TAX SEASON TOOLKIT 2019

Insight for California Businesses and Individuals

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California Conformity

As of December 2019, the Tax Cuts and Jobs Act turned 2 years old. As noted in the 2018 toolkit in the December 2018 issue of *California CPA*, California didn't conform to most federal tax law changes introduced in the TCJA. This added complexity for taxpayers who needed to calculate the correct amount of tax owed to the state.

Although California enacted a bill that realigns the state's tax code and adopts certain elements of the TCJA, there are still many areas of the TCJA with which California doesn't conform or only selectively conforms.

Doesn't Fully Conform

In the 2018 tax season guide, we addressed tax law changes that California taxpayers should watch out for. California still doesn't conform with many of those federal tax laws, including the following:

1. **Qualified Business Income Deduction.** California doesn't conform to Internal Revenue Code (IRC) Sec. 199A, which allows certain owners of sole proprietorships, partnerships, trusts and S corps to deduct 20 percent of qualified business income.

2. **Full-Expensing Deduction.** California hasn't and still doesn't conform to IRC Sec. 168(k), which allows the additional first-year depreciation deduction for the cost of certain tangible business-use personal property assets.
3. **State and Local Tax Deduction**. For federal tax purposes, an individual's deduction for the aggregate amount of state and local taxes (SALT) paid during a calendar year is limited to $10,000—or $5,000 in the case of a married individual filing separately. California doesn't conform to the federal limitation and doesn't allow a deduction for SALT paid in the calculation of income.

Now Conforms

To reduce taxpayer compliance burdens, California Gov. Gavin Newsom signed Assembly Bill 91 on July 1, 2019, which selectively aligned parts of California tax law to the TCJA.

A few important conformity changes are highlighted below. Unless otherwise noted, the legislation is effective July 1, 2019, and applies to tax years beginning on or after Jan. 1, 2019.

WHAT YOU NEED TO BUILD A SUCCESSFUL **TAX SEASON**

Accounting Methods for Small Businesses

The TCJA increased the average annual gross receipts thresholds, allowing more taxpayers to use simplified methods of accounting. AB 91 conforms to these changes. Specifically, AB 91 follows the TCJA in increasing the following average annual gross receipts:

1. **The cash method of accounting.** The average annual gross receipts threshold increased from $5 million to $25 million for taxpayers that are permitted to use the cash method of accounting.
2. **The accrual method of accounting.** The average annual gross receipts threshold increased from $5 million to $25 million for farming corporations that are exempt from using the accrual method of accounting.
3. **Uniform capitalization (UNICAP) provisions.** The average annual gross receipts threshold increased from $10 million to $25 million for resellers and zero to $25 million for producers to be exempt from UNICAP provisions.

In addition, California now conforms to TCJA changes that exempt businesses with average annual gross receipts of $25 million or less from rules that require taxpayers to maintain inventories.

Instead, these taxpayers can account for items that are either:

- Nonincidental materials and supplies; or
- In accordance with a taxpayer's method for financial accounting.

California now exempts certain taxpayers' construction contracts from the required use of the percentage-of-completion method. To qualify, the taxpayer must have average annual gross receipts that don't exceed $25 million. These changes apply to personal income taxpayers and corporate taxpayers.

All of these accounting-method changes are effective for tax years beginning on or after Jan. 1, 2019. Taxpayers can make an election to have these provisions apply to tax years beginning on or after Jan. 1, 2018. These elections must be manually filed on paper.

Net Operating Loss Carryback

California will follow the federal changes that disallow net operating loss (NOL) carrybacks for losses sustained in tax years beginning on or after Jan. 1, 2019.

The state retains a 20-year carryforward period under this legislation.

These changes apply to both personal and corporate taxpayers.

Like-Kind Exchanges

California will follow the federal treatment of IRC Sec. 1031, like-kind exchanges, enacted by the TCJA. Like-kind exchanges of tangible personal property no longer qualify for tax deferred treatment in California, except for individual taxpayers with less than $250,000 of federal adjusted gross income or $500,000 for head-of-household and joint filers.

This change is effective for exchanges completed after Jan. 10, 2019, and the change applies to both personal and corporate taxpayers.

Limitation on Excess Business Losses

In general, California conforms to IRC Sec. 461(l), disallowing deductions of excess business losses that are more than:

- $250,000 for a single filer
- $500,000 for a joint filer

The federal change expires in 2026 and provides a net operating loss carryforward for the amount greater than the limit.

However, California decouples from the federal expiration and NOL carryforward. Instead of being treated as an NOL, the disallowed excess business loss is treated as a carryover excess business loss that should be included in the following year's excess business loss computation.

Additional Changes

AB 91 introduces several additional filing changes, including:

- **Technical Termination of a Partnership.** AB 91 adopts the TCJA's repeal of the federal technical termination of partnership provisions.
- **IRC Sec. 338 Election.** For qualified stock purchased on or after July 1, 2019, a federal election made under IRC Sec. 338 will be the same for California purposes. This election treats qualified stock purchases of target corporations as asset purchases. In other words, a separate California IRC Sec. 338 won't be allowed.
- **Achieving a Better Life Experience (ABLE) Accounts.** AB 91 eliminates the differences in federal and California ABLE

qualification criteria and increases the contribution limits up to the federal poverty level. The bill allows taxpayers to roll over a IRC Sec. 529—college savings—plan to an ABLE account.

- **Federal Deposit Insurance Corporation Premiums.** In general, California conforms to IRC Sec. 162(r), which relates to the disallowance of Federal Deposit Insurance Corporation premiums.
- **Excess Employee Compensation.** In general, AB 91 conforms to the TCJA by revising the definitions of *covered employee* and *publicly held corporation*. This limits the amount these taxpayers may deduct for ordinary and necessary expenses. AB 91 also disallows the performance-based compensation and commission exceptions with respect to the limits for deductions relating to covered employees.
- **Student Loan Debt.** Generally, AB 91 confirms to IRC Sec. 108(f)(5) relating to the income exclusion of student loan indebtedness discharged on or after Dec. 31, 2017.

Income Tax Credit

Earned Income Tax Credit

In 2018, the California Earned Income Tax Credit was extended to help low-income taxpayers. AB 91 raises the maximum earned income to $30,000. The bill also added a refundable young child tax credit of up to $1,000 per qualified taxpayer, per taxable year.

The FTB webpage details credit amounts, income limits, qualifications and additional information.

California Competes Tax Credit

The California Competes Tax Credit (CCTC) program has been around since 2014 and is an economic-development incentive intended to attract or retain businesses considering a significant new investment in California. It does this by providing successful applicants with a nonrefundable tax credit that reduces taxpayers' personal income tax or corporation tax.

In the CCTC program's 2019–20 fiscal year, the California Governor's Office of Business and Economic Development is authorized to negotiate up to $237.8 million in tax credits over three application periods.

Application Periods

The first application period ended on Aug. 19, 2019. The next two CCTC application periods for the program's 2019–20 fiscal year are shown in Figure 1.

FIGURE 1

PERIOD BEGINS	PERIOD ENDS	ALLOCATION
January 6, 2020	January 27, 2020	$75 million
March 9, 2020	March 30, 2020	$71 million or more

Disaster Loss Deductions

California taxpayers may be able to claim a disaster loss deduction for any loss sustained in the state during an event proclaimed to be a state of emergency by the California governor. California hasn't conformed to the TCJA in this regard, instead generally following the former federal law regarding the treatment of losses incurred due to casualty or disaster.

Extended Deadlines

The FTB automatically follows the IRS extended deadlines to file or pay taxes until the date indicated for the specific disaster. Taxpayers are advised to write the disaster name in dark ink at the top of their tax return to alert the FTB of the disaster to which the return is related.

Tropical Storm Imelda

The FTB has announced that the federal postponement period for Tropical Storm Imelda will be recognized as shown in Figure 2.

FIGURE 2

DISASTER NAME	TAX YEAR	EXTENDED TAX DEADLINE
TROPICAL STORM IMELDA	2018	January 31, 2020

Additional Designated Areas

The IRS disaster relief webpage lists additional designated areas eligible for a postponement period. If a taxpayer qualifies for the postponement period, any interest, late-filing or late-payment penalties that would otherwise apply will be cancelled. The FTB will also follow these stipulations.

Other 2019 Disasters

Taxpayers may deduct a disaster loss for any loss sustained in a California city or county where the governor declares a state of emergency. Figure 3 (*next page*) shows a list of California Qualified Disasters, published on the FTB as of Oct. 31, 2019. For more information on California disaster losses, see the FTB website and Publication 1034, *Disaster Loss How to Claim a State Deduction*.

Additional Changes

The *Dynamex* Decision

On Sept. 18, 2019, the governor signed AB 5 into law. The bill served to codify the 2018 California Supreme Court decision in *Dynamex Operations West, Inc. v. Superior Court of Los Angeles* (*Dynamex*). As mentioned in last year's tax season guide, the *Dynamex* decision created a new standard for evaluating independent contractor relationships, identified as the ABC Test.

The ABC Test

The ABC Test requires a hiring entity to demonstrate that all three of the following requirements are met for a worker to be properly characterized as an independent contractor:

A. The worker is free from the control and direction of the hirer with the performance of the work, both under the contract for the performance of the work and in fact.

B. The worker performs work that is outside the usual course of the hiring entity's business.

C. The worker is customarily engaged in an independently established trade, occupation or business of the same nature as that involved in the work performed.

FIGURE 3

DISASTER CODE	INCIDENT PERIOD	DISASTER	COUNTY	GOVERNOR DECLARED	PRESIDENT DECLARED
112	October 19	Los Angeles and Riverside Fires	Eagle, Reche, Saddleridge, Sandalwood, and Wolf	Yes	No
111	July 19	Earthquake	Kern and San Bernardino	Yes	No
110	February 19	Atmospheric River Storm System	Amador, Glenn, Lake, Mendocino, and Sonoma	Yes	No
109	January and February 19	Atmospheric River Storm System	Calaveras, El Dorado, Humboldt, Los Angeles, Marin, Mendocino, Modoc, Mono, Monterey, Orange, Riverside, San Bernardino, San Diego, San Mateo, Santa Barbara, Santa Clara, Shasta, Tehama, Trinity, Ventura, and Yolo	Yes	No

Exemptions and Revisions

AB 5 also introduced additional classification changes to expand and refine the provisions articulated in the *Dynamex* decision. Among these changes were exemptions from the ABC Test for some licensed professionals, including physicians, lawyers and accountants, as well as a changes to the regulatory definition of an employee to make it more inclusive.

These changes will likely make employer-employee relationships more common than independent contractor relationships.

AB 5 is applicable to both the California Labor Code and the California Unemployment Insurance Code and is effective retroactively.

Interest Rates

Effective Jan. 1, 2019, the FTB will pay 2 percent interest on corporate refunds. This rate is effective through June 30, 2020. The interest rate for personal income tax underpayments and overpayments, corporation underpayments, and estimate penalties are shown in Figure 4.

For interest rates after June 30, 2020, the FTB will provide more information on their website once it's available.

FIGURE 4

START DATE	END DATE	INTEREST RATE
January 1, 2020	June 30, 2020	5%
July 1, 2019	December 31, 2019	6%
January 1, 2019	June 30, 2019	5%

Doing Business and Economic-nexus Thresholds

For California income tax purposes, *doing business* is defined as, "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."

For the taxable year beginning on or after Jan. 1, 2019, a taxpayer is seen as doing business in California for a taxable year if any of the following conditions are satisfied:

1. The taxpayer is organized or commercially domiciled in California.
2. The taxpayer's California sales exceed the lesser of $601,967 or 25 percent of total sales.
3. The taxpayer's real property and tangible personal property in California exceed the lesser of $60,197 or 25 percent of total real property and tangible personal property.
4. The taxpayer's compensation amount paid in California exceeds the lesser of $60,197 or 25 percent of total compensation paid.

The doing-business thresholds for taxpayers are indexed for inflation and revised annually.

Sourcing Rules for Self-employed Individuals

The California Office of Tax Appeals (OTA) recently issued a precedential decision that affects California nonresident—out of state—sole proprietors whose taxable income is derived from sources other than tangible personal property.

The *Bindley* Decision

In the *Appeal of Blair S. Bindley*, the taxpayer was a self-employed Arizona resident who performed his services in Arizona for California customers. The taxpayer didn't file a California personal income tax return because he believed the income was earned from where he performed the services in Arizona. The taxpayer received Form 1099s from two California entities.

The FTB was successful in arguing that the taxpayer's income from services was subject to the California apportionment rules under application of California Code of Regulations Section 17951. Having the OTA make its decision in *Bindley* precedential allows the FTB to use the case as authoritative guidance when applying the ruling to other similarly situated taxpayers.

Sales Tax

Sales and Use Tax and Economic Nexus

California has expanded its sales-tax nexus provisions to eliminate a physical presence requirement and create an economic nexus standard. Effective April 1, 2019, sellers with California gross receipts of $500,000 or more in either the preceding or current calendar years will be considered to have nexus for sales and use tax.

Marketplace Facilitators

AB 147 imposes a new sales and use tax collection responsibility upon marketplace facilitators. The bill was signed into law by Gov. Newsom on April 25, 2019.

These marketplace facilitator provisions apply to marketplaces such as Amazon, Etsy, eBay and other similar sales platforms. Sales platforms with nexus in California will be required to collect and report sales tax on behalf of those vendors who sell through their platform beginning Oct. 1, 2019.

For purposes of the $500,000 economic nexus threshold in California, a marketplace facilitator will include all sales of tangible personal property made through its marketplace for delivery into California, including the seller's own product sales and sales of products facilitated through its marketplace.

Manufacturing and R&D

On July 1, 2014, California implemented a partial state sales tax exemption for qualified taxpayers, based on primary lines of business associated with identified North American Industry Classification System codes. To qualify, these taxpayers must purchase qualified tangible personal property to be used in qualified manufacturing and R&D activities.

The tax exemption was originally set at 4.1875 percent and was reduced to 3.9375 percent on Jan. 1, 2017—where it will remain through the sunset date, currently slated for July 1, 2030.

Next Steps

Federal tax changes and related conformity requirements will continue to impact California taxpayers. Stay tuned for more.

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Federal Tax Update

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Taxpayer First Act

The following are highlights of some of the provisions in this Act (P.L. 116-25), enacted July 1, 2019.

Independent Appeals Office

The new Independent Office of Appeals continues to operate separately from compliance functions to resolve tax disputes and review IRS administrative decisions fairly and impartially.

The Act also provides taxpayers the right to review administrative case files and to protest a denial of a referral to the Appeals Office.

The right to review these files is limited to:

- Individuals with adjusted gross income of $400,000 or less for the tax year at issue; and
- Businesses with gross receipts of less than $5 million for the tax year at issue.

These taxpayers are allowed access to nonprivileged portions of their case files by the Appeals Office at least 10 days before their scheduled conference.

When designating a deficiency notice case as ineligible for referral to Appeals, the IRS must provide the taxpayer with a written detailed explanation of the basis for the denial—together with procedures to protest the denial.

Appeals can obtain legal advice and assistance from the IRS Office of Chief Counsel, but to the extent practicable, that assistance is to be provided only by Counsel staff who were not involved in advising the IRS employees working directly on the case before the referral to Appeals.

Third-party Contacts

The Act amended IRC Sec. 7602(c)(1) to require the IRS to issue advance notice of third parties the IRS intends to contact at the time this notice is issued.

This notice must state this intent; specify the time period for these contacts, which cannot exceed one year; and be sent to the taxpayer at least 45 days before contacting a third party.

The IRS cannot contact a third party until the 46th day after issuing this notice.

Memorandum SBSE-04-0719-0034 provides interim guidance for complying with amended Sec. 7602(c)(1).

Failure-to-File Penalty

Under Sec. 6651(a), the minimum penalty was the lesser of $215 (for returns required to be filed in 2019) or 100 percent of the amount required to be shown as tax on the return.

This minimum penalty applies if a return is filed more than 60 days after its due date, including extensions, unless the delay is due to reasonable cause and not willful neglect

The Act amended Sec. 6651(a) to increase this $215 amount to $330, which will continue to be adjusted for inflation, effective for returns required to be filed after 2019.

Other Provisions

Some of the other provisions are:

1. Authorizing credit card payments;
2. Lower threshold for filing electronic information returns; and
3. Uniform electronic signature requirements.

Nonemployee Compensation

The 2015 Protecting Americans from Tax Hikes Act (P.L. 114-113) added a new Sec. 6071(c) which provides that Forms W-2 and W-3 *and* any returns or statements required by the IRS to report nonemployee compensation must be filed on or before Jan. 31 of the year following the calendar year to which such returns relate.

New Sec. 6071(c) was effective for returns and statements relating to calendar years beginning after 2015.

For 2019 and prior years, nonemployee compensation had been reported on Form 1099-MISC, Box 7. However, nonemployee compensation paid in 2020 and subsequent years must be reported on new Form 1099-NEC, *due by Jan. 31 of the following year*.

Other types of income reportable on Form 1099-MISC can continue to be reported on Form 1099-MISC, due by Mar. 31 of the following year.

Additional IRS Guidance on Qualified Business Income Deduction

Rental Real Estate Safe Harbor

This month's FedTax column, Page 23, discusses Rev. Proc. 2019-38, which contains a final safe harbor under which a rental real estate enterprise will be treated as a trade or business *solely* for purposes of Sec. 199A and regs. secs. 1.199A-1 through-6. Other provisions in this rev. proc. are discussed next.

Safe Harbor's Specific Requirements

A. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise.
- If an enterprise contains more than one property, this requirement may be satisfied if income and expense statements for each property are maintained and then consolidated;

B. For rental real estate enterprises in existence less than four years, 250 or more hours of rental services are performed per year for the enterprise. These services are described below.
- For enterprises in existence for at least four years, in any three of the five consecutive tax years ending with the current tax year, 250 or more hours of rental services are performed per year for the enterprise; and

C. The taxpayer maintains *contemporaneous* records, including time reports or similar documents, regarding:
  1. Hours of all services performed;
  2. Description of all services performed;
  3. Dates on which these services were performed; *and*
  4. Who performed the services.

If the services for the enterprise are performed by employees or independent contractors, the taxpayer may provide:

  1. A description of the rental services performed by the employee or independent contractors;
  2. The amount of time the employee or independent contractors generally spends performing these services for the enterprise; and
  3. Time, wage or payments records for the employee or independent contractors.

These records are to be available for inspection at IRS request.

Note: This contemporaneous records requirement will *not* apply to tax tears beginning *before* 2020. But taxpayers bear the burden of showing the right to any claimed deductions in all tax years.

D. The taxpayer or relevant pass-through entities (RPE) attaches a statement to a timely filed original return (or an amended return for the 2018 tax year only) for each tax year in which the taxpayer or RPE relies on the safe harbor.

An individual or RPE, with more than one rental real estate enterprise, relying on this safe harbor may submit a single statement—but this statement must list the required information separately for each enterprise.

The statement must contain 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 tax year; and
  3. A representation that Rev. Proc. 2019-38's requirements have been satisfied.

Rental Services

For purposes of this revenue procedure, rental services include—but are not limited to:

1. Advertising to rent or lease the real estate;
2. Negotiating and executing leases;
3. Verifying information contained in prospective tenant applications;
4. Collecting rent;
5. Daily operation, maintenance and repair of the property—including purchasing materials and supplies;
6. Management of the real estate; and
7. Supervision of employees and ICs.

Rental services may be performed by owners, including RPE owners, or by the owners' employees, agents and/or independent contractors.

Non-rental Services

Rental services do *not* include financial or investment management activities, such as:

1. Arranging financing;
2. Procuring property;
3. Studying and reviewing financial statements or reports on operations;
4. Improving property under Regs. Sec. 1.263(a)-3(d) which deals with betterments, restorations or adapting the property to a new or different use; or
5. Hours spent traveling to and from the real estate.

Certain Rental Real Estate Arrangements Excluded

The following types of property may not be included in a rental real estate enterprise and, therefore, are not eligible for the safe harbor:

A. Real estate used by the taxpayer, including an RPE's owner or beneficiary, as a residence under Sec. 280A(d);

B. Real estate rented or leased under a triple net lease.

For Rev. Proc. 2019-38's purposes, a triple net lease includes a lease agreement requiring the tenant or lessee to pay taxes, fees and insurance and to pay for a property's maintenance activities in addition to rent and utilities;

C. Real estate rented to a trade or business conducted by a taxpayer or RPE which is commonly controlled under Regs. Sec. 1.199A-4(b)(1)(i); and

D. The entire rental real estate interest—if any portion of the interest is treated as a specified service trade or business (SSTB) under Regs. Sec. 1.199A-5(c)(2), which provides special rules where property or services are provided to an SSTB.

Effective Date

Rev. Proc. 2019-38 applies to tax years ending after 2017.

Alternatively, for the 2018 tax year, taxpayers and RPEs may rely on the safe harbor set forth in Notice 2019-07—which is referred to in this month's FedTax column.

Employee Services

Regs Sec. 1.199A-5(d)(1) and (2) precludes income from employee services to be treated as qualified business income, regardless of the employer's federal employment tax classification of the employee.

Presumption

Regs. Sec. 1.199A-5(d)(3)(i) contains a presumption that former employees are employees if they continue to provide substantially the same services, directly or indirectly, to the former employer (or related person) for three years after ending employee status.

This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

Rebuttal of Presumption

However, Regs. Sec. 1.199A-5(d)(3) provides that this presumption may be rebutted if an individual shows, that under federal tax law, regulations and principles (including common-law employee classification rules), the individual is performing services as a non-employee

Regs. Sec. 1.199A-5(d)(3)(i) states that, upon IRS notice, this rebuttal is made by providing records, such as contracts or partnership agreements, containing sufficient evidence to corroborate non-employee status.

Other Guidance

The IRS has released the following draft forms to be used to compute the Sec. 199A deduction:

- Form 8995, *Qualified Business Income Deduction Simplified Computation*; and
- Form 8995-A, *Qualified Business Income Deduction*.

In addition, the IRS issued a Fact Sheet (FS-2019-8, April 11, 2019), which discusses various aspects of this deduction and also states "The *Form 1040 Instructions* and Publication 535 provide worksheets to compute the deduction." Publication 535 is called *Business Expenses*.

Tax Benefit Rule

Rev. Rul. 2019-11 (IRB 2019-17, April 22, 2019) answers the following question: If a taxpayer received a tax benefit from deducting state and local taxes in 2018 and recovers all or a portion of those taxes in 2019, what portion of the refund must the taxpayer include in 2019 gross income?

This ruling discusses four situations under these facts for 2018:

- The taxpayers were unmarried individuals whose filing status was "single" and who itemized deductions on their federal income tax returns in lieu of using their $12,000 standard deduction.
- They did not pay state and local taxes in carrying on a trade or business or for an activity described in Sec. 212.
- These taxpayers used the cash method of accounting, were not subject to the alternative minimum tax and were not entitled to any tax credits.

Rationale

If the taxpayers in Situations 1 through 4 (below) had paid only the proper amount of state and local taxes in 2018, then their itemized deductions may have been lower or they may have used the standard deduction. Therefore, in each situation, the taxpayer must determine the amount of itemized deductions that the taxpayer would have deducted in 2018 if the taxpayer paid only the proper amount of state and local taxes.

The taxpayer must then compare this amount to the total itemized deductions claimed for 2018 or to the standard deduction that could have been taken for 2018. The difference must be included in 2019 gross income if the taxpayer received a tax benefit from the itemized deductions claimed for 2018.

This rationale is illustrated in the following four situations.

Situation 1: State Income Tax Refund Fully Includable in 2019 Gross Income

Mr. A paid the following taxes in 2018:

Local real property taxes	$4,000
State income taxes	5,000
Total state and local taxes	$9,000

This deduction was not limited by Sec. 164(b)(6) because it was below $10,000.

Mr. A claimed the following itemized deductions on his 2018 federal income tax return:

State and local taxes	$9,000
Other allowable itemized deductions	5,000
Total itemized deductions	$14,000

In 2019, Mr. A received a $1,500 state income tax refund due to his overpayment of his 2018 state income taxes.

If Mr. A paid only the proper amount of his 2018 state income taxes, his state and local tax deduction would have been reduced from $9,000 to $7,500. Consequently, Mr. A's itemized deductions would have been reduced from $14,000 to $12,500, a difference of $1,500.

Thus, Mr. A received a $1,500 tax benefit from his $1,500 overpayment of his 2018 state income taxes. Hence, he must include the entire $1,500 state income tax refund in his 2019 gross income.

Situation 2: State Income Tax Refund Not Includable in 2019 Gross income

Ms. B paid the following taxes in 2018:

Local real property taxes	$ 5,000
State income taxes	7,000
Total state and local taxes	$12,000

The deduction for these taxes was limited by Sec. 164(b)(6) to $10,000.

Ms. B claimed the following itemized deductions on her 2018 federal income tax return:

State and local taxes	$10,000
Other allowable itemized deductions	5,000
Total itemized deductions	$15,000

In 2019, Ms. B received a $750 state income tax refund due to her overpayment of her 2018 state income taxes.

If Ms. B paid only the proper amount of her 2018 state income taxes, her state and local tax deduction would still be $10,000. Consequently, Ms. B's itemized deductions would still be $15,000.

Thus, Ms. B received *no* tax benefit from her $750 overpayment of her 2018 state income taxes. Hence, she is *not* required to include the $750 state income tax refund in her 2019 gross income.

Situation 3: State Income Tax Refund Partially Includable in 2019 Gross Income

Mr. C paid the following taxes in 2018:

Local real property taxes	$5,000
State income taxes	6,000
Total state and local taxes	$11,000

The deduction for these taxes was limited by Sec. 164(b)(6) to $10,000.

Mr. C claimed the following itemized deductions on his 2018 federal income tax return:

State and local taxes	$10,000
Other allowable itemized deductions	5,000
Total itemized deductions	$15,000

In 2019, Mr. C received a $1,500 state income tax refund due to his overpayment of his 2018 state income taxes.

If Mr. C paid only the proper amount of his 2018 state income taxes, his state and local tax deduction would have been reduced from $10,000 to $9,500. Consequently, Mr. C's itemized deductions would have been reduced from $15,00 to $14,500, a difference of $500.

Thus, Mr. C received *only* a $500 tax benefit from his $1,500 overpayment of his 2018 state income taxes. Hence, he must include *only* $500 of his state income tax refund in his 2019 gross income.

Situation 4: Standard Deduction Could Have Been Allowable

Ms. D paid the following taxes in 2018:

Local real property taxes	$ 4,250
State income taxes	6,000
Total state and local taxes	$10,250

The deduction for these taxes was limited by Sec. 164(b)(6) to $10,000.

Ms. D claimed the following itemized deductions on her 2018 federal income tax return;

State and local taxes	$10,000
Other allowable itemized deductions	2,500
Total itemized deductions	$12,500

In 2019, Ms. D received a $1,000 state income tax refund due to her overpayment of her 2018 state income taxes.

If Ms. D paid only the proper amount of her 2018 state income taxes, her state and local tax deduction would have been reduced from $10,000 to $9,250. Consequently, Ms. D's itemized deductions would have been reduced from $12,500 to $11,750—which is less than the $12,000 standard deduction that she could have taken for 2018.

Her 2018 tax benefit is computed as follows:

Itemized deductions claimed	$12,500
Standard deduction that could have been claimed	12,000
Difference	$ 500

Thus, Ms. D received *only* a $500 tax benefit from her $1,000 overpayment of her 2018 state income taxes. Hence, she must include *only* $500 of her state income tax refund in her 2019 gross income.

Limitation on Deductible Business Interest Expense

For tax years beginning after 2017, the 2017 Tax Cuts and Jobs Act (TCJA), (P.L. 115-97 enacted Dec. 22, 2017) substantially amended old Sec. 163(j) to limit the deduction of business interest expense for all taxpayers for any tax year to the sum, for that tax year, of:

1. The taxpayer's business interest income;
2. 30 percent of the taxpayer's adjusted taxable income (ATI); and
3. The taxpayer's floor plan financing interest expense.

Any business interest expense not allowed as a deduction for any tax year may be carried forward indefinitely.

This limitation applies at the taxpayer level. However, there is a special carryforward rule for partnerships (discussed below). For affiliated corporation filing a consolidated return, the limitation applies at the consolidated return level.

Proposed regulations (REG-106089-18) were published Dec. 28, 2018. Also, the IRS released Form 8990 [(Dec. 2018), *Limitation on Business Interest Expense under Section 163(j)]* to be attached to tax returns.

Business Interest

Business interest expense means any interest paid or accrued on debt properly allocable to a trade or business. Any amount treated as interest for IRC purposes also is interest for Sec. 163(j) purposes.

Business interest income is the interest includible in the taxpayer's gross income for the tax year, which is properly allocable to a trade or business.

Business interest income and expense do not include investment interest income and expense within the meaning of existing Sec. 163(d), which only applies to non-corporate taxpayers. Thus, a corporation has neither investment interest income nor expense under Sec. 163(d). Consequently, a corporation's interest income and expense are properly allocable to a trade or business unless such trade or business is otherwise explicitly excluded from Sec. 163(j)'s application.

Example: If an insurance company, for regulatory (i.e., statutory accounting) purposes, has both underwriting income and expense and investment interest income and expense, *any* interest income and expense is business interest income and expense for Sec. 163(j) purposes.

ATI

ATI means the taxpayer's taxable income computed *without* regard to any:

1. Income, gain, deduction or loss not properly allocable to a trade or business;
2. Business interest income or expense;
3. Net operating loss deduction; and,
4. The deduction allowed under Sec. 199A for Qualified Business Income (discussed above).

   But, for tax years beginning after 2017 and before 2022, ATI is computed *without* regard to any deduction allowable for depreciation, amortization or depletion. On the other hand, for tax years beginning after 2021, ATI is computed *with* regard to these three deductions. The Treasury Department and/or the IRS may provide for other adjustments to compute ATI.

Floor Plan Financing Interest Expense

This type of interest is paid or accrued on floor plan financing debt, which is debt used to finance the acquisition of motor vehicles held for sale or lease to rental customers and secured by the inventory so acquired.

Property held exclusively for lease is *not* inventory, but instead property used in a trade or business under Sec. 1221(a)(2). Property simultaneously held for sale or lease *is* inventory until it first becomes leased when it is then no longer inventory.

A motor vehicle means a vehicle that is:

1. Any self-propelled vehicle designed for transporting persons or property on a public street, highway or road.;
2. A boat; or
3. Farm machinery or equipment.

Caution: If a taxpayer takes floor plan financing interest into account to increase the taxpayer's business interest limitation under Sec. 163(j) for a tax year, property placed in service by the taxpayer during that year and subsequent tax years is *not* eligible for the additional first-year depreciation deduction under Sec. 168(k) [See Sec. 168(k)(9)(B)].

Application of Other Limitations

It is generally intended that Sec. 163(j) apply after the application of other IRC provisions that subject interest deductions to deferral, capitalization or other limitations. Thus, Sec. 163(j) applies to interest deductions that are deferred, for example under Sec. 163(e)—regarding original issue discount—or Sec. 267(a)(3)(B)—concerning interest paid to certain foreign entities—in the tax year to which such deductions are deferred.

Sec. 163(j) also applies *after* Sec. 263A (uniform capitalization rules) is applied to capitalize interest and *after*, for example, Sec. 265 (interest related to tax-exempt income) or Sec. 279 (interest on debt incurred by corporation to acquire another corporation's stock or assets) is applied to disallow interest deductions.

However, Sec. 163(j) applies *before* the application of Sec. 465 (at risk rules) or Sec. 469 (passive activity rules).

Carryforward of Disallowed Business Interest

Business interest not allowed as a deduction under Sec. 163(j) for any tax year is treated as business interest paid or accrued in the succeeding tax year and may be carried forward indefinitely.

Special rules for the carryforward of disallowed partnership interest are set forth in Sec. 163(j)(4)(B). The *General Explanation of Public Law 115-97*, prepared by the Congressional Joint Committee on Taxation's staff, Dec. 2018, the "Blue Book," states that these rules are intended to prevent trafficking in carryforwards and it is intended that Sec. 163(j) be administered consistent with this intent.

These special rules do *not* apply to S corps and their shareholders [Sec. 163(j)(4)(D)].

Any carryforward of disallowed corporate business interest is an item taken into account in the case of certain corporation acquisitions described in Sec. 381[Sec. 381(c)(20)] and is subject to limitation under Sec. 382 [Sec. 382(d)(3)].

Application to Passthrough Entities

The business interest deduction limitation is applied at the partnership level. To prevent double counting, there are special rules to determine business interest income and ATI for each partner of a partnership.

Similarly, special rules apply to allow for an additional interest deduction by a partner in the case of an excess amount of either a partnership's business interest income or ATI.

Similar rules apply to S corps and their shareholders.

Exceptions

This business interest limitation does *not* apply to any taxpayer—*other than* a tax shelter prohibited from using the cash method under Sec. 448(a)(3)—that meets Sec 448(c)'s $25 million gross receipts test, the average annual gross receipts for the three-tax-year period ending with the preceding tax year cannot exceed $25 million.

Notes

1. This $25 million amount is adjusted for inflation, pursuant to Sec. 448(c)(4), for any tax year beginning after 2018. For 2019, this amount is $26 million.
2. Prop. Regs. Sec. 1.163(j)-2(h) states that arrangements entered

into with a principal purpose of avoiding Sec. 163(j) or the regulations thereunder, including using multiple entities to avoid this gross receipts test, may be disregarded or recharacterized by the IRS to the extent necessary to carry out Sec. 163(j)'s purposes.

The trade or business of performing employee services is *not* treated as a trade or business for the business interest limitation [Sec. 163(j)(7)(A)(i))]. For instance, an employee's wages are not counted in the employee's ATI.

At a taxpayer's election, any real property trade or business is *not* treated as a trade or business for purposes of this business interest limitation. Therefore, Sec. 163(j) does *not* apply to these trades or businesses.

A real property trade or business is defined in Sec. 469(c)(7)(C) as a real property trade or business conducting development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage.

Similar rules apply, at a taxpayer's election, to any farming business or any trade or business engaged in a specified agricultural or horticultural cooperative defined in Sec. 199A(g)(4).

Also, this limitation does not apply to certain regulated public utilities.

Caution

An electing real property trade or business must use the Alternative Depreciation System (ADS) under Sec. 168(g) for any nonresidential real property, residential rental property and qualified improvement property [Sec. 168(g)(1)(F) and (8)].

The ADS also must be used by an electing farming business [defined in Sec. 163(j)(7)(C)] for any property with a recovery period of ten years or more [Sec. 168(g)(1)(G)].

Observation: The December 2018 "Blue Book" (Page 138, Footnote 636), states that "a technical correction may be necessary to reflect that an electing real property trade or business is also required to use ADS to depreciate its qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property (as defined under prior law) that was placed in service prior to 2018 and is owned by the taxpayer as of the beginning of the year of the election out of the interest limitation. Congress intends that an election out of the interest limitation and resulting required use of ADS be treated as a change in use of the property. See Sec. 168(i)(5) and Treas. Reg. sec. 1.168(i)-4."

This election is made in the time and manner prescribed by the IRS and is invocable [Sec. 163(j)(7)(B)].

Election Procedure

This election is made for each eligible trade or business of the taxpayer and applies only to the trade or business for which the election is made. The election applies to the tax year in which the election is made and, generally, to all subsequent tax years [Prop. Regs. Sec. 1.163(j)-9(d)(1)].

Subject to any future guidance, this election is made by attaching an election statement to a timely filed *original* federal income tax return, including extensions. Elections for multiple trades or businesses may be made on a single election statement [Prop. Regs. Sec. 1.163(j)1-9(c)(1).

The election statement should be titled "Section 1.163(j)-9 Election" and must contain the following information for each trade or business:

- The taxpayer's name, address, Social Security number or employer identification number;
- A description of the taxpayer's electing trade or business, including the principal business activity code; and
- A statement that the taxpayer is making an election under Sec. 163(j)(7)(B) or (C), as applicable [Prop. Regs. Sec. 1.163(j)-9(c)(2)].

Partnerships

An election for a partnership must be made on the partnership's return with respect to any trade or business that the partnership conducts. An election by a partnership does not apply to a trade or business conducted by a partner outside the partnership [Prop. Regs. Sec. 1.163(j)-9(c)(4)].

Partners' Self-Employment Tax

Final Regs. Sec. 301.7701-2 (T.D. 9869) provides that partners in a partnership that owns a disregarded entity (DE) are *not* the DE's employees for employment tax purposes. Instead, they are subject to self-employment tax.

Debt versus Equity Regulations

Notice 2019-58 (IRB 2019-44, Oct. 28, 2019) states that, on Oct. 21, 2016, the Treasury Department and the IRS published T.D. 9790 in the *Federal Register*, which included final and temporary regulations under Sec. 385 addressing documentation in Regs. Sec. 1.385-2 and certain debt issued to a controlling shareholder in a distribution or in another related-party transaction in Regs. Sec. l.385-3.

On the same date, the Treasury Department and the IRS also published a notice of proposed rulemaking (REG-130314-16) in the *Federal Register*, "the 2016 Proposed Regulations," by cross-reference to the Sec. 385 temporary regulations, which included Temp. Regs. Sec. 1.385-3T and Temps. Regs. Sec. 1.385-4T—the "Temporary Regulations."

The Temporary Regulations expired Oct. 13, 2019. The 2016 Proposed Regulations, which do not expire, are proposed to apply to tax years ending after Jan. 18, 2017. *A taxpayer may rely on the 2016 Proposed Regulations for periods following Oct. 13, 2019, until further notice is given if the taxpayer, consistently applies the 2016 Proposed Regulations in their entirety.*

These proposed reliance regulations have been finalized, without change, to remove the Sec. 385 documentation requirements (T.D. 9880, regs. secs. 1.385-1 and -3 and Regs. Sec. 1.1275-1).

In addition, the IRS released an Advance Notice of Proposed Rulemaking stating that it intends to issue new streamlined and targeted proposed Sec. 385 regulations, under the Sec. 385 distribution rules, on when certain interests in corporations are stock or debt [Preamble to proposed regulations (REG-123112-19)].

Bonus Depreciation

Rev. Proc. 2019-33 (IRB 2019-34, Aug. 19, 2019) provides guidance allowing taxpayers to make a late election or to revoke an election, under Sec. 168(k)(5), (7) or (10), for certain property acquired after Sept. 27, 2017 and placed in service or planted or grafted (as applicable) by the taxpayer during its tax year that includes Sept. 28, 2017.

Sec, 168(k)(5) allows a taxpayer to elect to deduct additional first year depreciation for certain plants. Sec. 168(k)(7) allows a taxpayer *not* to deduct additional first year depreciation for any class of qualified property placed in service by the taxpayer during the tax year to which the election applies. Sec. 168(k)(10) allows a taxpayer to elect to deduct 50 percent, instead of 100 percent, additional first year depreciation for certain qualified property.

Like-kind Exchanges

The August 2018 *California CPA* (Page 31) reported that, under amended Sec. 1031(a), like-kind exchanges are allowed *only* for *real* property not held primarily for sale.

Real property relinquished and/or acquired in a potential like-kind exchange may be held by partnerships. Some or all of the parties to a potential exchange may want to exchange only partnership interests, instead of the underlying real property, which would obviate tax-free treatment.

However, the TCJA added Sec. 1031(e), generally effective for exchanges completed after 2017, which provides that, for Sec. 1031 purposes, an interest in a partnership which has in effect a valid Sec. 761(a) election to be excluded from the application of all of Subchapter K shall be treated as an interest in each of that partnership's assets—and not as an interest in a partnership.

Treasury Policy Statement Issued on Significant Changes to the Tax Regulatory Process

This policy statement calls for the Treasury Department and the IRS to:

1. Include a statement of good cause with immediately effective temporary regulations;
2. Continue its commitment to the notice-and-comment process;
3. Not seek judicial deference for interpretations that are set forth only in "subregulatory" guidance—such as revenue rulings, revenue procedures, notices, announcements and similar pronouncements; and
4. Include a statement in notices announcing intent to propose regulations, stating that if no proposed regulations or other guidance is released within 18 months after the notice is published, the IRS will not assert a position adverse to the taxpayer based on the notice

Form W-4 Update

In August, the IRS released a second draft of Form W-4, now called *Employee's Withholding Certificate*, and also announced that the new form does not change the withholding computation in the first draft issued May 31 (News Release IR-2019-98).

No further substantive changes are anticipated, except for minor inflation adjustments, in the final version expected to be published in November.

Commissioner's Comments

IRS Commissioner and CalCPA member Chuck Rettig said that people will still be able to use the form's previous version after the new one is released if they wish.

The form uses a new five-step process that should make it easier to determine how much tax to withhold annually. It moves away from the allowance system currently used, which is largely based on personal exemptions that were eliminated by the TCJA.

The new four-page Form W-4 requires a taxpayer to enter a name, address, Social Security number and filing status and sign the form—which would set withholding with no additional adjustments. The new form relies on the same taxpayer information for the current Form W-4.

Social Security Tax

The maximum amount of earnings subject to the Social Security tax will increase from $132,900 for 2019 to $137,700 for 2020.

Preparer Tax Identification Numbers (PTINs)

The IRS has announced that it is now PTIN renewal season for 2020 and that there is *no* fee/cost for 2020 PTINs.

Estate Tax Returns

Schedule R-1 (Form 706) has been removed from Form 706 and is now a separate form. It is used as a payment voucher for the Generation-Skipping Transfer Tax imposed on a direct skip from a trust. This tax is paid by the trust's trustee.

The executor completes Schedule R-1 and provides copies to the trustee.

New Filing Address

Form 706 and Schedule R-1 should be mailed to: Department of the Treasury, Internal Revenue Service Center, Kansas City, MO 64999.

If a private delivery service (PDS) is used, send the returns to: Internal Revenue Service Center; 333 W. Pershing Road, Kansas City, MO 64108.

New Address for Filing Gift Tax Returns

The Form 709 instructions require gift tax returns to be filed at: Department of the Treasury; Internal Revenue Service Center; Kansas City, MO 64999.

If a PDS is used, send to Internal Revenue Service; 333 W. Pershing Road; Kansas City, MO 64108.

Note: A married couple splitting gifts should file both returns in the same envelope.

New Address for Exempt Organization Submissions

For private delivery or express mail, Forms 1023, 1024, 1024A, 1028, 8940 and group exemption requests should be sent to: Internal Revenue Service; Mail Stop 31A, Team 105; 7940 Kentucky Drive; Florence, KY 41042.

For regular mail, the following P.O. Box address remains the same: Internal Revenue Service; P.O. Box 12192; Covington, KY 41012-0192.

New Address for Employee Plan Submissions

Requests for determination letters, private letter rulings and IRA opinion letters should be sent to: Internal Revenue Service; Mail Stop 31A; 7940 Kentucky Drive; Florence, KY 41042.

This address should be used for both U.S. mail and overnight deliveries, such as Federal Express and United Parcel Service.

Pre-approved plan submissions should continue to use the address shown in Rev. Proc. 2019-4, Section 31.

Stuart R. Josephs, CPA, has a San Diego-based Tax Assistance Practice specializing in assisting practitioners in resolving their clients' tax questions and problems. Josephs, chair of the Federal Subcommittee of CalCPA's Committee on Taxation, can be reached at stuartrjosephs@yahoo.com.