2021 year-end tax letter

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Hjerpe & Tennison CPAs, LLC

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We hope all our clients have been doing well over the last several months. It has been a while since you heard from us, it has been quite the challenging 18 months in the tax/accounting profession. We had weathered the storm and were hoping for some stability in the coming months, however as you will read, that is highly unlikely. This is a long letter because of all the past changes and the potential for changes in the coming months. As we write this year's tax letter, we are reminded of 2017. While it is said history does not repeat itself, sometimes its events are awfully similar. In the fall of 2017, it was unclear whether the Tax Cuts and Jobs Act (TCJA) would be enacted. Provisions were being debated and there was no clear path to passage. The same can be said of 2021: The original $3.5 trillion (now trimmed to $1.75 trillion) "human" infrastructure reconciliation package remains mired in debate between moderate and progressives within the Democratic Party. The bipartisan infrastructure bill is also ensnared in the same conflict, with the legislation's future likely tied to the outcome of a successful budget reconciliation package negotiation. With little likelihood of Republican support, all but three Democratic votes will be needed in the House and all 50 Democratic senators will be needed for passage using the reconciliation process.

What does this mean for you? At this time, it is difficult to say as the contents of the reconciliation bill are currently being fiercely debated. Whether the package's top line is $1.5 trillion, $3.5 trillion or some amount in between, if Democrats compromise and successfully pass a bill, it's certain to include major tax changes. These changes could come in the form of a capital gains rate increase (not in the released text of the Build Back Better bill), corporate and individual rate increases, and modifications to the estate and gift tax (not in the released text of the Build Back Better bill). Based on the initial House Ways and Means Committee bill most of the provisions would not become effective until 2022, with the notable exception of capital gains (currently proposed for an effective date of Sept. 13, 2021). Consequently, we strongly recommend you monitor the progress of the ongoing negotiations carefully. Accelerating income into 2021 and deferring significant expenses until 2022 where practical may be the best planning strategy depending upon your tax bracket. With respect to capital gains, if a

September effective date remains, the planning door may have closed; however, it is possible there will be a change in effective dates as negotiations progress, possibly to the date of enactment or even Jan. 1, 2022.

Since writing the original newsletter, the BBB text was released. We are keeping some of the potential changes in this letter given the fluid nature of the negotiations in DC. If a final bill is passed, we will send an updated notification. This letter is to plant the seeds for planning before year end.

Our focus in this year's letter is on the tax code modifications being considered, critical issues in healthcare and employee benefits, state and local tax trends as well as important reminders of expiring taxpayer-friendly provisions enacted via previous COVID-19 stimulus legislation.

Tax planning should be addressed throughout the year and be an integral part of financial planning.

Please contact us should you wish to update your tax plan for 2021. Email us at info@hjerpecpa.com.

As this last 18 months has been a whirlwind, we don't have a good feel for all the clients that started a new business. If you are one that started a new business after February 15, 2020, have employees, and are still in business, please reach out to us and we can start work on applying for the Employee Retention Credits for you. See page 9 for details on the Employee Retention Credit for "Recovery Startup businesses".

Reconciliation bill

There are two bills moving through Congress. The first is the $1.2 trillion bipartisan infrastructure bill, which has passed the Senate and contains only very modest tax changes. It remains held up in the House, as some progressive congressional members are withholding support while they negotiate for a larger $3.5 trillion (now $1.75 trilion) "human" infrastructure reconciliation package, officially known as the Build Back Better Act, to also be passed by the Senate. This has effectually linked the two bills, at least for the time being. The future of the bipartisan infrastructure bill likely depends on the success of the Build Back Better Act, which can only pass via the reconciliation process.

The tax components of the Build Back Better package cleared the Ways and Means Committee in September and await action on the House floor. It is increasingly looking like the Senate will not produce its own version of the bill, but rather negotiate the final package with the House and any changes (such as a state and local tax cap modification or limitations on estate "step-ups") would be incorporated through amendments on the House floor before the final package is sent to the Senate for consideration.

The current Ways and Means bill is likely to be the initial framework of any successful legislation. Below are a few key provisions from the bill:

Individual provisions

- Top ordinary income rate increase: Rate would bump up to 39.6% from 37%
- Top capital gains rate increase: Long-term capital gains and qualified dividends would be taxed at 25%, up from the current 20%; this would generally be effective for gains recognized after Sept. 13, 2021 (an exception applies to transactions that are under a binding contract but have yet to be executed)
- High-income surtax: A new 3% surtax would be imposed on individuals with modified adjusted gross income (MAGI) over $5 million ($2.5 million for married taxpayers filing separately) and trusts and estates with MAGI greater than $100,000

- Retirement account changes: Individuals with retirement account balances of $10 million or more, who meet certain income thresholds, would have to take required minimum distributions of 50% of the amount by which the account exceeds $10 million1 regardless of age; additionally, high-income taxpayers would no longer be able to contribute to Roth IRAs via "back-door" contributions

Trust and estate provisions

- Gift and estate tax exemption reduced. The unified credit that rose to $10 million (indexed for inflation) under the TCJA and is set to expire at the end of 2025 would instead expire at the end of 2021; the unified credit would become $6.02 million (indexed for inflation) in 2022
- Grantor trusts included in estate: The transfer to a grantor trust would no longer be an effective estate planning strategy; for post-2021 transfers, grantor trust assets would be placed into a decedent's estate when the decedent was the deemed owner of the trust

Business provisions

- Top corporate tax rate increase: Rate would jump to 26.5% from 21 % for taxable income over $5 million; a lower 18% rate would apply to taxable income of $400,000 and under, while the 21 % rate would continue to apply to taxable income above $400,000 but not greater than $5 million; once a corporation reaches $10 million in income, the graduated rates disappear and all income would be taxed at 26.5%
- Qualified business income deduction limitation: The 20% qualified business income deduction under IRC section 199A would be limited to annual deductions of $500,000 for married filing joint returns and $400,000 for single and head-of-household filers
- Net investment income tax (NIIT) expansion: All trade or business income for taxpayers with taxable income over $400,000 ($500,000 for joint filers) would be

subject to the NIIT, regardless of material participation, unless it is subject to self-employment tax

- Excess business loss limitation: The $500,000 current-year loss limitation for noncorporate taxpayers that was set to expire after 2025 would be made permanent, and it would treat any suspended losses as a deduction instead of a net operating loss. thereby subjecting it to testing and potential limitation in subsequent years
- Carried interest modification: In order to obtain capital gain treatment, carried interests would need to be held for five or more years, up from three years

Expiring tax provisions

Over the course of the COVID-19 pandemic, Congress enacted several packages of stimulus legislation, including the Families First Coronavirus Response Act (FFCRA), the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the Consolidated Appropriations Act, 2021 (CAA) and the American Rescue Plan Act of 2021 (ARPA). Each of these laws contained targeted tax modifications to relieve some of the economic burden caused by the coronavirus. Many changes delayed the implementation of Tax Cuts and Jobs Act of 2017 (TCJA) provisions, while others granted temporary relief from long-standing tax statutes.

As we approach the end of 2021, it's important to incorporate the impact of any changing or expired provisions in the year-end tax planning process.

Net operating loss changes

The TCJA made considerable changes to the treatment of net operating losses (NOLs) effective as of Jan. 1, 2018. The changes were generally unfavorable for taxpayers - removing the two-year carryback option and allowing NO Ls to offset only 80% of taxable income when carried forward. The only favorable change was removing the 20-year limit on NOL carryovers to make them indefinite.

The CARES Act altered the NOL rules to help affected taxpayers access cash. For NOLs generated in tax years 2018 through 2020, the carryback provision was reinstated and extended to five years, allowing NOL generated in these years to offset 100% of taxable income to the extent they were carried back.

ln 2021 and all subsequent years, we revert to the TCJA treatment of NOLs. All NOLs generated can only be carried forward and those incurred in tax years 2018 or after may only offset 80% of current-year taxable income. Taxpayers with an NOL must wait until a future year with taxable income to realize the tax benefits.

Payroll tax deferral

The CARES Act allowed employers to defer deposit and payment of the employer's portion of Social Security taxes and self-employed individuals to defer their equivalent portions of self-employment taxes otherwise due between March 27, 2020, and Dec. 31, 2020. Deferred deposits must be made by the following dates to be treated as timely (to avoid penalties and interest charges):

- 50% of deferred amounts due Dec. 31, 2021
- Balance of deferred amounts due Dec. 31, 2022

Any taxpayers who utilized the deferral must deposit the first 50% (or more) of the amount deferred by the end of the calendar year. It is important to note the IRS recently determined that a failure to deposit any portion of the deferred taxes by the applicable installment date would result in a section 6656 failure to deposit taxes penalty on the entire deferred amount going back to the original due date. To avoid costly penalties, employers and self-employed individuals with deferred payroll deposits or payments should pay a minimum of 50% no later than Dec. 31, 2021.

Employee retention credit

The employee retention credit (ERC) was one of the hallmark tax provisions included in the CARES Act, incentivizing employers to continue paying employees despite operations being affected by COVID-19. The payroll tax credit has been available to eligible trades or businesses as follows:

- 2020: ERC of 50% of qualified wages of up to $10,000 per employee (for the year)
- 2021: ERC of 70% of qualified wages of up to $10,000 per employee per quarter
    - **Important note!** The proposed bipartisan Infrastructure Investment and Jobs Act (IIJA), if enacted, will remove the fourth quarter eligibility for most taxpayers, ending the credit as of Sept. 30, 2021

- **Third and fourth quarter 2021: Recovery startup businesses** (broadly, qualifying employers that began operating a trade or business after Feb. 15, 2020, and meet additional requirements) are eligible for an ERC of 70% of qualified wages of up to $10,000 per employee per quarter, subject to a limit of $50,000 per quarter

Though the I IJA is likely to terminate the ERC for employers other than recovery startup businesses after Sept. 30, businesses that are eligible in any calendar quarter from the first quarter of 2020 through the third quarter of 2021 may still apply. The credit is claimed via quarterly payroll tax filings and can be obtained by filing adjusted returns as long as the statute of limitations remains open, which is generally three years from the filing due date. Businesses that experienced a full or partial suspension, or modification of operations due to a governmental order or a significant decline in gross receipts (measured differently in 2020 and 2021), should consult their payroll professional about their eligibility. Claiming the ERC for 2021 wages will impact your 2021 income tax filing.

Retirement plan changes

The CARES Act brought about two retirement plan changes, both of which expired at the end of 2020:

- Waived required minimum distributions (RMDs): This relief only applied to 2020. RMDs are compulsory for 2021 for taxpayers 72 and older. RMDs must be withdrawn by the end of 2021 to avoid potentially significant penalties.
- Retirement account hardship withdrawals: The CARES Act allowed for hardship withdrawals from eligible retirement accounts of up to $100,000 per participant without incurring the 10% Withdrawal penalty through 2020. Taxpayers could choose from one of two treatments: (1) take the distribution as taxable income with the election to pay tax over a three-year period, or (2) repay the distribution amount over a three-year period. Taxpayers who made such

withdrawals will need to make a repayment or recognize taxable income in 2021, accordingly.

Emergency paid sick leave and expanded family and medical leave

The FFCRA created and the CAA broadened new emergency paid sick leave (ESPL) and expanded family and medical leave (EFML) payroll tax credits. Both credits expired on Sept. 30, 2021.

Business meals

The CAA provided a temporary 100% deduction for business meals provided by a restaurant, applicable for 2021 and 2022 expenses. While this provision is not immediately expiring, all indications from Congress currently point to the expiration of this provision after 2022.

Above-the-line charitable contributions

In 2020, the CARES Act allowed a one-time $300 above-the-line charitable contribution deduction for taxpayers who donated to qualified charities. This allowed taxpayers who do not otherwise itemize deductions, a group that has drastically increased in size since the implementation of the new standard deduction and state and local tax limitation by the TCJA, to realize a tax benefit for their donations.

The CAA continued the program for 2021 - expanding the benefit to a maximum of $600 for joint filers and maintaining $300 for single or other filers who do not itemize.
In addition, both the CARES Act and CAA suspend the 60% charitable contribution deduction limitation for qualified cash contributions in 2020 and 2021, allowing taxpayers to offset up to 100% of their current-year adjusted gross income (AGI) via itemized charitable contribution deductions.

Finally, corporations, typically limited to 10% charitable contribution deduction, may offset up to 25% of taxable income with qualified charitable deductions in 2020 and 2021.

Exclusion of unemployment benefits from taxable income

ARPA allowed taxpayers with a modified AGI of less than $150,000 to exclude up to $10,200 of unemployment compensation received from taxable income in 2020. Though unemployment benefits continued into the third quarter of 2021, no such exclusion exists for the 2021 tax year. Taxpayers who received unemployment compensation in the current year will need to include these benefits in taxable income.

Expanded child tax credit and child and dependent care credit

ARPA increased several tax credits - with two key expansions of the child tax credit (CTC) and child and dependent care credit (COCC). The following expansions apply to the 2021 tax year only:

Child tax credit: expanded credit amounts for taxpayers not phased out

- Increase in credit to $3,000 from $2,000 ($3,600 for children 5 and under)
- Children up to 17 qualify for the credit
- Phase-out range: $150,000 for joint filers, $112,500 for head-of-household filers, $75,000 for all other filers
- Those over the phase-out range: revert to existing (non-expanded) CTC amounts and ranges provided monthly payment mechanism for last 6 months of 2021

Child and dependent care credit: expanded qualifying expenses and reimbursement rates

- Increase in qualifying expenses to $8,000 for one child and $16,000 for two or more children from $3,000 for one child and $6,000 for two or more children

Reimbursement rates that previously ranged from 20% to 35% now range from 0% to 50% and don't begin phasing down until a much higher level of income is attained

Though the expansion of these credits is currently set to expire after 2021, they are a central piece of the Build Back Better agenda, and we may see their renewal in the pending budget reconciliation.

Employee Retention Credit – in depth

In August, the IRS released extensive guidance on the employee retention credit (ERC), providing helpful clarity on several questions previously surrounding the credit. However, areas of uncertainty remain, and the IRS has informally remarked that it does not anticipate issuing additional guidance on the ERC, at least in the near future. As such, in some cases, taxpayers will need to take reasonable positions absent concrete guidance with respect to eligibility and the computation of the credit. It is imperative that such positions have foundational merit to bolster their chances of being sustained in the event of an IRS audit.

Suspension test

The area of the ERC that arguably remains most unclear is the suspension test for determining credit eligibility. An employer will satisfy this test, if they experience a full or partial suspension or modification of operations during any calendar quarter in 2020 or 2021 (though the Senate version of the bipartisan infrastructure plan would revoke the availability of the credit in the fourth quarter of 2021 as a revenue-raiser) due to orders from an appropriate **domestic governmental authority** (federal, state or local) limiting commerce, travel or group meetings (for commercial, social, religious or other purposes) **due to COVID- 19. It is critical to note that to be eligible under this test, the employer must be more than nominally impacted by the suspension or modification or could not continue comparable operations through telework.**

The highly subjective, facts-and-circumstances nature of the suspension test analysis makes it difficult to conduct; it also consequently leaves a great deal of room for interpretation.

Nominal Impact

The manner in which an employer can demonstrate it has been more than nominally impacted by a COVID-19-related government order is another area of the suspension test that often causes confusion .. IRS Notice 2021-20 provides safe harbors for employers to use under specific circumstances - the "more than nominal portion" and "more than nominal effect" tests.

1. The gross receipts from that portion of the business make up at least 10% of the employer's total gross receipts (both determined using the gross receipts from the same calendar quarter in 2019), or
2. The hours of service performed by employees in that portion of the business make up at least 10% of the employer's total employee service hours (both determined using the service hours performed by employees in the same calendar quarter in 2019).

The latter applies when no portion of the employer's operations have been suspended, but rather are subject to a government-ordered modification. The safe harbor covering this fact pattern provides that a modification will have "more than a nominal effect" on the employer's operations if it results in a 10% or more reduction in an employer's ability to provide goods or services in its normal course of business. Unfortunately, no useful parameters are provided for how this standard is to be measured.

It is critical to note that these tests are not interchangeable under the available guidance - each applies in the respective specific instances described above. Notice 2021-20 does provide the following helpful example to illustrate the difference between the concepts (modified for length):

Employer F, a restaurant business, must close its restaurant to on-site dining due to a governmental order closing all restaurants, bars and similar establishments for sit-down service. Employer F is allowed to continue food or beverage sales to the public on a carryout, drive-thru or delivery basis. On-site dining is more than a nominal portion of Employer F's business operations. Employer F's business operations are considered to be partially suspended because, under the facts and circumstances, more than a nominal portion of its business operations - its indoor and outdoor dining service - is suspended due to the governmental order.

Three months later, under a further governmental order, Employer F is permitted to offer indoor dining service, in addition to outdoor sit-down and carryout service, provided that all tables in the indoor dining room must be spaced at least 6 feet apart. This spacing constraint has more than a nominal effect on Employer F's business operations. During this period, even though Employer F resumed all categories of its business operations, Employer F's business operations continue to be partially suspended because, under the facts and circumstances, the governmental order restricting its indoor dining service has more than a nominal effect on its operations.

Risks of taking aggressive ERC positions

As stated above, it is imperative that ERC positions taken in the absence of clear guidance be based on reasonable interpretations of current law and the available guidance. While it is clear Congress intends for the ERC to be a powerful means to provide relief to employers who have been impacted by COVID-19, it should not be misconstrued as being universally available. The fact that the American Rescue Plan Act extended the statute of limitations for assessment of payroll tax returns on which the ERC is claimed to five years and the Treasury Department issued regulations that provide erroneous refunds of the ERC will be treated as underpayments of Social Security or Medicare taxes and subject to assessment, should make it clear the IRS will be examining employer eligibility and the amount of credits claimed with heightened scrutiny. Additionally, the IRS can assess interest and potential penalties on these erroneously claimed credits. ERC calculations producing lucrative results certainly make them appealing to a prospective employer; however, if pursued without technical merit, a successful IRS challenge could result in substantial payment back to the government.

IRS Update

IRS enforcement is a constantly changing environment. With the current negotiations on the federal budget including discussions on larger appropriations to the IRS plus the need to raise revenue to offset some of the administration's spending priorities, taxpayers should anticipate increased audit activity going forward as the IRS is and will be tasked to raise revenue for the U.S. Treasury. In addition, taxpayers and their representatives are having a more difficult time dealing with the IRS. The challenge in reaching an IRS employee, the expanded enforcement campaigns, the increased scrutiny of partnerships and other pass-through entity returns, and the decreased likelihood of penalty abatement, all create a compelling reason to maintain robust and contemporaneous support for positions taken on a tax return. This has been a real challenge since the pandemic began, and we believe it will continue to be a challenge over the coming months.

Virtual Currency

When the Internal Revenue Service (IRS) first issued tax guidance on virtual currency, a single Bitcoin was worth approximately $573. At the time of this writing, that value has increased to almost $60,000. As a result, the IRS and other federal government agencies continue to expand efforts to enforce reporting compliance for taxpayers that transact in virtual currency. In fact, Congress is currently negotiating stricter reporting requirements on the part of brokers and other handlers of virtual currency in the infrastructure and reconciliation bills. Furthermore, the Department of Justice indicated in a legal filing that there could be instances where virtual currency may not always be considered property for federal tax purposes. This article summarizes key recent developments as well as information to assist taxpayers with proper reporting on 2021 tax returns and other filings.

Legislative developments

The largest revenue-raiser included in the infrastructure bill, estimated to generate $28 billion over 10 years, results from increased enforcement on cryptocurrency transactions. Reporting requirements to the IRS for brokers would now include virtual currency transactions, including purchases, sales, transfers and transactions exceeding $10,000.

Specifically, the bill would expand the definition of the term "broker" to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person." In addition, the definition of specified securities would include "any digital asset." The bill states, "Except as otherwise provided by the Secretary, the term 'digital asset' means any digital representation of value that is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary." Since reporting would not be required until 2023, brokers would have some time to update systems to comply with the proposed rules.

There are no new requirements for individual holders of cryptocurrencies. However, once effective, taxpayers could expect to receive detailed reports of their digital asset transactions such as sales price, basis, and dates purchased and sold. The projected revenue increase is a result of the IRS' ability to "match" the information reported by the broker to what is disclosed on an individual tax return (as they currently do with W-2s, 1099s, etc.). Presumably, Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business, would be modified or replicated to collect this information.

IRS Operation Hidden Treasure

Furthering the government's priority of enforcing virtual currency reporting and taxation, the IRS has rolled out "Operation Hidden Treasure." Personnel from the agency's civil office of fraud enforcement and the criminal investigation unit have been jointly tasked with examining tax evasion among users of virtual currency. These agents will concentrate on taxpayers that omit such income from their tax returns. Areas of focus include:

- Transactions structured in increments under $10,000 (purposefully avoiding certain reporting requirements)
- Use of shell corporations or other entities potentially hiding the ultimate taxpayer or funds subject to taxation on the virtual currency transactions

The IRS is also working with consultants to analyze blockchain activity in an effort to ascribe virtual currency connections to the appropriate taxpayers. The IRS will consider civil and criminal penalties as well as other actions on those taxpayers omitting such data from their tax returns. In some cases, civil penalties could equal 75% of the understatement of tax.

2021 Form 1040

Slightly modified from 2020, the 2021 draft Form 1040 asks the following question on Page 1: At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? The question appears underneath the name and address fields.

FBAR reporting

In December 2020, the Financial Crimes Enforcement Network (FinCEN) announced its plans to propose regulations that amend the rules implementing the Bank Secrecy Act. FinCEN intends to include virtual currency as a type of account reportable on a Report of Foreign Bank and Financial Accounts (FBAR) on FinCEN Form 114.

At this time, FinCEN has not yet issued those proposed regulations nor is it clear whether any anticipated guidance would be effective for 2021. Also unknown is whether the definition will include virtual currency held in "cold storage" wallets under self-control on a hard drive and assets held on a virtual currency exchange located outside of the United States. Furthermore, how the value of the accounts should be measured for FBAR reporting purposes when the assets are not held in U.S. dollars is not defined.

Additional information will be provided on the impact of FBAR reporting after FinCEN issues the proposed regulations.

Background

The IRS defines "virtual currency'' as a digital representation of value, other than a representation of the U.S. dollar or a foreign currency ("real currency"), which functions as a unit of account, a store of value or a medium of exchange.

A transaction involving virtual currency includes:

- The receipt or transfer of virtual currency for free (without providing any consideration), including from an airdrop or hard fork
- An exchange of virtual currency for goods or services
- A sale of virtual currency
- An exchange of virtual currency for other property, including for another virtual currency
- A disposition of a financial interest in virtual currency

Virtual currency can operate similar to coins and paper money as used in the United States but generally does not have legal tender. Some forms of virtual currency have an equivalent value in real currency. A taxpayer's basis in virtual currency is the fair market value (as measured in U.S. dollars) as of the date of receipt. Fair market value is determined by a virtual currency exchange or a real currency exchange that can be converted into U.S. dollars.

Virtual currency continues to be taxed as property. Basically, this means when property is acquired in exchange for virtual currency, the taxpayer recognizes a taxable gain if the fair market value of the property exceeds the adjusted basis in the virtual currency used to effect the transaction. However, as noted earlier in this article, there may be some potential changes from the Justice Department implying virtual currency could be taxed as something other than property. This could be a seismic change in how virtual currency is taxed and reported in certain, as yet undefined, circumstances.

Payments for services to employees and independent contractors in virtual currency are taxable (valued at fair market value and measured in U.S. dollars at the date of receipt) and subject to the same withholding, self-employment tax and reporting rules as amounts paid in real currency. In on-chain transactions, this value is determined on the date {and time) the transaction is recorded on the distributed ledger.

If a taxpayer exchanges property for virtual currency and the fair market value exceeds the taxpayer's basis in the virtual currency, the taxpayer has a taxable gain. The character of such gain depends on whether the virtual currency is a capital asset in the hands of the taxpayer. Sales of virtual currency will likely result in recognizable capital gain or loss, subject to the same tax rules as traditional property. However, the wash sale rules do not apply at this time. Virtual currency held for more than one year prior to sale or exchange will result in long-term capital gain or loss treatment. The holding period begins on the day after acquisition and ends on the date of the sale or exchange. Gain or loss is the difference between the adjusted basis and the amount received in exchange for the virtual currency.

Additional Updates

1. Maximum age for IRA contributions: As of 2020, there is no longer an age limit prohibition for making contributions to a traditional IRA.
2. Required age for required minimum distributions (RMD) is 72: This allows taxpayers to retain their retirement savings in tax-favored arrangements, thus delaying income tax on the RMDs.
3. Employer payroll tax credits for emergency paid sick leave (EPSL) and emergency family and medical leave (EFML): The Families First Coronavirus Response Act established tax credits for COVID-19-related paid sick and family medical leave. The Consolidated Appropriations Act (CAA) extended the benefits through March 31, 2021, but eliminated the mandatory requirement for 2021. The American Rescue Plan Act {ARPA) further extended the leave through Sept. 30, 2021. It also increased availability of the leave by expanding qualifying reasons for the leave to include wages paid for EPSL or EFML by employees to receive COVID-19 vaccinations or to recover from any injury, disability, illness, or condition related to the vaccinations and by employees seeking or waiting for results of a COVID-19 test if either the employee has been exposed to COVID-19 or the employer has requested the COVID-19 test.

An eligible employer paying the leave can receive a tax credit equal to the wages paid to employees for that day, up to the following limits:

- Paid sick leave: 10 days (80 hours) capped at $5,110 per employee
- Family and medical leave: capped at $12,000 per employee
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As of April 1, 2021, the 1 0-day limitation on the maximum number of days for which an employer can claim the paid sick leave credit with respect to wages paid to an employee resets, and the limit on wages that can be taken into account for computing the family leave credit with respect to all calendar quarters in total increases to $12,000 from $10,000. For example, if, as of March 31, 2021, an employer reaches both limits for an employee, the employer would be able to claim an additional family leave credit up to $2,000 of qualified family leave wages plus a paid sick leave credit up to 10 days for qualified sick leave wages paid to that same employee from April 1, 2021, through Sept. 30, 2021. In addition to the qualifying reasons discussed above, the ARPA further expands the qualifying reasons for the EFML to include all the qualifying reasons for the EPSL

4. Nonrefundable tax credit for startup costs of adopting a new qualified retirement plan: An employer with 100 or fewer employees may be eligible for a nonrefundable income tax credit for startup costs of adopting a new qualified retirement plan. The amount of the credit for a taxable year is the greater of (1) $500 or (2) the lesser of (a) $250 multiplied by the number of non-highly compensated employees of the eligible employer who are eligible to participate in the plan or (b) $5,000. The credit is for three years.

Estate planning

Time is ticking on estate planning as we know it. Soon, one of the most favorable planning eras will likely come to an end. Recent months have seen a myriad of tax proposals seeking to eliminate many popular wealth-transfer techniques.

Tax proposals

Since March of this year, no fewer than four proposals have been released to modify current gift and estate tax rules. Most recently, on Sept. 12, 2021, the House Ways and Means Committee issued its proposal for the budget reconciliation bill. The draft legislation includes several significant changes affecting high-income and high-net-worth individuals, but from an estate planning perspective, it proposes to:

- Add a surcharge high-income trusts and estates: The proposal would apply a 3% surtax on trusts and estates with adjusted gross income over $100,000. This change would be effective for tax years after Dec. 31, 2021.
- Reduce the gift, estate and GST tax exemptions: The proposal would reduce the gift, estate and generation-skipping transfer (GST) tax exemptions to their 2010 levels. Indexed for inflation, this would result in the 2022 exemptions equal to approximately $6 million per person, or $5.7 million less than the 2021 amount of $11.7 million per person.
- Pull grantor trusts into decedent's estates: The proposal would require grantor trusts to be included in their deemed owner's estate. This change would apply to grantor trusts created after the date the provision is enacted (which could be this year) or to any portion of a granter trust created before enactment attributable to a contribution made on or after such date. Although not clear at this point, the proposal could eliminate planning with grantor-retained annuity trusts (GRATs), qualified personal residence trusts (QPRTs) and certain charitable lead trusts.

- Tax certain sales between grantor trusts and their owners: The proposal would cause sales between grantor trusts and their deemed owners to be taxable. Traditionally, taxpayers have been able to sell assets to their grantor trusts without recognition of gain and without receiving taxable 1ncome on any corresponding note payments. This provision, which could be effective this year (on the date of enactment), would change that.
- Eliminate valuation discounts for nonbusiness assets: The proposal would effectively eliminate valuation discounts for passive assets not used in an active trade or business. This provision would be effective on the date it is enacted.

In addition to the House proposal, three other proposals were released earlier this year. Some of the concepts included in those proposals were incorporated into the House bill but others were not. Notable absent. provisions include increasing estate tax rates, capping annual exclusion gifts, limiting the. duration of dynastic trusts and eliminating the step-up in basis rule. However, clients should keep these in mind, as they may be revived in the Senate's version of a budget bill.

Importantly, the House bill is a mere proposal at this point. The situation continues to be fluid", and changes are expected as the bill moves through the legislative process. As a result, the final timing and content of the bill is unknown. The Senate Finance Committee will likely advance its own version of a bill, and both the Senate and the House will need to combine their respective bills to form one comprehensive package.

State news

As the federal tax landscape threatens to change, the state and local tax world is constantly evolving to meet the needs of constituents plus adapting to conform or decouple from the seemingly never-ending federal modifications.

Telecommuting

The emergency orders issued last year forced employers to have most, if not all, employees to telework. What started as two weeks at home is closely approaching two years! Some employees fled small apartments, cold climates and/or cities with high rates of infection and started moving to new locations. Many never informed their employer of their new whereabouts. The fight for talent is forcing employers to reimagine employment and hiring policies and procedures to allow for permanent teleworking, but this is not without issues for both the employer and employee.

Certain employers have always had teleworking/remote workers. Sales personnel often work from a home office and travel from state to state soliciting orders on behalf of a company. Global employers have key executives traveling from location to location. Repair, service and/or installation activity keeps employees on the go. Pre-pandemic, these mobile employees created challenges with states requiring employers to withhold wages based on where employees performed services. Numerous companies either ignored or may not have understood the potential implications of these activities on state and local taxes and, instead, withheld payroll taxes only based on the employee's state of residency. However, one difference between then and now is there was little change of employee residency location unless the employer required the move. Today, employees are actively moving about the United States; staying days, weeks or months before moving on to the next location without their employers' knowledge. These are not extended vacations but rather the new normal of work with travel adventure. If the employer is unaware of the movement of its employees, it may not be properly withholding taxes from the wages earned. While this may have been an issue for employers pre-pandemic, the awareness of the matter is at an all-time high.

Employees working in multiple states create payroll withholding, unemployment insurance and state tax nexus issues for the employer and employee. Failure to properly withhold and/or remit payroll taxes can come at a high price if a state imposes a penalty on the employer. If a state considers the employer's failure to do so intentional, it may have the power to impose a penalty as high as 100% of the amount not withheld.

If payroll withholding is required in a state, be sure to check whether a reciprocity agreement exists With neighboring states. It is important to distinguish that while withholding employee wages may be required for an employee for more than one state based on where they are working, unemployment compensation insurance differs. Unemployment compensation insurance is generally reported to the state in which the employee's services are localized. States follow "localization of work" provisions established by the U.S. Department of Labor in order to avoid duplicate coverage or no coverage when an employee works for an employer in more than one state.

In general, services are localized within a state when services are performed entirely within the state or when the services performed outside of the state are incidental to the services performed within the state. If the services are not localized in one particular state, then a hierarchy is used to determine where the employee's base of operations is located.

Considerations must be given to employees that will transition to teleworking permanently or that have relocated during the pandemic as those work arrangements are no longer "temporary" and will most likely require a change in reporting. This, of course, assumes the employer is knowledgeable of such changes on a timely basis.

Having an employee telework in another state can create additional compliance requirements for the business it possibly did not have before. These employees can create income tax, sales and use tax, gross receipts, local occupational taxes, various excise taxes, or local license filing requirements. Only a few jurisdictions lifted their withholding and/or nexus rules for the duration of the emergency orders, which are starting to expire. Therefore, it is important to ensure all compliance considerations, in addition to payroll, are evaluated when contemplating employees in new states/jurisdictions. Do you know where your employees are working? If the answer is "no" or "unsure," it may be time to require employees to update location with your payroll department.

SALT cap

Since the Tax Cuts and Jobs Act of 2017 (TCJA) limited an individual's federal itemized state and local tax (SALT) deduction to $10,000, states have been exploring pass-through entity {PTE) tax workarounds. Fast forward to November 2020 when the IRS gave guidance regarding state tax deductions for specified income tax payments at the PTE level and opened the floodgates to states enacting PTE tax legislation in the ensuing months, with California, Illinois, Minnesota and New York being among the latest.

PTE tax workarounds permit the PTE to pay the state tax at the entity level. As the $10,000 SALT cap applies to individuals, PTE taxes are taken as a partnership or S corporation deduction, which flows through to the owners without limitation. The partners, members or shareholders of the PTE that have paid the state PTE tax either receive a credit against their state individual income tax liability or are able to deduct their distributive share of income from their adjusted gross income in determining their state income tax liability. As straightforward as it sounds, it really is far from it. Because every state has different regulations, not every PTE owner will benefit the same.

Currently, nineteen states have enacted PTE-level taxes. Five states (Connecticut, Louisiana, Oklahoma, Rhode Island and Wisconsin) were early adopters and enacted these laws effective for tax years 2018 and/or 2019. Maryland and New Jersey enacted their PTE taxes effective for tax year 2020.

Seven states (Alabama, California, Idaho, Illinois, Minnesota, New York and South Carolina) are effective for tax year 2021 and the remaining states (Arizona, Arkansas, Colorado, Georgia and Oregon) for tax year 2022. All are annual elections with the exception of Connecticut, which is a mandatory tax on the PTE. Be careful, California, Illinois, Minnesota and New York are among the states for which the election is irrevocable. The mechanics of making the election as well as the timing of when to make the election varies by state. New York's deadline for making an election for tax year 2021 was Oct. 15, 2021. For tax year 2022, a New York election is due by March 15, 2022.

These elections can cause cash-flow issues especially in the first year of making an election. For those states allowing election for tax year 2021, the PTE and/or the owners may have been required to withhold or make estimated tax payments thus far for tax year 2021. Safe harbor rules, underpayment interest and late payment penalties should be analyzed when calculating the overall benefit in the initial year. However, in order for an electing PTE to benefit, it too will need to make a tax payment by Dec. 31, 2021, in order to deduct, for federal tax purposes, the state taxes as a specified income tax payment.

Even though a PTE would expect a federal tax benefit by making the election, it is possible an individual will lose some of their tax credits, perfected state losses OF other personal state tax attributes. A resident's analysis of their credit for taxes paid to other states should also be conducted to determine the benefit. Many states that have not adopted a PTE tax have not adjusted their statutes or regulations to allow for a credit for a PTE tax paid to another state. Further, states have clarified that a credit for taxes paid can only be taken if made by or on behalf of the taxpayer. For this reason, tax paid by an electing PTE may not be an eligible credit against the personal income tax of a resident owner. The risk of losing any tax attributes should be considered by PTEs conducting business on a multistate basis prior to making a PTE tax election. Bottom line, each state with a PTE-level tax for which a company operates in needs to be analyzed separately but collectively with all other states the taxpayer files returns in.