7 | Net short-term capital gain (loss) | | |
| 8a | Net long-term capital gain (loss) | | |
| 8b | Collectibles (28%) gain (loss) | | |
| 8c | Unrecaptured section 1250 gain | | |
| 9 | Net section 1231 gain (loss) | | |
| 10 | Other income (loss) | 15 | Alternative minimum tax (AMT) items |

# Background

| 16. | **Foreign transactions** | |
|---|---|---|
| **A** | Name of country or U.S. possession | Form 1116, Part I |
| **B** | Gross income from all sources | Form 1116, Part I |
| **C** | Gross income sourced at partner level | Form 1116, Part I |
| | *Foreign gross income sourced at partnership level* | |
| **D** | Section 951A category | Form 1116, Part I |
| **E** | Foreign branch category | Form 1116, Part I |
| **F** | Passive category | Form 1116, Part I |
| **G** | General category | |
| **H** | Other | |
| | *Deductions allocated and apportioned at partner level* | |
| **I** | Interest expense | Form 1116, Part I |
| **J** | Other | Form 1116, Part I |
| | *Deductions allocated and apportioned at partnership level to foreign source income* | |
| **K** | Section 951A category | Form 1116, Part I |
| **L** | Foreign branch category | Form 1116, Part I |
| **M** | Passive category | Form 1116, Part I |
| **N** | General category | Form 1116, Part I |
| **O** | Other | Form 1116, Part I |
| | *Other information* | |
| **P** | Total foreign taxes paid | Form 1116, Part II |
| **Q** | Total foreign taxes accrued | Form 1116, Part II |
| **R** | Reduction in taxes available for credit | Form 1116, line 12 |
| **S** | Foreign trading gross receipts | Form 8873 |
| **T** | Extraterritorial income exclusion | Form 8873 |
| **U** | Section 951A(c)(1)(A) tested income | See the Partner's Instructions |
| **V** | Tested foreign income tax | See the Partner's Instructions |
| **W** | Section 965 information | See the Partner's Instructions |
| **X** | Other foreign transactions | See the Partner's Instructions |

# Background

- No adjustment to the Form K-1 after the TCJA transformed international tax
- Companies were forced to provide necessary international information as footnotes to the K-1
  - IRS had to manually review the attachments
  - Recipients of the K-1 were left confused as not all information was presented consistently
- K-2 and K-3 provide international information in a consistent manner



651121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

**Schedule K-1 (Form 1065)** **2021**
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year
beginning / / 2021 ending / /

**Partner's Share of Income, Deductions, Credits, etc.** ► See back of form and separate instructions.

**Part I Information About the Partnership**

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

C IRS center where partnership filed return ►

D ☐ Check if this is a publicly traded partnership (PTP)

**Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items**

| | | | |
|---|---|---|---|
| 1 | Ordinary business income (loss) | 14 | Self-employment earnings (loss) |
| 2 | Net rental real estate income (loss) | | |
| 3 | Other net rental income (loss) | 15 | Credits |
| 4a | Guaranteed payments for services | | |
| 4b | Guaranteed payments for capital | 16 | Schedule K-3 is attached if checked . . . . ► ☐ |
| 4c | Total guaranteed payments | 17 | Alternative minimum tax (AMT) items |
| 5 | Interest income | | |
| 6a | Ordinary dividends | | |

# Background

- K-2 provides the information at the entity level
- K-3 provides the information at the individual level
  - Part of the K-1 package provided to partners or shareholders
- IRS' intention was that all the information required on these forms was either:
  - Already necessary for the partnership to provide to partners; OR
  - Already available to the partnership

# Who Needs to File – 2021 Tax Year

- Original understanding was that these forms would only apply to flow-through entities with items of international tax relevance.
- IRS estimated it would affect less than 5% of taxpayers. This was grossly understated.
- In reality, assume that all flow through entities will NEED to file these schedules for 2021 unless all of the following items are true:
  - No foreign partners
  - No foreign source income
  - No assets generating foreign source income
  - No foreign taxed paid of accrued
  - No partner that files Form 1116/Form 1118
  - No partner requesting the information
  - No foreign information was provided in 2020

# Examples – 2021 Tax Year

- US S Corporation with 2 US Shareholders
  - No foreign transactions in ordinary course of business
  - S Corporation has an investment account which holds foreign stock and receives $200 of foreign tax credit a year
  - US S Corporation is required to file K-2 and provide K-3 to all partners
- US Partnership with 3 US Partners
  - No foreign transactions
  - No foreign assets
  - 1 Partner files Form 1116
  - US Partnership is required to file K-2 and provide K-3 to partner who files Form 1116

# Penalties

- Failure to File penalty for return required to be filed in 2022 is $210 per partner or shareholder per month (not to exceed 12 months)
- Failure to Supply to IRS penalty
  - Corrected before 8/1/22 is $110 per partner or shareholder
  - Corrected after 8/1/22 is $280 per partner or shareholder
  - Intentional disregard is greater of $570 or 10% of aggregate amount required to be reported
- Failure to Supply to Partner or Shareholder penalty
  - Corrected before 8/1/22 is $110 per partner or shareholder
  - Corrected after 8/1/22 is $280 per partner or shareholder
  - Intentional disregard is greater of $570 or 10% of aggregate amount required to be reported

# Penalty Relief

- Notice 2021-39, 2021-27 IRB 12 provides transition relief, provided “good faith effort” is made to comply with the filing requirements.
- Good Faith Effort is defined as:
  - Company made changes to its systems, process, and procedures to collection and processing information relevant to filing K-2 and K-3
  - Company made reasonable assumptions when information was not obtained
  - Steps taken by company to modify partnership or S corporation agreement to facilitate sharing of info to determine if K-2 and K-3 was necessary
  - IRS will consider effort made, reasonableness of assumptions and size of partner (less than 10%) for information that was not obtained.
- Keep in mind this relief is only for 2021 filings.

# Who Needs to File – 2022 Tax Year

- 2022 K-2 instructions show a domestic filing exception to these forms if EACH of the following criteria is met:

1. No or limited foreign activity. Limited Activity is defined as:
   - Passive category foreign income
   - No more than $300 of foreign income taxes allowed as a credit
   - Foreign income and taxes are on a statement furnished to the partnership
2. During the tax year, all direct partners are one of the following:
   - Individuals that are US citizens
   - Individuals that are US resident aliens
   - Domestic decedent's estates with solely US citizen and/or resident alien individual beneficiaries
   - Domestic grantor trusts with solely US citizen and/or resident alien individual grantors and beneficiaries
   - Domestic non-grantor trusts with solely US citizen and/or resident alien individual beneficiaries
3. If a partnership meets the criteria of 1 and 2, the partnership must notify partners either by mail or electronically within 2 months of the due date of the tax return (WITHOUT extension) that the partners will NOT receive K-3 from the partnership unless the partners request the schedule.
   - Calendar year partnerships would notify by January 15, 2023 for 2022 tax year

# Who Needs to File - 2022 Tax Year

4. The partnership does not receive a request from any partner for Schedule K-3 information on or before 1 month before the due date (WITHOUT extension)

    Calendar year partnerships would be notified by February 15, 2023 for 2022 tax year

- If the partnership receives a request from a partner for the Schedule K-3 information after the 1-month date and has not received a request from any other partner for Schedule K-3 information on or before the 1-month date, the domestic filing exception is met, and the partnership is not required to file the Schedule K-2 and K-3 with the IRS or furnish the Schedule K-3 to the non-requesting partners

    Partnership is required to provide the Schedule K-3 to the requesting partner on the later of the date on which the partnership files the Form 1065 or one month from the date on which the partnership receives the request from the partner

# Examples - 2022 Tax Year

- US S Corporation with 2 US Individual Shareholders
  - No foreign transactions in ordinary course of business
  - S Corporation has an investment account which holds foreign stock and receives $200 of foreign tax credit a year. The foreign income and tax is reported on Form 1099 to the S Corporation.
  - S Corporation notifies shareholders on January 10, 2023 they will not receive Schedule K-3 unless requested
  - No shareholder requests Schedule K-3
  - S Corporation is NOT required to file K-2 or K-3
- US S Corporation with 2 US Individual Shareholders
  - No foreign transactions in ordinary course of business
  - S Corporation has an investment account which holds foreign stock and receives $200 of foreign tax credit a year. The foreign income and tax is reported on Form 1099 to the S Corporation.
  - S Corporation notifies shareholders on January 10, 2023 they will not receive Schedule K-3 unless requested
  - Shareholder A requests K-3 on February 1, 2023
  - S Corporation is required to file relevant parts of K-2 and K-3 with the IRS and Shareholder A

# Examples - 2022 Tax Year

- US S Corporation with 2 US Individual Shareholders
  - No foreign transactions in ordinary course of business
  - S Corporation has an investment account which holds foreign stock and receives $200 of foreign tax credit a year. The foreign income and tax is reported on Form 1099 to the S Corporation.
  - S Corporation notifies shareholders on January 10, 2023 they will not receive Schedule K-3 unless requested
  - S Corporation files return on August 31, 2023
  - Shareholder A requests K-3 on February 20, 2023
  - S Corporation is NOT required to file relevant parts of K-2 and K-3 with the IRS, but must provide the Schedule K-3 to Shareholder A on August 31, 2023

# Examples - 2022 Tax Year

- US S Corporation with 2 US Individual Shareholders
  - No foreign transactions in ordinary course of business
  - S Corporation has an investment account which holds foreign stock and receives $200 of foreign tax credit a year. The foreign income and tax is reported on Form 1099 to the S Corporation.
  - S Corporation notifies shareholders on January 10, 2023 they will not receive Schedule K-3 unless requested
  - S Corporation files return on August 31, 2023
  - Shareholder A requests K-3 on February 1, 2023
  - Shareholder B requests K-3 on February 20, 2023
  - S Corporation is required to file relevant parts of K-2 and K-3 with the IRS for Shareholder A. Only needs to provide the K-3 information for Shareholder B to the shareholder on August 31, 2023.

# Who Needs to File - 2022 Tax Year

- If a partnership doesn't qualify for domestic filing exception, they may qualify for Form 1116 Exemption
  - Domestic partnership is not required to file Schedules K-2 and K-3 if all partners are eligible for Form 1116 exemption and the partnership receives notification of the partners' eligibility for the Form 1116 exemption by the 1-month date.
  - If partnership only receives notification from some of the partners being eligible for Form 1116 exemption, the partnership need not complete the Schedule K-3 for those exempt partners.
- Form 1116 Exemption
  - Claim foreign tax credit without filing Form 1116
  - All of foreign source income was passive category income
  - All of the foreign source income and taxes were reported on a payee statement (1099-DIV, 1099-INT, Schedule K-1, etc)
  - Creditable foreign taxes are not more than $300 if filing single or $600 if filing married filing joint

# Example - 2022 Tax Year

- US S Corporation with 2 US Individual Shareholders
  - No foreign transactions in ordinary course of business
  - S Corporation has an investment account which holds foreign stock and receives $400 of foreign tax credit a year. The foreign income and tax is reported on Form 1099 to the S Corporation. Each shareholder receives $200 of foreign tax credit.
  - S Corporation notifies shareholders on January 10, 2023 they will not receive Schedule K-3 unless requested
  - Shareholders have no other foreign source income or taxes so they qualify for Form 1116 exemption and notify S Corporation on February 1, 2023 they do not need Schedule K-3.
  - S Corporation is NOT required to file Form K-2 and K-3 with the IRS

# Overview 1065 K-2 and K-3

- **Form 1065 Schedule K-2 Partners' Distributive Share Items –International**
- Part I: Partnership's other current year international information
- Part II: Foreign tax credit limitation
- Part III: Other information for preparation of Form 1116 or 1118
- Part IV: Information on partners' IRC section 250 deduction with respect to foreign derived intangible income (FDII)
- Part V: Distributions from foreign corporations to partnership
- Part VI: Information on partners' IRC §951(a)(1) Subpart F and §951A GILTI Inclusions from CFCs
- Part VII: Information to complete Form 8621 regarding PFICs and QEF Information
- Part VIII: Partnership's interest in foreign corporation income (IRC §960)
- Part IX: Partners' information for Base Erosion and Anti-Abuse Tax (BEAT) IRC §59A
- Part X: Foreign partners' character and source of income and deductions (ECTI subject to IRC §1446 foreign partner withholding and FDAP income subject to IRC §§1441 and 1442 withholding)
- Part XI: IRC section 871(m) covered partnerships
- Part XII: Reserved for future use

- **Form 1065 Schedule K-3 Partner's Share of Income, Deductions, Credits, etc.–International**
- Part I: Partner's share of partnership's other current year international information
- Part II: Foreign tax credit limitation
- Part III: Other information for preparation of Form 1116 or 1118
- Part IV: Information on partner's IRC section 250 deduction with respect to foreign derived intangible income (FDII)
- Part V: Distributions from foreign corporations to partnership
- Part VI: Information on partner's IRC §951(a)(1) Subpart F and §951A GILTI Inclusions from CFCs
- Part VII: Information to complete Form 8621 regarding PFICs and QEF Information
- Part VIII: Partner's interest in foreign corporation income (IRC §960)
- Part IX: Partner's information for Base Erosion and Anti-Abuse Tax (BEAT) IRC §59A
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- Part XI: IRC section 871(m) covered partnerships
- Part XII: Reserved for future use
- Part XIII: Foreign partner's distributive share of deemed sale items on transfer of partnership interest

# Overview 1120S K-2 and K-3

- **Form 1120-S Schedule K-2 Shareholder's Pro Rata Share Items –International**
- Part I: Corporation's other current year international information
- Part II: Foreign tax credit limitation
- Part III: Other information for preparation of Form 1116 or 1118
- Part IV: Distributions from foreign corporations to corporation
- Part V: Information on shareholders' IRC §951(a)(1) Subpart F and §951A GILTI Inclusions from CFCs
- Part VI: Information to complete Form 8621 regarding PFICs and QEF Information
- Part VII: Corporation's interest in foreign corporation income (IRC §960)

- **Form 1120-S Schedule K-3 Shareholder's Share of Income, Deductions, Credits, etc.–International**
- Part I: Shareholder's share of corporation's other current year international information
- Part II: Foreign tax credit limitation
- Part III: Other information for preparation of Form 1116 or 1118
- Part IV: Distributions from foreign corporations to corporation
- Part V: Information on shareholder's IRC §951(a)(1) Subpart F and §951A GILTI Inclusions from CFCs
- Part VI: Information to complete Form 8621 regarding PFICs and QEF Information
- Part VII: Shareholder's share of corporation's interest in foreign corporation income (IRC §960)

# Overview 8865 K-2 and K-3

- **Form 8865 Schedule K-2 Partners' Distributive Share Items – International**
- Part I: Partnership's other current year international information
- Part II: Foreign tax credit limitation
- Part III: Other information for preparation of Form 1116 or 1118
- Part IV: Information on partners' IRC section 250 deduction with respect to foreign derived intangible income (FDII)
- Part V: Distributions from foreign corporations to partnership
- Part VI: Information on partners' IRC §951(a)(1) Subpart F and §951A GILTI Inclusions from CFCs
- Part VII: Information to complete Form 8621 regarding PFICs and QEF Information
- Part VIII: Partners' information for Base Erosion and Anti-Abuse Tax (BEAT) IRC §59A

- **Form 8865 Schedule K-3 Partner's Share of Income, Deductions, Credits, etc.– International**
- Part I: Partner's share of partnership's other current year international information
- Part II: Foreign tax credit limitation
- Part III: Other information for preparation of Form 1116 or 1118
- Part IV: Information on partner's IRC section 250 deduction with respect to foreign derived intangible income (FDII)
- Part V: Distributions from foreign corporations to partnership
- Part VI: Information on partner's IRC §951(a)(1) Subpart F and §951A GILTI Inclusions from CFCs
- Part VII: Information to complete Form 8621 regarding PFICs and QEF Information
- Part VIII: Partner's information for Base Erosion and Anti-Abuse Tax (BEAT) IRC §59A

# Summary

- Overwhelming number of parts, but only applicable sections need to be completed if company doesn't qualify for domestic filing exception
- Having direct partners or shareholders that are flow-through entities will still require company to analyze which parts of Schedule K-2 need to be completed
- The K-2 and K-3 may may have tripled the size of your return, but it is ultimately to assist in the following ways:
  - IRS to process the information quicker
  - Make preparation of partner and shareholder returns easier with consistent information

# Poll Question


Questions?

# Thank you.

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