Baker Tilly’s
2022 year-end tax letter
2022 year-end tax letter

It has been a challenging year both economically speaking and in terms of tax planning. While we have seen some federal tax legislation, the changes have been far more limited than many expected. Additionally, the continuing tight labor market, worries over a possible recession and high inflation are dominating concerns. In this vein, the Federal Reserve increased the benchmark interest rate by 300 basis points to date in 2022. Recent comments by the Fed indicated it intends to further increase rates until the funds level hits a “terminal rate,” or end point, with a current target of 4.6% in 2023. This not only raises business borrowing costs, but also the correlating interest expense tax deduction, which is more likely to be reduced due to the limitations enacted in the 2017 Tax Cuts and Jobs Act (TCJA). A challenging economy, ever-changing tax rules and rising interest rates make tax and business planning more critical than ever.

To date, 2022 has seen limited federal tax legislation in the Inflation Reduction Act (IRA) and United States Innovation and Competition Act of 2021 (USICA aka CHIPS-plus Act). The IRA contains a multitude of energy credits, an excise tax on stock repurchases and a new corporate alternative minimum tax (AMT). While the IRA is less expansive than the initial Build Back Better proposals, it does add numerous complexities to tax law requiring new guidance from the Treasury Department. Besides the IRA, taxpayers continue to wait on further guidance pertaining to the many other tax provisions enacted over the past five years. Finally, the CHIPS-plus Act includes over $52 billion for semiconductor facilities plus a 25% tax credit for semiconductor manufacturing. For additional discussion of the IRA, see our previous tax alert.

As we head toward a post-election lame-duck congressional session, tax legislation may resurface that targets retirement plans, digital assets and the so-called tax extenders that either expired at the end of last year or will expire at the end of 2022. There are more than 40 temporary tax provisions that expired Dec. 31, 2021, including:

- Extension of research and development expensing and/or a refundable research credit
- Refundable and/or enhanced child and dependent care tax credit
- Increased child tax credit
- Credit for qualified fuel cell motor vehicles
- Credit for construction of new energy-efficient homes
- Increase in exclusion for employer-provided dependent care assistance
- Extension of favorable formula used to compute business interest expense deduction under section 163(j)
- Charitable contribution deduction by non-itemizers

Five tax extenders expiring at the end of 2022 that may be retroactively reinstated include the full deduction for business meals provided by a restaurant (otherwise limited to 50%) as well as incentives for biodiesel and renewable diesel fuel.

We expect any legislation in the lame-duck session to be centered around items with bipartisan support. While some may push for far-reaching provisions, being able to use reconciliation in the Senate and bypass the filibuster rules will still require the sign off of Sens. Joe Manchin (D-W.Va.) and Kyrsten Sinema (D-Ariz.). Sinema’s reluctance to raising tax rates or rolling back certain TCJA provisions coupled with Manchin’s concern that expanding social programming will further overheat an economy struggling with inflation derailed last year’s larger Build Back Better proposals. We do not expect the end of 2022 to be any different.

With this in mind, look for potential legislation to include a continuation of fully expensing R&D expenses with certain retirement provisions of the Setting Every Community Up for Retirement Enhancement (SECURE) Act rolled in. Both of these enjoy strong support on both sides of the aisle. Things could get
more interesting if Democrats attempt to continue the expanded child tax credit. Absent the inclusion of a work requirement, it is doubtful Manchin or congressional Republicans will support expanding the credit.

Following the midterm elections, any tax legislation is largely dependent upon the composition of the next Congress. House Republicans have offered a broadly stated policy proposal if they control the House in January. For tax policy, their statement includes a promise to “increase take-home pay, create good-paying jobs, and bring stability to the economy through pro-growth and deregulatory policies.” Actual provisions are not outlined but their statement suggests the GOP would extend TCJA tax relief provisions for individuals currently expiring at the end of 2025 as well as continuing bonus depreciation. Key individual tax elements expiring in 2025 include the top tax rate for individual taxpayers reverting to 39.6% from 37%, an end to the 20% section 199A qualified business income deduction, removing the $10,000 cap on the state and local tax (SALT) deduction and reinstating the personal and dependent exemption deductions.

If Democrats maintain control of the House and increase their majority in the Senate, they may pursue remaining policies from the original Build Back Better bill. Many provisions of the TCJA would be subject to change, such as increasing the corporate tax rate, raising individual tax rates on those earning over $400,000, and subjecting S corporation income to self-employment tax. Earlier administration proposals would raise the individual tax rate to 39.6% from 37%. Finally, long-term capital gains and qualified dividends would be taxed at 25%, up from the current 20%.

In a turbulent political year, we cannot predict the midterm election results. However, unless Democrats retain control of both houses of Congress, we expect little in the way of legislation for the next two years. Should Republicans gain control of both the House and the Senate, the Biden administration indicated any tax-related legislation passed would likely be vetoed. If one party controls each house, it’s an understatement to say compromise will be difficult. In this event, we expect extremely modest tax legislation, if any, before 2025.

One notable exception to our expectation of a stalemate in a split Congress is the possibility of a bipartisan bill addressing the regulation and taxation of digital assets. The need for clarity in the federal oversight and tax treatment of digital assets is rapidly escalating. The Infrastructure Investment and Jobs Act, a bipartisan bill passed in late 2021, made changes to reporting requirements for digital assets, including cryptocurrencies. In the intervening 12 months, several digital asset bills have been introduced, most with bipartisan sponsorship. For more details, please see our article on the ever-changing world of digital asset taxation.

Potential legislation notwithstanding, we also anticipate a multitude of regulatory guidance from the Treasury Department. For several months, we have expected the IRS and Treasury to issue additional regulations on the business interest expense deduction, cryptocurrency reporting, deferred compensation and noncompensatory options. Furthermore, we are awaiting a number of regulations dealing with partnerships taxation. Specific partnership areas we are watching include disguised sale rules, related parties, a host of basis and capital account guidelines and the fractions rule. Given the competing priorities of the IRS and Treasury, particularly considering the extent of guidance needed to implement the recently passed IRA, it remains to be seen whether any of this pending guidance will be issued in the near future. Regardless as to which regulations are published first, taxpayers can expect more compliance and documentation requirements.

We remind you that tax planning should be addressed throughout the year as an integral part of overall financial health. To assist you in this endeavor, our year-end tax letter also includes articles on the evolving world of digital assets, happenings at the IRS, information reporting, new international tax issues and reporting as well as the latest in state and local taxation.

As always, we encourage you to contact your Baker Tilly advisor or visit bakertilly.com/contact to discuss how these issues impact your tax position.
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Projected 2023 bracket changes

Authored by Michelle Hobbs and Paul Dillon

Multiple amounts in the Internal Revenue Code are tied to the chained Consumer Price Index and modified on an annual basis. After a year of inflationary increases, taxpayers can expect significant changes to a variety of tax thresholds in 2023. Besides adjusting tax brackets, inflation adjustments impact the section 199A qualified or business deduction, excess business loss threshold and the Social Security wage base, among others. Generally, the IRS releases final adjustments during the fall. Given the volatility of the prices the last few months, it’s possible that final adjustment information will be released later than normal.

### Individual taxes

<table>
<thead>
<tr>
<th>Tax item</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing joint – top bracket</td>
<td>37% for taxable income over $647,850</td>
<td>37% for taxable income over $693,750</td>
</tr>
<tr>
<td>Single – top bracket</td>
<td>37% for taxable income over $539,900</td>
<td>37% for taxable income over $578,125</td>
</tr>
<tr>
<td>Capital gains – married filing jointly</td>
<td>15% rate with net capital gain between $83,350-$517,200; 20% over $517,200</td>
<td>15% rate with net capital gain between $89,250-$553,850; 20% over $553,850</td>
</tr>
<tr>
<td>Capital gains – single</td>
<td>15% rate with net capital gain between $41,675-$459,750; 20% over $459,750</td>
<td>15% rate with net capital gain between $44,625-$492,300; 20% over $492,300</td>
</tr>
<tr>
<td>Standard deduction – married filing jointly</td>
<td>$25,900</td>
<td>$27,700</td>
</tr>
<tr>
<td>Standard deduction – single</td>
<td>$12,950</td>
<td>$13,850</td>
</tr>
<tr>
<td>Section 199A qualified business income deduction income limitation – married filing jointly</td>
<td>$340,100</td>
<td>$364,200</td>
</tr>
<tr>
<td>Section 199A qualified business income deduction income limitation – single</td>
<td>$170,050</td>
<td>$182,100</td>
</tr>
<tr>
<td>Excess business loss disallowance threshold – married filing jointly</td>
<td>$540,000</td>
<td>$578,000</td>
</tr>
<tr>
<td>Excess business loss disallowance threshold – single</td>
<td>$270,000</td>
<td>$289,000</td>
</tr>
</tbody>
</table>
Social Security wage base | $147,000 | $160,200

Remember, the thresholds for the net investment income tax (3.8% tax) and additional Medicare tax (0.9% tax) are not tied to inflation and remain at $250,000 for married filing jointly taxpayers, $125,000 for married filing separately taxpayers and $200,000 for other taxpayers.

While still a few years away, the individual tax environment will change (barring new tax legislation) after 2025 when provisions enacted under the Tax Cuts and Jobs Act (TCJA) expire. Key items include increasing the top tax rate for individual taxpayers back to 39.6%, ending the 20% section 199A qualified business income deduction, removing the $10,000 cap on the state and local tax deduction and reinstating the personal and dependent exemption deductions.

**Business taxes**

<table>
<thead>
<tr>
<th>Tax item</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts threshold</td>
<td>$27 million</td>
<td>$29 million</td>
</tr>
<tr>
<td>Section 179 expensing</td>
<td>$1.08 million</td>
<td>$1.16 million</td>
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<tr>
<td>Section 179 expensing limit</td>
<td>$2.7 million</td>
<td>$2.89 million</td>
</tr>
</tbody>
</table>

The gross receipts threshold is used to help determine eligibility for a number of exceptions to different rules and limitations, including computing the business interest limitation under section 163(j), use of the cash method of accounting in computing taxable income, ability to determine taxable income for long-term contracts under the percentage-of-completion method and having to capitalize certain direct and indirect costs into inventory.

**Transfer taxes**

<table>
<thead>
<tr>
<th>Tax item</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unified estate and gift tax exclusion</td>
<td>$12.06 million</td>
<td>$12.92 million</td>
</tr>
<tr>
<td>Generation-skipping tax exemption</td>
<td>$12.06 million</td>
<td>$12.92 million</td>
</tr>
<tr>
<td>Gift tax annual exclusion</td>
<td>$16,000</td>
<td>$17,000</td>
</tr>
</tbody>
</table>

Similar to the individual tax threshold sunsets from TCJA, the estate and gift tax exclusion limitations will also revert back to pre-2018 levels after 2025. Again, without future legislation, the estate and gift tax exclusion is projected to drop back to $5 million and indexed for inflation (currently estimated to be approximately $6.4 million) for 2026.
As we move into the final quarter of 2022, Congress is considering two separate bills that would make significant changes to retirement plans. The Senate is expected to act on the bipartisan Enhancing American Retirement Now (EARN) Act introduced by the Senate Finance Committee in September 2022. In addition, the Securing a Strong Retirement Act of 2022 (SECURE 2.0) was passed by the House in June 2022 and has bipartisan support. SECURE 2.0 expands and clarifies certain provisions of the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019. With all of that said, the following topics of interest will be important for you to consider both for year-end tax planning and perhaps for tax planning in the coming year:

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. IRA catch-up contributions: Currently, catch-up contributions to IRAs are limited to $1,000. Both SECURE 2.0 and the EARN Act would index the limit on an annual basis. Catch-up contributions to IRAs would continue to be pre-tax.

3. Required age for required minimum distributions (RMD) is age 72: This allows taxpayers to retain their retirement savings in tax-favored arrangements, thus delaying income tax on the RMDs. SECURE 2.0 would gradually increase the RMD age to 75 over a 10-year period. The EARN Act would eliminate the graded schedule and increase the RMD age to 75 from 72 beginning in 2032.

4. Deadline for plan amendments to tax qualified plans is extended: The IRS extended the deadline for adopting plan amendments to comply with the SECURE Act and the Coronavirus Aid, Relief and Economic Security (CARES) Act to 2025 from 2022. However, the amendment deadline for COVID-19 relief provisions in the CARES Act has not been extended: coronavirus-related distributions, increase in the plan loan cap and extension of loan repayment periods. Therefore, plan sponsors should proceed with amendments for these provisions based on the original deadline which ends the last day of the first plan year beginning in January 2022.

5. Catch-up contributions to employer-sponsored plans: Under current law, catch-up contributions are pre-tax unless the employer-sponsored retirement plan allows them to be after-tax Roth contributions. The EARN Act would require catch-up contributions to employer-sponsored qualified retirement plans to be designated Roth contributions for taxable years beginning in
Although this provision is also included in SECURE 2.0, the effective date would be for taxable years beginning in 2023.

6. Extended due date for adopting a qualified retirement plan: An employer may adopt a qualified retirement plan for a taxable year after the last day of the taxable year provided it is adopted before the due date, including extensions, for filing the employer’s tax return for the taxable year. For example, an employer who wants to adopt a qualified retirement plan for calendar-year 2022 has until Sept. 15, 2023, for a partnership or corporate employer, or Oct. 15, 2023, for a self-employed employer, to adopt the plan.

7. 401(k) plan sponsors with long-term, part-time employees: An employer who sponsors a 401(k) plan is required to include eligible part-time employees as participants for purposes of making elective deferrals. An eligible part-time employee is an employee who has worked at least 500 hours in three consecutive years and is at least age 21. Both SECURE 2.0 and the EARN Act would reduce the three-year rule to two years.

8. Pooled employer plans for retirement benefits: Pooled employer plans permit unrelated employers to participate in a single plan. Employers must follow the qualification requirements to ensure that one employer’s failure to meet the qualification requirements will not result in the disqualification of the plan.

9. Nonrefundable tax credit for startup costs of adopting a new qualified retirement plan: To encourage an employer to adopt a new qualified retirement plan, the employer may take advantage of a tax credit up to 50% of startup costs incurred for adopting the plan. The tax credit is available to an employer with 100 or fewer employees. 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 nonhighly compensated employees of the eligible employer who are eligible to participate in the plan or (b) $5,000. The credit is for three years. Both SECURE 2.0 and the EARN Act would modify the credit by reducing the number of employees for an employer to qualify and increasing the credit.

10. Federal Insurance Contributions Act (FICA) taxation rules for nonqualified deferred compensation: As a reminder, an employer is required to subject deferred compensation to FICA taxation at the appropriate time. Generally, pursuant to a “special timing rule,” deferred compensation is required to be taken into account at such time as the benefit becomes vested. However, the Self-Employed Contributions Act (SECA) rules generally require the deferred compensation to be taken into account upon actual or constructive receipt of the benefit.
The centralized partnership audit regime (CPAR) revolutionized how the IRS examines most Forms 1065, U.S. Return of Partnership Income. As a consequence to CPAR’s dramatic changes, most partnerships are unable to amend Form 1065; instead, they will now “amend” Form 1065 via an administrative adjustment request (AAR). Possibly the most critical concept in CPAR is the imputed underpayment (IU). The IU is a partnership-level income tax for any positive adjustments (e.g., increases to income, decreases to expenses, decreases to credits) to Form 1065. To the extent the partnership does not wish to pay the IU, there is a complex system to push the positive adjustments to the partners. Prior to CPAR, the IRS was responsible for administering any adjustments made to a Form 1065. CPAR essentially shifts this burden to partnerships and their advisors.

CPAR was created in 2015 via the Bipartisan Budget Act (BBA). The BBA dictated that CPAR was first mandatory for the 2018 Form 1065. Essentially, this meant the IRS would implement CPAR in 2020, which is when 2018 Forms 1065 would be examined and amended. However, the Coronavirus Aid, Relief and Economic Security (CARES) Act further delayed the implementation of the CPAR rules for AARs. Moreover, the IRS opened little to no new examinations during the pandemic. Functionally, the pandemic further delayed the implementation of CPAR until 2022. What follows are four takeaways from 2022, our first full CPAR year.

1. CPAR impacts more than just CPAR partnerships

Partners in a CPAR partnership are (finally) beginning to receive push-out statements, i.e., IRS Form 8986, Partner’s Share of Adjustment(s) to Partnership-Related Item(s). If a pass-through partner receives a Form 8986 that reports positive adjustments, the pass-through partner can either (a) pay an imputed underpayment or (b) push the positive adjustments to its owners. These options apply equally to S corporations and non-CPAR partnerships. A pass-through partner’s failure to make the push-out election by the extended due date of the AAR partnership’s return will result in an IU assessment against the pass-through partner. Non-pass-through partners, on the other hand, must report the contents of the pushout statement on the income tax return for the year in which they receive a push-out statement. For example, Partnership A files a 2020 AAR in 2022. Partner B, an individual, reports the adjustments on the push-out statement via the 2022 Form 1040. Partner C, an S corporation, has the option to push out any positive adjustments or simply pay the IU.
2. Exercise caution with respect to negative adjustments (the Doomsday Scenario)

Negative adjustments (e.g., decreases to income, increases to expenses, and increases to credits) may create nonrefundable credits that a partner cannot carry into subsequent years. As such, CPAR partnerships should exercise caution before filing AARs to report negative adjustments. In an AAR setting, a partnership must push out negative adjustments to its partners. Those partners will report the Form 8986 on the income tax return for the year in which the Form 8986 is received. CPAR essentially requires partners to prepare a “dummy” income tax return for the year the 8986 relates to and then claim any resulting credit based on any difference tax for the year in which the Form 8986 relates.

For example, Partnership A files a 2020 AAR during 2022 to report negative adjustments. Presume Partner B paid $100 of income tax with the 2020 Form 1040. Further, Partner B has a net operating loss on the 2022 Form 1040. Partner B will report the contents of the push-out statement via a 2022 Form 8978, Partner’s Additional Reporting Year Tax. The Form 8978 will produce a credit for Partner B in 2022. However, because Partner B has a 2022 NOL, Partner B cannot use the credit because there is no tax for the credit to offset and the credit does not carry forward.

If the above-described “Doomsday Scenario” applies, a partnership and its partners should consider various planning options. The partnership could accelerate 2022 income (so its partners can absorb the 2022 credit). The partners can also accelerate 2022 income. Finally, the partnership could also consider filing its AAR in 2023, hoping that the Doomsday Scenario would not apply at the partner level.

3. Imputed underpayments can be a helpful tool

When Congress passed the BBA, the consensus was that IUs were unhelpful for taxpayers because taxpayers calculate the IU by multiplying any positive adjustments by the highest marginal tax rate in effect. The IU generally does not account for the actual impact an adjustment would have at the partner level. Thus, in most cases, it is prudent to file push-out statements and administer adjustments at the partner level.

However, there are cases in which the IU can be helpful. Consider, for example, partnerships with complex tiered structures. For relatively small positive adjustments, the professional fees to administer the push-out statements plus the public relations downside of amending Schedules K-1 may outweigh the cost of the IU. Moreover, the partnership can modify the IU in certain circumstances. The so-called modification procedures allow CPAR partnerships to account for adjustments that would be subject to capital gains tax rates. Likewise, the modifications procedures can account for tax-exempt partners or C corporation partners that have a lower tax rate than the highest marginal tax rate. Given the right fact pattern, an IU can be a simplified procedure to adjust a Form 1065.

4. Know your partnership representative

In an IRS examination, the partnership representative (PR) has unilateral power to make all decisions. Under the prior examination regime (i.e., TEFRA), the IRS was required to provide notices and appeal rights to various partners. Now, the PR is solely responsible for negotiating penalties and conducting the exam with the IRS; there is no opportunity for other partners to participate in the examination proceedings. As such, partnerships should exercise caution when selecting the PR. The PR does not have to be a partner in the partnership. Baker Tilly’s experience has been that the PR is an important designation in IRS examinations. Failure to select a diligent PR will result in the IRS selecting a PR for the partnership.

CPAR remains in its infancy. Taxpayers, practitioners and the IRS are all still wrestling with the new processes to adjust partnership tax returns. We anticipate administrative and judicial developments in the coming years. In the meantime, it is prudent to consult with tax professionals for CPAR examinations and AARs.
The ever-changing world of digital asset taxation

Authored by Kasey Pittman and Michelle Hobbs

Introduction

Digital assets have become a mainstream part of our financial system over the last several years. In particular, cryptocurrencies, the most popular type of digital asset in the market today, has seen enormous growth. In 2021, cryptocurrency market capitalization peaked at just over $3 trillion, an increase of more than 21,000% from the market capitalization of $14 billion just five years earlier. Though cryptocurrencies have seen a sharp decline in value over the course of 2022, their prevalence has not decreased. An estimated 40 million Americans continue to invest in, trade or otherwise transact using cryptocurrencies.

Despite the rise in their use, the taxation of digital assets remains rife with uncertainty. Practitioners are eager for updated guidance, as the digital asset ecosystem has significantly changed in the years since IRS guidance was last issued. A lack of reporting transactions has led the IRS to increase examination and enforcement efforts, creating additional pressure for taxpayers and practitioners. Several proposed pieces of digital asset legislation could bring direction and clarity, but they seem to be stalled in both the Senate and House of Representatives. Finally, the general oversight of digital assets is still yet to be determined; the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CTFC) are currently publicly negotiating cryptocurrency regulatory authority.

As businesses and individuals interact with digital assets with increasing frequency, it is critical for taxpayers and their advisors to understand the implications of owning and transacting with digital currencies.

Background

Digital assets were recently defined in the Internal Revenue Code as “any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as prescribed by the Secretary.” The most common type of digital asset is cryptocurrency, such as bitcoin or ether, but can also include other items such as nonfungible tokens (NFTs), central bank digital currencies (CBDCs) and other tokens.

Generally, digital assets use peer-to-peer networks, called blockchains, to securely record transactions. Blockchains are public databases or ledgers that memorialize transactions; new entries can be made but existing entries cannot be altered. Each entry into the database is called a block and each new block
contains information about the preceding block, effectively forming a chain. (Hence, the name blockchain).

The most common ways taxpayers use digital assets are:

- **Exchanges** – Users can purchase, sell, exchange and tokenize digital assets. These functions are often similar to those of stock or securities trading.
- **Marketplaces** – Users can purchase goods and services using digital assets. Purchases may be for other digital assets (i.e., NFTs) or goods and services off the blockchain, such as a cup of coffee.
- **Decentralized finance (DeFi)** – Users can lend or borrow funds, purchase insurance, partake in liquidity pools, trade cryptocurrencies or participate in many other applications without the need for a financial intermediary such as a bank, brokerage or exchange. DeFi transactions are facilitated by automated programs called smart contracts.

The decentralized nature of the digital asset ecosystem allows increased innovation and decision-making speed; as a result, the market is constantly and rapidly evolving.

**Current taxation principles**

Several years ago, the IRS issued guidance on the taxation of convertible virtual currencies stating they are to be treated as property, subject to general tax principles applicable to property transactions. Taxpayers recognize gain or loss on the sale or exchange of virtual currency. The type of gain will depend on whether the virtual currency is a capital asset in the hands of the taxpayer. The receipt of virtual currency as payment for goods or services can create taxable income, the fair market value of which must be measured in U.S. dollars, for the recipient.

With only limited guidance available, taxpayers and practitioners have received no direction for how to conduct many now-commonplace transactions. Furthermore, the IRS has not provided guidance for any other types of digital asset transactions outside of convertible virtual currency.

**IRS focus and enforcement**

The decentralized and anonymous nature of the digital asset ecosystem, along with a lack of reporting requirements, has contributed to tax evasion in recent years. In 2021 testimony with the Senate Finance Committee, IRS Commissioner Chuck Rettig surmised annual tax evasion has likely reached $1 trillion, citing cryptocurrency as a driving force in the ever-expanding tax gap. Furthermore, a recent Barclays analysis found cryptocurrency investors are possibly paying less than half of the taxes they owe on virtual currency trades. In response, the IRS is rapidly increasing enforcement efforts related to digital asset transactions.

In 2021, the IRS unveiled “Operation Hidden Treasure,” a joint effort between the Office of Fraud Enforcement and the Criminal Investigation Unit, focusing on taxpayers who omit cryptocurrency income from tax filings. The IRS is working with third-party vendors to analyze the blockchain and identify parties who may have committed tax fraud. Operation Hidden Treasure will pursue both civil and criminal cases. In civil cases, the IRS may assert a civil fraud penalty equal to 75% of the understatement of tax.

The IRS has also been using “John Doe summonses” to gather information on taxpayers who use cryptocurrency. This type of summons is used when the IRS is seeking to obtain tax-related information when the taxpayer’s identity is unknown. In recent years, federal district courts have granted the IRS authority to investigate several virtual currency exchanges, including Coinbase, Circle Internet Financial, Kraken and SFOX. Information obtained is used by the IRS to assess taxes and penalties on unreported or underreported taxable income.

The IRS has also expanded its ability to process the data from John Doe summonses and enhance its tracking ability via well-publicized public-private partnerships with companies such as Chainalysis and...
TaxBit. Access to these sophisticated digital asset applications allows the IRS to pursue civil enforcement in addition to criminal enforcement. Taxpayers who non-willfully omitted digital asset transactions from a tax filing can correct mistakes by filing amended or past due returns.

Since 2019, the IRS has emphasized that owners of digital assets must report income, gains and losses on their returns by asking taxpayers about virtual currency holdings. In 2020, this question became mandatory for all individual filers. Now in 2022, the IRS plans to increase the scope of the question beyond virtual currency, to include all digital assets. The 2022 Draft Form 1040 asks:

“At any time during 2022, did you (a) receive (as a reward, award, or compensation), or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?”

It’s important that taxpayers answer this question truthfully, as a “no” response will not keep the IRS from pursuing a taxpayer who does transact with digital assets.

Recent developments

The Infrastructure Investment and Jobs Act (IIJA), which was signed into law in late 2021, brings about a new reporting requirement for digital assets, including cryptocurrencies. The legislation broadened the definition of securities reportable on Form 1099-B to include digital assets and expanded the definition of a broker to include those who operate trading platforms for digital assets, thereby requiring such transactions be disclosed to the IRS. In addition, the IIJA specifies digital assets will be treated as cash for certain reporting purposes; the effect is that any person or business who receives payment of more than $10,000 in digital assets will need to file Form 8300 reporting the identity of the sender. Both reporting requirements are effective for 2023 returns and statements.

Early in 2022, President Joe Biden released the “Executive Order on Ensuring Responsible Development of Digital Assets.” While the executive order does not discuss tax policy, it does highlight the importance of “addressing the risks and harnessing the potential of digital assets” and lays out a national policy across six priorities. As a result of the executive order, we expect to see additional movement in the regulation, development and use of digital assets.

Proposed legislation

The Senate and House have several pieces of proposed legislation that would affect the taxation of digital assets. While we do not expect much movement on digital asset legislation until the new Congress is seated, there is a growing urgency to regulate the ever-evolving market. Most current proposals have bipartisan sponsors, but none are viewed as likely to pass in their current forms.

The most comprehensive proposal on the table is the Lummis-Gillibrand Responsible Financial Innovation Act (RFIA). If passed, the RFIA would make significant changes to the regulation and taxation of digital assets and provide clear guidance on a number of crucial outstanding questions. Several provisions in the legislation are particularly taxpayer favorable including a gain recognition exemption for gains on personal transactions under $200, deferred tax liabilities for mining and staking rewards and nonrecognition treatment for certain loan transactions.

When the IIJA changed the reporting requirements, as discussed above, a broad definition of the term “broker” was used. There is a legitimate concern that the new law could have unintended consequences, subjecting nonfinancial intermediaries, such as crypto miners who may not have the ability to comply, to rigid reporting requirements. As a result, numerous bipartisan proposals, including the RFIA, would correct the error if enacted.

Biden is also advocating for changes to the taxability of digital assets. The General Explanations of the Administration’s Fiscal Year 2023 Revenue Proposals, commonly referred to as the “Green Book,” which highlights the administration’s revenue priorities, proposes cryptocurrency reform. Green Book proposals include new reporting requirements for purposes of international information exchange and several
taxpayer-favorable changes, such as allowing dealers and traders in digital assets to use mark-to-market rules.

The need for guidance

While we wait for Congress to act on new digital asset legislation, tax advisors are requesting additional direction from the IRS. To date, the IRS has only released two pieces of guidance: Notice 2014-21 (in 2014) and a set of frequently asked questions (in 2019). At the time of their release, the guidelines left numerous important questions unanswered. Additionally, in the intervening years, the digital asset market has drastically evolved and expanded, creating many new applications and types of transactions not covered by existing guidance.

Tax advisors are using the available IRS guidance, general tax principles and other tax law precedent to develop positions and report digital asset transactions. Any taxpayer who receives, buys, sells or gifts digital assets should consult with their Baker Tilly advisor on the tax implications prior to filing.
Beneficial ownership reporting – new FinCEN regulations

Authored by Michelle Hobbs, Kasey Pittman, Mark Heroux and Paul Dillon

Introduction

On Sept. 29, 2022, the U.S. Department of Treasury’s Financial Crimes Enforcement Network (FinCEN) released a 330-page final rule implementing the beneficial ownership information (BOI) reporting requirements as part of its implementation of the Corporate Transparency Act (CTA) passed by Congress in January 2021.

The final rule describes who must file a BOI report, what information must be reported and when a report is due. Specifically, the final rule requires reporting companies to file reports that identify (1) the beneficial owners of the entity and (2) the company applicants of the entity. FinCEN expects to issue two additional rules focusing on safeguards to protect access and confidentiality of information and revising FinCEN’s customer due diligence. Reporting forms are also expected in advance of the reporting due date.

Requirements and purpose

Effective Jan. 1, 2024, reporting companies are required to disclose their BOI. Existing entities have one year from the effective date to file an initial report (due no later than Jan. 1, 2025); however, newly formed or registered entities only have 30 days.

The rule is designed to enhance the government’s ability to protect U.S. national security and the U.S. financial system from illicit use. The federal government expects to gather data deemed essential to national security to help prevent drug traffickers, fraudsters and corrupt actors from laundering money and other assets in the country. Furthermore, the rule is intended to strengthen the U.S. financial system by making it more difficult to use shell companies to illegally access and transact in the U.S. economy.

Report due dates

Companies required to file BOI reports, referred to as reporting companies, will file an initial report and will be required to file updated reports as relevant information changes.

- Initial reports for existing companies – domestic companies formed and foreign entities registered before Jan. 1, 2024, have one year to file their initial report (due by Jan. 1, 2025)
• Initial reports for new companies – domestic companies formed and foreign entities registered after Jan. 1, 2024, have 30 days after the date of their formation or registration to file their initial report

• Initial reports for companies that no longer meet exemptions – companies that no longer meet the criteria for an exemption have 30 days after the date that they no longer qualify to file an initial report

• Updated reports – if there is a change with respect to required information previously submitted, updated reports need to be filed within 30 days of the change

• Inaccurate reports – companies with inaccurately reported information must file a corrected report within 30 days of when the inaccuracy is, or should have been, discovered

The 30-day period modifies the original 14-day reporting period under the proposed rule. It also matches with the correction period time frame in an effort to lessen the burden on reporting companies.

**Reporting companies**

The final rule adopts the proposed rule definitions of the two types of reporting companies: domestic and foreign.

A **domestic reporting company** includes a corporation, limited liability company (LLC), or any other entity created by the filing of a document with a secretary of state or similar office under the law of a state or Indian tribe.

A **foreign reporting company** includes a corporation, LLC, or other entity formed under the law of a foreign country and that is registered to do business in any state or tribal jurisdiction by the filing of a document with a secretary of state or similar office.

These definitions include limited liability partnerships, limited liability limited partnerships, business trusts and most limited partnerships in addition to corporations and LLCs. Other types of legal entities, including certain trusts, are excluded if they are not created by filing a document with a secretary of state or similar office.

The proposed rule exempts 23 types of entities from reporting requirements. Principal among these are:

• Large operating companies – entities that employ more than 20 full-time employees (measured on an entity-by-entity basis) in the U.S., with an operating presence at a physical office within the U.S. and filed a federal income tax or information return in the U.S. for the previous year demonstrating more than $5 million in gross receipts or sales (excluding sales from outside the U.S.). Unlike the full-time employee count, the $5 million gross receipts threshold is aggregated with the other entities owned by the entity in question as well as other entities through which the entity operates.

• Tax-exempt entities – organizations described in Internal Revenue Code (IRC) section 501(c) and exempt from tax under section 501(a), political organizations defined under IRC section 527(e)(1) and exempt from tax under section 527(a), or a trust described in IRC section 4947(a) paragraphs (1) or (2)

• Inactive entities – entities that were in existence before Jan. 1, 2020, are not engaged in active business, are not owned by a foreign person (directly or indirectly, wholly or partially), have not experienced any change in ownership in the preceding 12-month period, have not sent or received any funds in an amount greater than $1,000 in the preceding 12-month period, and do not otherwise hold any kind or type of assets (including ownership in any corporation, limited liability company or similar entity).
The remaining 20 exemptions include:

1. Securities reporting issuers
2. Governmental authorities
3. Banks
4. Credit unions
5. Depository institution holding companies
6. Money transmitting businesses
7. Brokers or dealers in securities
8. Securities exchange or clearing agencies
9. Other Exchange Act registered entities
10. Investment companies or advisers
11. Venture capital fund advisers
12. Insurance companies
13. State-licensed insurance producers
14. Commodity Exchange Act registered entities
15. Accounting firms (registered under section 102 of Sarbanes-Oxley Act of 2002)
16. Public utilities
17. Financial market utilities
18. Pooled investment vehicles
19. Entities assisting a tax-exempt entity
20. Subsidiaries of certain exempt entities

While the law allows the Treasury Department to provide further exceptions as long as certain standards are met, the final rule makes no adjustments at this time.

**Information to be reported**

A reporting company must identify itself by disclosing its name, any trade name under which it does business, the current street address, the state or tribal jurisdiction of formation or registration and the taxpayer identification number (TIN). In addition, the full legal name, date of birth, address and a unique identifying number (including an image of the underlying document) for each beneficial owner must be provided.

Reporting companies and beneficial owners may obtain a FinCEN identifier, which is a unique identifying number assigned by FinCEN. Once a FinCEN identifier is issued, an individual or reporting company may use this in lieu of supplying required information.

**Beneficial owners**

A **beneficial owner** includes any individual who, directly or indirectly, either (1) exercises substantial control over a reporting company, or (2) owns or controls at least 25% of the ownership interests of a reporting company.

**Substantial control**

The final rule states “substantial control” is exercised by an individual if the individual serves as a senior officer of the company; has authority over the appointment or removal of any senior officer or a majority of the board of directors; directs, determines or has substantial influence over important decisions; or has any other form of substantial control such as a trustee of a trust or similar arrangement.

The exercise of substantial control can be direct or indirect and can be attained through board representation; ownership or control of a majority of voting power or rights; rights associated with financing arrangements; control over intermediary entities that separately or collectively exercise
substantial control; arrangements or relationships with nominees; or any other contract, arrangement, understanding or relationship.

**Control of 25% of ownership interests**

Determining whether an individual owns or controls at least 25% of a reporting company is determined by dividing the total ownership interests owned by the individual, both directly and indirectly, by the total outstanding ownership interests. Ownership interests can come in the form of equity, stock, capital and profits interests, convertible instruments, options or a variety of other instruments or mechanisms used to establish ownership. Additionally, ownership can be direct or indirect, exercised through a variety of different mechanisms including joint ownership, the use of an intermediary and some trust arrangements (including as a trustee or other individual with the authority to dispose of trust assets or as a beneficiary who is the sole recipient of income and principal from the trust, has the right to demand a distribution or withdraw substantially all assets from the trust or is a grantor or settlor with the right to revoke the trust or otherwise withdraw assets of the trust).

Ownership is current at the present time and any options or similar interests must be treated as if they are exercised.

- For companies with capital and profits interests (including partnerships) – the individual’s ownership includes both capital and profits interests of the company, calculated as a percentage of the total outstanding capital and profits interests
- For corporations – the individual’s ownership percentage is the larger of: (1) the owner’s percentage of combined voting power or (2) the owner’s percentage of value of all classes of stock
- For other companies – if the facts and circumstances don’t permit the calculations described above to be performed with reasonable certainty, any individual who owns or controls 25% or more of any class or type of ownership interest of a reporting company is deemed to own or control 25% or more of the ownership interests

The final rule provides exceptions for certain individuals, including: minors (provided the company reports the required information for a parent or legal guardian); anyone acting on behalf of another individual as a nominee, intermediary, custodian, agent or similar; an employee whose control is derived solely from their employment and is not a senior officer; individuals whose only interest is a future interest through the right of inheritance; or the creditor of a reporting company.

**Conclusion**

FinCEN is currently creating a secure infrastructure in order to protect and store submitted data. The CTA has strict confidentiality and security requirements that must be met. The actual reporting form, also under development, is expected to be published for comment in advance of the due date. In addition, FinCEN anticipates issuing two more sets of rules in the near term: access and disclosure of BOI and revising customer due diligence to reflect CTA requirements.

While the deadline for this BOI reporting is not due for a couple of years, businesses may want to begin taking steps to facilitate the collection and reporting of beneficial ownership information.
Research credit changes bring good news and bad news

Authored by Patrick Balthazor

Changes to research and experimental expenditures

Prior to the Tax Cuts and Jobs Act (TCJA), taxpayers could deduct research and experimental expenditures as paid or incurred, thus receiving a current deduction. An election could also be made to amortize the expenditures over a period of not less than 60 months. A third alternative allowed the expenditures to be amortized over a 10-year period under section 59(e). The TCJA changed the rules for current deductions and amortization with a delayed effective date.

For tax years beginning after Dec. 31, 2021, taxpayers may no longer take current deductions for research and experimental expenditures. For tax years beginning in 2022, they must deduct the expenditures ratably over a five-year period beginning with the midpoint of the taxable year in which the expenditures are paid or incurred. Expenditures attributable to foreign research must be deducted ratably over a 15-year period. The rules in effect for taxable years after Dec. 31, 2021, also apply to software development. According to the Ways and Means Committee, these provisions were enacted because the expenditures have a useful life beyond the year in which they are incurred.

The changes to the treatment of expenditures is an accounting method change. The Treasury Department has not yet provided guidance on how the change will be made, although it has stated that it expects to issue guidance on an automatic change procedure.

Taxpayers in certain trades or businesses, such as software developers and technology companies, may be impacted more than others by these changes. Startups that depend on research for product development will also be impacted. Cash flow will need to take into account the reduced deductions related to amortizing the expenditures.

Increased payroll tax credit

Qualified small businesses may elect to claim a certain amount of their research credit against their payroll tax liability. The election allows up to $250,000 of the credit to be applied against the employer’s portion of the Social Security taxes (but not the Medicare taxes) instead of against the income tax liability. For tax years beginning after Dec. 31, 2022, the Inflation Reduction Act increased the amount to $500,000 from $250,000 and also allows the election to offset the employer’s portion of both the Social Security and Medicare taxes.
In general, a qualified small business, with respect to a tax year, is one that has less than $5 million in gross receipts and had no gross receipts for any tax year before the five-tax-year period ending with the current tax year.

The provision is intended to benefit startup companies that may not have a tax liability sufficient to claim the credit as an offset to income tax. The election is important in industries such as life sciences and technology where substantial expenditures are made for research but there is often little taxable income to offset the credit. The cash savings from the payroll credit can provide a needed boost for additional investments in research.
Navigating through the world of state and local tax

Authored by Donna Scaffidi and Alyssa Geracie

State and local tax planning seems to be in a never-ending world of flux. As soon as one issue appears to be somewhat settled, another area of complexity comes into being. Two such areas, pass-through entity tax elections and the Supreme Court’s Wayfair decision are cases in point. With the $10,000 cap on the state and local tax (SALT) deduction enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA), more and more states have enacted workarounds in an effort to circumvent the limitation. On the other hand, Wayfair was decided four years ago, with many believing the issue of economic nexus for sales tax purposes appeared to be settled. However, the Multistate Tax Commission (MTC) revised its Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States, calling into question how broadly Wayfair and P.L. 86-272 can be applied to the taxation of different internet transactions.

Pass-through entity tax elections – state-side

During 2022, approximately 12 additional states enacted a pass-through entity tax (PTET) election which brings the total number of states to 29 plus New York City. As a reminder, the PTET elections are in response to the SALT deduction limitation which was enacted under the TCJA legislation. Currently, individual taxpayers are only allowed a maximum deduction of $10,000 on federal Schedule A for all state taxes paid.

The following states (and New York City) currently have a PTET election: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Idaho, Illinois, Kansas, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Utah, Virginia and Wisconsin.

The PTET allows the entity to pay state taxes and deduct them for federal income tax purposes thus reducing the overall federal tax liability. However, the formula is not as simplistic on the state side of these elections. Careful analysis of owners’ tax attributes, the mechanics of calculating the PTET liability and limitations for taking credit for other state taxes paid, including the PTET as well as other implications to the owners’ state income tax filings, must be completed. When owners of a pass-through entity are residents of different states, the outcome of these elections can produce both winners and losers, meaning some may pay more tax while others less. How an entity resolves the tax differences that may occur among its owners with these elections needs to be addressed proactively. Careful consideration should also be given to S corporations; an unintended consequence of these elections could result in a second class of stock thus invalidating the federal S corporation election. Partnership agreements should be reviewed to ensure they address the tax differences that can result between its partners.
All but Connecticut’s PTET are elective. Most are irrevocable once made. Many elections expire in 2026 when the SALT cap deduction is lifted under the original law of TCJA. The requirements for making a valid PTE election and adherence to estimated tax payments must be observed as the rules vary by state. For example, failure to make a payment by June 15 can bar a taxpayer from making a valid election in California when the entity files its return. New York’s election is required to be made by Sept. 15 of the tax year for which it applies and must be made via the state’s online tax portal.

Each state has determined what type of entity can make the election as well as who is a qualified member. In some states, a C or S corporate partner will prevent the entity from making election and in others it will not.

In the majority of the PTET states, the owner reports both the income and the tax paid at the entity level on their personal income tax return. If the pass-through entity is a multistate business, the owner most likely pays income taxes to other states. The ordering rules may require the owner to use credit for taxes paid to other states prior to claiming the credit for taxes paid by the pass-through entity. In California, the PTET is not refundable and currently only allowed to be carried forward through to the 2026 tax years.

While these can be great regimes for reducing overall tax liabilities, the importance of analyzing the implications of these elections on the owners’ overall income tax posture prior to making election(s) is paramount to avoid or prevent adverse tax consequences.

**Wayfair and P.L. 86-272**

It's been four years since the U.S Supreme Court ruled in South Dakota v. Wayfair, Inc. (Wayfair) that South Dakota’s economic nexus for sales tax purposes was valid. Currently, all 46 jurisdictions that impose a sales tax have economic nexus. In 1959, Congress enacted Federal Public Law 86-272 (P.L. 86-272) to prevent states from imposing an income tax when the company’s activities are limited to soliciting sales of tangible property for which the order is approved outside the state of destination and the goods are shipped from a point outside of destination state. The actual language of P.L. 86-272 is stated below.

> No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following: (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)

It’s important to emphasize P.L. 86-272 doesn’t apply to any other state tax but income taxes and doesn’t apply to any company that sells intangible licenses or provides services, like repairs, installation etc. The renting or leasing of tangible property, while it may be tangible property, also is outside of the P.L. 86-272 protection. Lastly, it’s important to note, the language of P.L. 86-272 does not actually include anything about having physical presence in the state. This is an important distinction to point out as this law was written in 1959 when one can assume the authors had no vision of the internet and the magnitude of e-commerce.

The last U.S. Supreme Court case to interpret P.L. 86-272 was Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992). This decision clarified a bit about what solicitation is and is not. Activity, explicitly or implicitly, to invite an order is generally considered to be solicitation and therefore within the boundaries of P.L. 86-272. The decision also provided guidance to indicate activities that are “entirely ancillary” to solicitation are those that serve no business function apart from their
connection to solicitation such as providing sales personnel with free samples or a vehicle for travel and thus if performed in a state will not lose P.L. 86-272 protection. However, it does not include activities that may be assigned to sales personnel such as resolving disputes with the customer or replacing stock goods (the list is not all inclusive). Another way to view this is any activity generally occurring after a sale has taken place is not within the boundaries of P.L. 86-272 and thus may create an income tax liability.

As with most things, state and local tax is in a constant state of motion and subject to change. The MTC, an intergovernmental state tax agency whose “mission is to promote uniform and consistent tax policy and administration …” approved in August 2021, its update to its Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272 (Statement). While the Wayfair decision did not address P.L. 86-272, the MTC workgroup proactively addressed through this update how business activities conducted through the internet impact the application of P.L. 86-272.

As stated above, back in 1959, when P.L.86-272 was enacted, it did not mention physical presence. Today, businesses have websites, instead of brick-and-mortar stores and many offer the ability to purchase from these sites which under Wayfair may cause them to be remote sellers. Numerous sellers use marketplace facilitator sites such as Amazon and eBay to reach consumers. When one visits a seller’s website, the user can accept cookies or at least modify what the cookie captures from the user’s experience. No computer handy, no problem, we can download an app to our phone for our favorite retailers. In the MTC’s Statement, it has identified 11 additional scenarios in which tangible personal property is purchased via the internet and whether the activity is afforded the protection from income taxation under P.L. 86-272 or not. In each of these examples, the sale involves only tangible property, unless specifically noted otherwise. The orders are accepted or rejected and shipped from a state other than the destination state and the seller has no other contact with the consumer’s state. If there is uncertainty about the details of how customers are interacting with website or what data is captured from cookies, now would be the time to find out.

The 11 scenarios per the Statement are as follows.

1. The business provides post-sale assistance to in-state customers by posting a list of static frequently asked questions with answers on the business’s website. This posting of the static FAQ does not defeat the business’s P.L. 86-272 immunity because it does not constitute a business activity within the customer’s state.
2. The business regularly provides post-sale assistance to in-state customers via either electronic chat or email that customers initiate by clicking on an icon on the business’s website. For example, the business regularly advises customers on how to use products after they have been delivered. This in-state business activity defeats the business’s P.L. 86-272 immunity in states where the customers are located because it does not constitute, and is not entirely ancillary to, the in-state solicitation of orders for sales of tangible personal property.
3. The business solicits and receives online applications for its branded credit card via the business’s website. The issued cards will generate interest income and fees for the business. This in-state business activity defeats the business’s P.L. 86-272 immunity in states where the online application for cards is available to customers because it does not constitute, and is not entirely ancillary to, the in-state solicitation of orders for sales of tangible personal property.
4. The business’s website invites viewers in a customer’s state to apply for nonsales positions with the business. The website enables viewers to fill out and submit an electronic application as well as to upload a cover letter and resume. This in-state business activity defeats the business’s P.L. 86-272 immunity in the customer’s state because it does not constitute, and is not entirely ancillary to, the in-state solicitation of orders for sales of tangible personal property.
5. The business places internet “cookies” onto the computers or other electronic devices of in-state customers. These cookies gather customer search information that will be used to adjust production schedules and inventory amounts, develop new products or identify new items to offer
for sale. This in-state business activity defeats the business’s P.L. 86-272 immunity because it does not constitute, and is not entirely ancillary to, the in-state solicitation of orders for sales of tangible personal property.

6. The business places internet “cookies” onto the computers or other devices of in-state customers. These cookies gather customer information that is only used for purposes entirely ancillary to the solicitation of orders for tangible personal property, such as: to remember items that customers have placed in their shopping cart during a current web session, to store personal information customers have provided to avoid the need for the customers to re-input the information when they return to the seller’s website, and to remind customers what products they have considered during previous sessions. The cookies perform no other function, and these are the only types of cookies delivered by the business to its customers’ computers or other devices. This in-state business activity does not defeat the business’s P.L. 86-272 immunity because it is entirely ancillary to the in-state solicitation of orders for sales of tangible personal property.

7. The business remotely fixes or upgrades products previously purchased by its in-state customers by transmitting code or other electronic instructions to those products via the internet. This in-state business activity defeats the business’s P.L. 86-272 immunity because it does not constitute, and is not entirely ancillary to, the in-state solicitation of orders for sales of tangible personal property.

8. The business offers and sells extended warranty plans via its website to in-state customers who purchase the business’s products. Selling, or offering to sell, a service that is not entirely ancillary to the solicitation of orders for sales of tangible personal property, such as an extended warranty plan, defeats the business’s P.L. 86-272 immunity — see Article I.

9. The business contracts with a marketplace facilitator that facilitates the sale of the business’s products on the facilitator’s online marketplace. The marketplace facilitator maintains inventory, including some of the business’s products, at fulfillment centers in various states where the business’s customers are located. This maintenance of the business’s products defeats the business’s P.L. 86-272 immunity in those states where the fulfillment centers are located — see Article V.

10. The business contracts with in-state customers to stream videos and music to electronic devices for a charge. This in-state business activity defeats the business’s P.L. 86-272 immunity because streaming does not constitute the sale of tangible personal property for purposes of P.L. 86-272 — see Article I.

11. The business offers for sale only items of tangible personal property on its website. The website enables customers to search for items, read product descriptions, select items for purchase, choose among delivery options and pay for the items. The business does not engage in any in-state business activities that are not described in this example, such as the activities described in examples 2-5 and 7-10 above. This business activity does not defeat the business’s P.L. 86-272 immunity because the business engages exclusively in in-state activities that either constitute solicitation of orders for sales of tangible personal property or are entirely ancillary to solicitation.

The reaction to the MTC’s updated Statement has been varied certainly by SALT practitioners and taxpayers alike. One thing most agree on is that conducting business via the internet is here to stay. Whether that means a state can impose its income tax on such seller because it falls outside of P.L. 86-272 protection may need to be decided by the courts. It’s up to the states to either adopt the MTC’s Statement or develop their own guidance like California and New York. And if one thought Wayfair settled the question of economic nexus for sales tax purposes, Pennsylvania recently ruled that an out-of-state seller, whose only activity in the state was sales through a marketplace facilitator, did not have nexus for sales nor income taxes even if the seller had inventory in the state. We expect this case to be further litigated.

When it comes to managing a company’s state and local tax liabilities, it’s generally best to do so in a proactive manner such that it allows the company to make informed business decisions.
As we previewed in last year’s update, a theme emerging from 2021 is the potential for a large overhaul of U.S. international tax provisions in alignment with a prospective imposition of global minimum tax rules in implementing jurisdictions around the world. In the time since that last update, there have been a number of notable developments, both in the U.S. and abroad, which we will look to highlight here as it helps frame the continuing evolution (and current state) toward a global consensus.

Before diving into that evolution, our international tax update will begin with an introduction of certain other new guidance released in the U.S. since that last update and, specific to newly issued final foreign tax credit regulations, include areas of needed focus in mitigating risk of potential double taxation under those new regulations. Separately, we will also highlight select changes in the application of already existing enacted laws and filing requirements effective for the 2022 tax year which might warrant a closer look from an impact assessment, planning and resourcing perspective.

We will then close with our transfer pricing update, which first includes an identification of opportunities for Value Chain Alignment planning to help navigate through each of the enacted and proposed tax law changes discussed in the international tax update, as well as other emerging global trends. Finally, we will then conclude our transfer pricing update with select documentation, guidelines and enforcement updates.

What follows is a high-level outline of selected international tax and transfer pricing updates, guidance and proposals from late 2021 and 2022 to date.

International tax update

IRS and Treasury issue new regulations

Issued final foreign tax credit regulations fundamentally change rules for determining creditability of foreign taxes

On Dec. 28, 2021, the IRS and Treasury Department released final regulations (corrected in April 2022) that include fundamental changes to the definition of a foreign income tax for foreign tax credit purposes. The final regulations in large part finalize earlier proposed foreign tax credit regulations published Nov. 12, 2020.

These new rules will impact the creditability of foreign taxes paid or accrued in taxable years beginning on or after Dec. 28, 2021, as foreign taxes that were creditable under the previous rules may no longer be
creditable under the final regulations. The IRS and Treasury had indicated in the preamble to the final regulations that they do not intend on publishing a list of qualifying or nonqualifying foreign taxes, which only lends to the complexity of applying these new regulations.

Although the changes to the definition of a creditable foreign tax were initially motivated to limit the creditability of “novel extraterritorial taxes” (e.g., gross-basis digital services taxes), the final regulations are much broader in their potential impact and require a close review and analysis of where and how foreign taxes are ultimately levied in making creditability determinations under these new regulations. Areas of particular focus might include taxes levied by developing countries more apt to levy extraterritorial taxes, countries that lack tax treaties with the U.S. through which potential relief might be available, countries that do not follow the arm’s-length standard for transfer pricing and countries that do not withhold taxes on a nonresident’s items of gross income based on sourcing rules substantially similar to those in the U.S. (with a potential emphasis on foreign taxes withheld on each payment for royalties and services as well as capital gains taxable to a nonresident on an alienation of shares).

Issued final and proposed regulations provide for aggregate treatment of domestic partnerships for Subpart F and PFIC inclusion purposes

On Jan. 25, 2022, the IRS and Treasury issued final regulations (with a correcting amendment issued on Feb. 24, 2022) that generally align the global intangible low-taxed income (GILTI) and Subpart F rules applicable to partners of domestic partnerships (and, more generally, shareholders of S corporations) by treating such partnerships (S corporations) as aggregates of their partners (shareholders) in computing Subpart F and section 956 income inclusions. Unless taxpayers early adopted the aggregate treatment of domestic partnerships for Subpart F purposes under earlier proposed regulations, the final regulations are effective for taxable years of foreign corporations beginning on or after Jan. 25, 2022, and to taxable years of U.S. persons with or within which such taxable years of foreign corporations end (certain consistency requirements must also be satisfied).

Not all Subpart F inclusion provisions (e.g., previously taxed earnings and profits and basis adjustment transition rules) are addressed in the final regulations, but are anticipated to be addressed in future regulation packages. Aggregate treatment for Subpart F purposes is not applicable to domestic nongrantor trusts and domestic estates.

Also on Jan. 25, 2022, the IRS and Treasury issued proposed regulations that generally treat domestic partnerships and S corporations as aggregates of their partners or shareholders for purposes of passive foreign investment company (PFIC) inclusions and related elections. The proposed regulations generally align the GILTI, Subpart F and PFIC rules applicable to partners and shareholders of these pass-through entities. The proposed regulations would generally apply to tax years beginning on or after the date they are finalized and, if finalized as currently drafted, will require U.S. partners (shareholders) to monitor PFIC elections as they would no longer be made at the partnership (S corporation) level.

Other select areas of focus arising from changes effective for the 2022 tax year

More restrictive limitation on deductibility of interest expense

For the 2021 tax year, the business interest expense deduction was limited under section 163(j) to the sum of the taxpayer’s business interest income, plus 30% of adjusted taxable income (ATI), plus floor plan financing interest expense with the ATI component more closely approximating earnings before interest, taxes, depreciation and amortization (EBITDA). However, effective for the 2022 tax year, the ATI component must be calculated without the add-back for depreciation and amortization (more closely approximating earnings before interest and taxes (EBIT)), meaning a lower limit and smaller interest deductions.

Some taxpayers were already feeling the stress of a 30% of ATI limitation for the 2021 tax year (down from a 50% of ATI limitation for the 2018 and 2019 tax years under temporary COVID relief provided
under the Coronavirus Aid, Relief and Economic Security (CARES) Act), and it is anticipated that many more might experience interest deductibility concerns for the 2022 tax year upon further change to an EBIT-like base for the ATI component. This could prove particularly costly for inbound financing of U.S. subsidiaries of a foreign-parented multinational enterprise (MNE) group for which a cash tax (and, as applicable where valuation allowance recorded for the interest expense carryforward tax attribute, potential financial tax) cost burden arises for the taxation of the foreign lending party’s accrual of interest income for which a corresponding tax benefit of full interest expense might not be available for U.S. tax purposes under this limitation (a situation made all the more worse if the interest paid that foreign lending party is not otherwise exempt from U.S. withholding tax under an applicable income tax treaty for which eligibility for treaty benefits are satisfied). This, taken together with the prospect of an enactment of new section 163(n) interest limitation rules (discussed below) that might work in tandem with the section 163(j) limitation (interest expense limited based on the more restrictive of the two limitations), may necessitate a closer look at potential planning for the rationalization and restructuring of existing debt structures.

**New capitalization requirements for research and experimental expenses**

Under current tax law, the ability to immediately deduct R&E expenses is no longer available for tax years beginning after Dec. 31, 2021. Instead, in the absence of any legislative relief forthcoming to the contrary, taxpayers will now be required to capitalize and amortize R&E expenses over five years (for U.S. expenses) and 15 years (for foreign expenses) starting with the 2022 tax year.

For foreign-placed R&E activities, these new capitalization requirements can have a pervasive impact on the acceleration of taxable income for U.S. tax purposes given the long 15-year recovery period for deductibility of related expense. R&E activities conducted through controlled foreign corporations (CFCs) of U.S. shareholders are anticipated to be an area of particular focus for many taxpayers due to the potential of an increase and acceleration of deemed inclusion income (and residual U.S. tax liability due) under the GILTI rules. While an emphasis might be placed on CFCs that beneficially own any intellectual property rights that arise from the R&E activities performed (e.g., where the CFC is party to a cost-sharing arrangement), the application of these new capitalization requirements in the context of CFCs performing contract R&D services for some other principal is a bit ambiguous.

**“Year Two” of expanded reporting requirements on new Schedules K-2 and K-3**

The 2021 tax year marked the initial year for expanded reporting requirements on new Schedule K-2 (an extension of Schedule K used to report items of international tax relevance from the operation of a partnership or S corporation) and Schedule K-3 (an extension of Schedule K-1, generally used to report the share of the items reported on Schedule K-2 to partners or S corporation shareholders for use in their tax or information returns) for Forms 1065, 1120-S and 8865. The new schedules are designed to assist partnerships and S corporations in providing partners and shareholders with the information necessary to complete their returns with respect to the international tax items.

For that initial year of reporting on new Schedules K-2 and K-3, there was transition relief provided from the imposition of penalties for a demonstrated good faith effort made toward compliance with the new reporting requirements, and, separately, a limited exemption from initial year compliance with these new reporting requirements provided to certain eligible taxpayers under FAQ issued by the IRS. In the absence of any further relief granted for Year Two of the expanded reporting, it is anticipated that there will be a large increase in the number of taxpayers needing to comply (more fully comply) with the completion of Schedules K-2 and K-3 as part of their 2022 tax year filings requiring advance planning and budgeted cost for the related data pull and analysis required in completing these schedules.
Democrats continue with proposals to overhaul international tax rules while an implementation draws nearer on the OECD’s framework for a global minimum tax

Biden administration’s Green Book

In March 2022, the Treasury released information about the Biden administration's fiscal year 2023 tax proposals, the annual summary of the current president's tax proposals is traditionally called the “Green Book.” The Green Book starts from a baseline premise that the international tax proposals set out in the earlier House-passed Build Back Better (BBB) Act will be enacted into law in their existing form unless otherwise modified by the latest proposals contained in the Green Book.

We covered in detail the key international tax provisions included in the BBB Act in earlier alerts, Build Back Better bill: international tax provisions and International tax proposals in House Ways and Means “Build Back Better” draft tax legislation. The international tax provisions previously detailed included, among others, each of the following:

- A new corporate alternative minimum tax (AMT) that imposes a 15% tax on adjusted financial statement income (AFSI) of certain corporations with a three-year average of AFSI over $1 billion, with application to a U.S. corporation of a foreign-parented group that meets this $1 billion requirement also requiring that the U.S. group itself earn an average of at least $100 million (including the income of any CFCs and foreign disregarded entities held by the U.S. group) over the same three-year period;

- Amendments to the GILTI deemed inclusion rules that works to align the U.S. GILTI tax rate with the global minimum effective tax rate of 15% under the Organization for Economic Cooperation and Development (OECD) framework, and, consistent with that framework, applies the GILTI calculation on a country-by-country basis, allows for tested losses (and certain tested foreign income taxes of tested loss “taxable units”) to carry forward to subsequent periods to help ameliorate the negative effects of timing differences and the change from a single aggregate calculation, and reduces qualified business asset investment (QBAI) to 5% (10% in U.S. territories) for purposes of calculating GILTI inclusion amounts;

- Required application of the foreign tax credit calculation and limitation provisions in all baskets on a country-by-country basis, and a repeal of the one-year carryback of excess foreign taxes for foreign tax credit purposes while retaining an existing 10-year carryforward for separate limitation categories (with a phased-in approach provided for carryforward of certain excess GILTI-related foreign taxes);

- Amendments to the foreign-derived intangible income (FDII) rules to subject FDII to a tax rate of 15.8% by reducing the section 250 deduction to 24.8% in conjunction with a 21% corporate tax rate, and to exclude from FDII certain gains from the sale of property giving rise to rents or royalties derived in the active conduct of a trade or business;

- Enactment of a new section 163(n) which more broadly limits the deduction of interest expense of certain U.S. corporations in financial groups with non-U.S. corporate members to a share of reported net interest expense on an applicable financial statement of the financial group in proportion to the U.S. corporation’s relative share of book EBITDA of the overall group; and

- Substantial modification of the base erosion and anti-abuse tax (BEAT) to include treating components of cost-of-goods sold as base erosion payments in broadening the application of the BEAT, phasing out the separate 3% (2% for certain financial services taxpayers) base erosion percentage safe harbor in determining an “applicable taxpayer” for BEAT (leaving more taxpayers potentially subject under a $500 million average annual gross receipts threshold alone), narrowing BEAT’s application in now generally excluding from base erosion payments any amounts subject to a sufficient minimum level of tax (more generally, the global minimum
effective tax rate of 15% under the OECD framework), increasing the BEAT tax rate to 18% on a fully phased-in basis, and allowing for full credits in reduction of regular tax liability and corresponding base erosion minimum tax amounts.

With limited exception, the Green Book leaves those earlier BBB Act international tax proposals substantially unchanged. As we previously discussed in an earlier alert, President Biden proposes tax changes in FY 2023 budget, one notable exception is the administration’s proposal to eliminate the BEAT and replace it with an undertaxed profits rule (UTPR) consistent with OECD proposals. Effective for tax years beginning after Dec. 31, 2023, the UTPR would, subject to certain de minimis exceptions, generally apply to foreign-parented multinational entities that are members of financial reporting groups with global revenue of $850 million or greater in at least two of the previous four tax years. The proposal also includes a domestic minimum top-up tax that would protect U.S. revenues from the imposition of UTPR by other countries. Using a jurisdiction-by-jurisdiction computation based on adjusted financial statement information, the UTPR would disallow certain U.S. tax deductions or require an adjustment to the overall tax liability of the group for member entities not subject to a tax rate of at least 15% in each foreign jurisdiction where the group has a profit.

Additionally, the administration’s proposed increase in the corporate tax rate to 28% would raise the GILTI effective tax rate to 20% (from 10.5% as currently enacted, and increased from the 15% rate contemplated under the BBB Act). Also, in line with OECD proposals and proposed changes under the BBB Act, GILTI would be applied on a country-by-country basis. These changes would be effective for taxable years beginning after Dec. 31, 2022, with a transition rule provided for fiscal-year taxpayers.

**Inflation Reduction Act signed into law**

On Aug. 16, 2022, President Biden signed the Inflation Reduction Act into law. Among other things, that enacted legislation created a new 15% corporate AMT which, in final enacted form, resembles in large part that which was previously included in the House-passed BBB Act. The AMT is effective for tax years ending after Dec. 31, 2022, and requires that corporations apply complex aggregation rules to determine if the $1 billion AFSI threshold (and, as applicable to a U.S. corporation of a foreign-parented group, the incremental $100 million AFSI threshold for the U.S. group) is met as prerequisite to imposition of the new tax.

Prospective legislation that might enact into law the other key international tax proposals set forth in the House-passed BBB Act, as modified by the additional proposals contained in the Green Book, remains uncertain at the time of this release as we await the outcome of the November midterm elections to see if the requisite votes needed in the House and Senate are available to pass any such prospective legislation. What remains abundantly clear is the amount of pressure on the U.S. to adopt the additional measures needed (e.g., proposed amendments to the GILTI rules, a new UTPR rule in replacement of BEAT) to align with, and help advance implementation for, the OECD global minimum tax framework.

**OECD update on Pillar One and Pillar Two**

The OECD released the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS) Progress Report on Oct. 4, 2022. The report comments on progress made between September 2021 and September 2022 and addresses an update on the implementation of the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy agreed in October 2021. A summary of progress for Pillar One and Pillar Two contained in the Progress Report are included below.

**Pillar One**

The OECD Progress Report comments that significant progress was made on the design of the technical rules for reallocation of taxing rights under Amount A that relates to the residual profits of the largest multinational enterprises. MNEs with global revenues above 20 billion euros and profitability above 10% will be covered by the new rules, with 25% of profit above the 10% threshold to be reallocated to market
jurisdictions using an innovative, formulaic approach. The new rules for Pillar One and taxing rights for Amount A will be negotiated through a Multilateral Convention (MLC) through which Amount A will be implemented. The work on the detailed provisions of the MLC and its Explanatory Statement are expected to be completed so that a signing ceremony of the MLC can be held in the first half of 2023, with the objective a 2024 entry into force, once a critical mass of jurisdictions, as defined by the MLC, have ratified it.

**Pillar Two**

Pillar Two consists of the Global Anti-Base Erosion (GloBE) Rules and a treaty-based Subject to Tax Rule (STTR). The GloBE Rules introduce a 15% global minimum tax that applies to MNE groups with consolidated revenues of at least 750 million euros. They consist of a coordinated system of rules, under a common framework, which ensures in-scope MNE groups pay at least the agreed minimum level of tax on the income arising in each of the jurisdictions in which they operate. The minimum level of tax may also be imposed locally under a qualified domestic minimum top-up tax. The STTR allows source jurisdictions to impose limited source taxation on certain related-party payments that are subject to tax below a minimum rate.

Following a public consultation, held at the end of April 2022, the OECD/G20 Inclusive Framework commenced work on the GloBE Implementation Framework that will facilitate the coordinated implementation of the GloBE Rules. The GloBE Implementation Framework will be used to establish a peer review process, produce further administrative guidance, agree on a common filing and information exchange architecture, develop safe harbors to minimize compliance costs and provide capacity building and technical support to tax administrations. The GloBE Implementation Framework is anticipated to be released by the end of 2022. Work on the STTR has focused on the development of a draft model tax treaty provision and its commentary, which is expected to be released for public comment later in the year.

**Anti-Tax Avoidance Directive (ATAD) 3 update and substance**

On Dec. 22, 2021, the European Commission adopted a proposal for an ATAD 3 that targets the misuse of shell entities for tax purposes. This new directive seeks to provide direction on minimum levels of substance that are required to carry out the intended business activities of particular entities. While the concept of substance is not necessarily new, this directive puts pressure on European Union member states to deny certain treaty benefits and tax benefits to companies that fail to meet minimum substance requirements.

The draft directive sets out a seven-step minimum substance test to determine whether an entity is to be regarded as a "shell" and it applies to all undertakings resident in an EU member state, regardless of their legal form. Criteria which are considered to be indicators of low substance are: 75% of an entity’s income is “passive income” over a two-year lookback period; 60% of the book value of an entity’s assets are located outside the EU member state of which it is resident or 60% of its income is from outside the EU member state, over a two-year lookback period; and the administration of day-to-day functions and decision-making is outsourced. An entity with at least five full-time employees carrying out the income-generating activities of the entity is exempt from the minimum substance test.

The consequences of an entity being considered a shell include: it will not be issued a tax residence certificate by the EU member state that it is considered resident in or it will come with a warning to prevent its use for claiming double taxation; the entity will be denied relief under measures designed to prevent double taxation; reporting requirements in EU member states; and a minimum 5% penalty on an entity’s turnover will apply if an entity is found to be noncompliant with reporting requirements.

The proposed directive has not yet been passed but it is expected to pass through the legislative process and should come into effect from Jan. 1, 2024. Given that effective date and in consideration for a two-
year lookback period, compliance with these new minimum substance requirements might be evaluated from Jan. 1, 2022.

Transfer pricing update

Value Chain Alignment

As the global economy continues to navigate the follow-on financial impacts of the recent COVID-19 crises, a number of global supply chain trends continue to evolve and impact MNEs’ global transfer pricing models. The following explores a few trends and topics that remain top of mind for taxpayers, some of which are more prevalent than others depending on the industry.

Environmental, social and corporate governance (ESG) is a C-suite level agenda item that has continued to come into closer focus during 2022. A company’s strategy for ESG and how it responds to and manages both external forces in the market and its own internal reporting around ESG can lead to financial impacts across the organization. It has become more critical for companies to also assess their overall transfer pricing strategies as they relate to ESG financial impacts. For example, understanding which entities in a global organization incur significant costs, realize revenues (or declines in revenues) or are the beneficiaries of various ESG-related tax incentives may have a direct impact on the results of a company’s transfer pricing framework. As ESG plays a more prevalent role in how companies manage their global supply chains and inform corporate strategies, there will be increasingly more opportunities for taxpayers to evaluate their transfer pricing models to account for these changes.

Onshoring and near-shoring are strategies that companies continue to explore as global supply chain issues continue to impact business models across various industries. As taxpayers consider strategic investments in new manufacturing, distribution or other key supply chain hubs, various transfer pricing model considerations come into play.

Digital and e-commerce trends as well as the continued evolution of cryptocurrencies and blockchain technology remain areas of development in the transfer pricing and Value Chain Alignment space. As the economy evolves and the creation and exploitation of value changes from its traditional forms, transfer pricing analyses and the standard prescribed methods for analyzing transfer pricing issues continue to be challenged. Issues around intangible property valuation and the development of value across global networks put pressure on company transfer pricing policies for those operating in these industries.

Global mobility and work-from-anywhere trends also continue to impact global transfer pricing models and Value Chain Alignment as companies compete for top global talent and hire strategic resources wherever they can locate them across the globe, sometimes regardless of the relevant tax or transfer pricing model consequences. Companies prioritize talent and operating their business models at the highest level, but will need to continue to evaluate the alignment of their value chains and the impact to their tax and transfer pricing risk profiles.

Global transfer pricing documentation and enforcement

Finally, as the global economy continues to evolve and as taxing authorities around the globe continue to look at corporate income taxes as one significant element of their government’s fiscal strategy (perhaps even more so following COVID), let’s not forget about the ongoing global transfer pricing documentation and compliance requirements. These requirements have not gone away, and more countries continue to adopt more strict requirements. It is important that taxpayers continue to focus their efforts on documenting their global transfer pricing positions in various countries to avoid potential double taxation and related tax penalty risk. The IRS, in particular, was recently allotted significant funds from the Inflation Reduction Act, part of which is to be used to step up tax enforcement efforts. We expect that the IRS and other foreign taxing authorities will continue to step up their enforcement related to transfer pricing issues.

OECD releases 2022 edition of the OECD guidelines
The OECD Transfer Pricing Guidelines provide guidance on the application of the “arm's-length principle,” which represents the international consensus on the valuation, for income tax purposes, of cross-border transactions between associated enterprises. In today’s economy where MNEs play an increasingly prominent role, transfer pricing continues to be high on the agenda of tax administrations and taxpayers alike. Governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein, and taxpayers need clear guidance on the proper application of the arm’s-length principle.

This latest edition consolidates into a single publication the changes to the 2017 edition of the Transfer Pricing Guidelines resulting from:

- The report, Revised Guidance on the Transactional Profit Split Method, approved by the OECD/G20 Inclusive Framework on BEPS on June 4, 2018, and which replaced the guidance in Chapter II, Section C (paragraphs 2.114-2.151) found in the 2017 Transfer Pricing Guidelines and Annexes II and III to Chapter II;

- The report, Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles, approved by the OECD/G20 Inclusive Framework on BEPS on June 4, 2018, which has been incorporated as Annex II to Chapter VI;

- The report, Transfer Pricing Guidance on Financial Transactions, adopted by the OECD/G20 Inclusive Framework on BEPS on Jan. 20, 2020, which has been incorporated into Chapter I (new Section D.1.2.2) and in a new Chapter X; and

- The consistency changes to the rest of the OECD Transfer Pricing Guidelines needed to produce this consolidated version of the Transfer Pricing Guidelines, which were approved by the OECD/G20 Inclusive Framework on BEPS on Jan. 7, 2022.

For more information on this topic, contact our team.
Things to watch for at the IRS

Authored by Michelle Hobbs and James Creech

Armed with a budget increase of $80 billion and anticipating hiring another 87,000 revenue agents over the next few years, the IRS is poised to increase enforcement efforts and enhance taxpayer data safety. As we had discussed in last year’s annual tax letter, wealthier taxpayers can certainly continue to expect increased audit activity, especially with respect to large partnerships and other pass-through entities. Other areas where increased IRS activity is projected include tax return scanning technology, taxpayer identity protection, data security, issue enforcement and tax-scam protection.

Tax return scanning technology

Similar to the barcodes scanned in most retail establishments for purchasing purposes, the IRS is considering implementing a similar technology in processing income tax returns. In an effort to overcome the enormous backlog of unprocessed paper returns (8.7 million as of August 2022), the National Taxpayer Advocate (NTA) is pushing the IRS to adopt barcode scanning of paper-filed returns. The NTA is also encouraging the IRS to work with tax software providers to develop and voluntarily implement a 2-D barcode on returns prepared with its products. In addition, the IRS is being asked to upgrade internal systems in order to accommodate barcode scanning, optical character recognition and machine-readable text. Currently, the IRS is piloting different technologies but will not commit to specifics or timing. The IRS continues to make more forms available for electronic filing and encourages taxpayers to e-file their returns instead of paper filing.

Taxpayer identity protection

Taxpayers wanting to proactively protect themselves and their Social Security numbers (SSNs) from identity theft can apply for an identity protection (IP) PIN. This is a six-digit number designed to prevent a person from using an SSN or individual taxpayer identification number (ITIN) that does not belong to them. The IP PIN is an identifying number known only to the specific taxpayer and the IRS. Taxpayers who are known victims of identity theft are automatically assigned an IP PIN.

IP PINs are valid for one year and are automatically generated each subsequent year. Once obtained, it must be used when filing Form 1040 (as well as Forms 1040-NR, 1040-PR and 1040-SS) during the tax year (including prior-year returns). If lost, the IRS has a system in place to recover or reassign the IP PIN. Spouses and dependents can also obtain an IP PIN.

Requesting an IP PIN by validating a taxpayer’s identity can be done in three ways:

- Using the IRS’s online tool
Generally available between mid-January and mid-November

- Completing and filing an application
- Requesting an in-person authentication

Data security

Another IRS focus area is protecting taxpayer data. Tax-related identity theft has become a multimillion-dollar enterprise with national and international reach. Criminals steal taxpayer names, addresses and Social Security numbers using a variety of scams (described below) as well as through business and organizational data breaches. This information is then used, in part, to file false tax returns in order to claim refunds from the IRS.

To offset this theft, the IRS works with state tax agencies and the private-sector tax industry to create data safety parameters. Over time, changes such as strengthened password protocols on tax products, driver’s license requirements to file certain state returns and redaction of personal information from tax transcripts have been implemented in an effort to protect taxpayer information. On their end, taxpayers can help themselves by increasing their own security measures around their personal identifying information. Using virus protection on all electronic devices, strong passwords and multifactor authentication on all accounts as well as safe file back-up programs are steps that can be taken to secure personal data.

Issue enforcement

The Large Business and International (LB&I) division of the IRS is responsible for tax administration activities for domestic and foreign business with a U.S. tax reporting requirement. The LB&I works with corporate (including S corporations) and partnership entities with assets equal to or greater than $10 million. With over 70 different enforcement campaigns aimed at various subcategories of taxpayers, resources continue to be poured into LB&I in order to collect the greatest amount of tax revenues. Additionally, the IRS is targeting partnerships in an effort to close the perceived tax gap (lost government revenue attributed to the difference between taxes owed and paid to the IRS).

A new campaign, begun in February 2022, targets partnership losses in excess of a partner’s basis. Generally, each partner in a partnership has a basis in their interest representing their distributive share. Basis can go up or down based on several factors, including contributions, distributions, increase or decrease in shared liabilities and allocation of income or loss items. Calculating basis and determining whether allocated losses need to be suspended can be complicated. The IRS is hoping this new campaign will help identify taxpayers that had deducted losses that should have otherwise been suspended.

Another LB&I campaign deals with the sale of a partnership interest. In keeping with IRS concerns of correctly computing basis, this campaign addresses those taxpayers that do not report correct gain or loss on the sale or exchange of a partnership interest. Areas of focus include whether the partnership interest was owned for more than one year and if the partnership had depreciable assets, inventory or unrealized receivables at the time of sale.

Not to be outdone, S corporation distributions and losses in excess of basis have their own LB&I campaigns. In the former, S corporation shareholders have to analyze whether a received distribution is taxable, plus the S corporation has to recognize gain on the distribution to its shareholders of appreciated property. Similar to partnerships, the latter campaign consists of analyzing S corporation shareholder basis and whether losses in excess of that basis were utilized in error instead of being suspended.

Pass-through members should also be aware that the IRS is taking a second look at the qualified business income (QBI) deduction under section 199A. The IRS has expressed concern that some of the QBI calculations include tax attributes that should be excluded from the deduction.
Virtual currency is another area in which the IRS is ramping up enforcement. In 2021 and 2022, the IRS aggressively used John Doe summonses to force virtual currency exchanges to turn over the names of U.S taxpayers who may have failed to disclose income. See our article, “The ever-changing world of digital asset taxation,” for additional information on this. The IRS is also expected to promulgate new regulations under IRC section 6045 which would require virtual currency exchanges to proactively report transactions in a similar manner to traditional securities brokerages.

Additional campaigns include:

- Allocation of success-based fees
- Expatriation of individuals
- Foreign earned income exclusions
- Forms 1042/1042-S compliance
- Limitations on consolidated net operating loss carryovers
- S corporations built-in gains tax
- Self-employment taxes
- Syndicated conservation easement transactions
- TCJA

Tax scam protection

In general, the IRS contacts taxpayers using U.S. mail and not via email, text message, telephone or social media. The agency typically initiates contact through a mailed notice letter outlining a specific issue needing to be addressed. At times, this letter may be followed up with a telephone call. On the other hand, scammers do use all of the aforementioned communications in an effort to con taxpayers and tax professionals. Tax scammers impersonate IRS employees and steal taxpayer identities, refunds and other personal data. Since the IRS does not use threatening collection techniques, taxpayers that receive urgent pre-recorded voice messages, demands for immediate payment, threats of arrest, requests for credit and debit card numbers or require payment without an appeal opportunity should report the activity to the proper authorities.

Unfortunately, a vast myriad of tax scams are being conducted at any given time. A handful of these are described below. Additional information on tax scams can be found at irs.gov.

- Pandemic-related email scams: Emails appear to come from a trusted source and try to trick the receiver into opening an attachment or clicking on an unsecure link. Once opened, malware downloads onto the user’s computer and provides content access to thieves.
- Charitable organization fraud: Fake charities are created during times of tragedy and disaster and entice taxpayers to donate to a false cause. Also, cybercrimes target valid charitable organizations.
- Educational institutions, students and staff scams: Phishing scam involves individuals with an “.edu” email address. Targeted taxpayers are sent an email with a fake IRS logo and subject lines such as “tax refund payment” or “recalculation of your tax refund payment.” Solicited individuals are asked for personal data including Social Security numbers, name, address, driver’s license numbers, address, etc.
- Identity theft and unemployment benefits: Criminals file for fraudulent unemployment benefits using stolen identities and affected taxpayers receive Form 1099-G, Certain Government Payments, for monies never received.

These scams are not limited to individuals. Recently, many scammers have begun to target businesses as well. These scams include email phishing to access sensitive client data, or even using the business’s EIN to prepare fraudulent documents to claim a refund or issue false information returns.
Form 1099-K, Payment Card and Third-Party Network Transactions, is an information return used to report certain payment transactions. The American Rescue Plan Act of 2021 substantially lowered the filing threshold for the form to $600 from $20,000. In addition, payment transactions settled after Dec. 31, 2021, no longer have a minimum transaction threshold under which reporting is not required. Certain large third-party payers, such as Amazon or PayPal, may still be exempt from filing a Form 1099-K if total payments to a taxpayer are less than $20,000 or they have fewer than 200 transactions within the calendar year.

Background

In general, banks and other payment settlement entities (those settling payment card transactions) are required to disclose on Form 1099-K the gross amount of transactions exceeding $600 to businesses or individuals accepting credit and debit cards for payment in exchange for goods and services. Taxpayers using a third-party payment network, such as online payment platforms, marketplaces or internet payment service providers, will receive a Form 1099-K from each payment settlement entity used. Each form reports annual and monthly goods and service transaction amounts, the number of transactions and any federal or state withholding. Personal gifts, charitable contributions and reimbursements do not need to be reported.

Payment card transactions are any transactions where a payment card (credit, debit or stored-value card) is accepted as payment. Reportable gross sales can include sales proceeds, sales tax, tips, shipping charges, gift-wrapping, etc. The reportable amount likely will not be reduced by any credits, discounts, fees or refunded amounts. For example:

Taxpayer uses a national bank credit card to purchase $650 worth of sporting equipment from a retailer. The national bank is contractually obligated to settle with the retailer for the credit card transaction. National bank charges a $13 fee so it pays the retailer $637. However, national bank must provide the retailer with Form 1099-K reporting the full $650.

Payment settlement entities must provide Forms 1099-K to taxpayers by Jan. 31 of the following year. Electronically filed forms are due to the IRS by March 31, while paper forms are due by Feb. 28. Should any of these dates fall on a weekend or holiday, the due date becomes the following business day.

The IRS will use Form 1099-K data to verify and improve tax compliance. Taxpayers receiving Forms 1099-K should reconcile the amounts reported on the form to credit card receipts and merchant statements to verify accuracy and then to gross receipts reported on a tax return. Any form errors should be discussed with the issuing payment settlement entity. Form recipients will then want to make sure that...
the Form 1099-K information is reported on their income tax returns. Guidance regarding specific reporting situations is expected to come later.

Issues

Most settlement entities will not have insight as to whether or not a transaction is taxable. As a result, under these new rules, Form 1099-K could be issued to nonbusiness taxpayers if they sold goods or services through a payment settlement entity. For example, Forms 1099-K could be issued to a college student selling back their textbooks, an individual occasionally selling household items on eBay or a teenage babysitter accepting Venmo or PayPal.

The IRS is also unlikely to have the resources to accommodate the processing of potentially millions of additional Forms 1099-K or to handle the influx of taxpayer questions that are bound to result from the increased reporting requirements. Even with the budget increase enacted as part of the Infrastructure Reduction Act, the IRS has competing priorities, multiple demands and a preexisting historic backlog.

Finally, there is a bipartisan push to change the reporting threshold back to $20,000 or some lesser amount (such as $5,000) and/or reset to a minimum number of transactions. It is uncertain whether this could become part of a late-fall package to renew tax extenders or be included in a future piece of legislation. Without legislative changes, taxpayers can expect to receive Forms 1099-K for transactions not historically reportable.
The excess business loss (EBL) limitation is here to stay — at least through the 2028 tax year. The provision, codified in Internal Revenue Code section 461(l), limits the amount of trade or business losses noncorporate taxpayers can utilize to offset nonbusiness income. The EBL limitation took effect in the 2021 tax year and, due to the Inflation Reduction Act (IRA), will remain in effect for a minimum of eight years. Taxpayers who own pass-through entities, which include sole practitioners and their advisors, must understand and incorporate the EBL limitation into annual tax compliance and planning.

Excess business loss limitation history

In recent years, the EBL limitation has been on an implementation roller-coaster. First introduced as part of the Tax Cuts and Jobs Act (TCJA), the provision was originally effective for tax years 2018 through 2025. However, in response to significant pandemic-induced economic uncertainty and market declines, the Coronavirus Aid, Relief and Economic Security (CARES) Act retroactively delayed the provision’s implementation to 2021. This provided taxpayers who had already filed 2018 and 2019 returns incorporating the EBL limitation an opportunity to amend returns, fully claiming business losses.

After the CARES Act, two additional pieces of legislation changed the effective dates of the EBL limitation. The American Rescue Plan Act (ARPA) and, more recently, the IRA extended the EBL limitation for one and two additional years, respectively. Ultimately, this means the provision will be in effect for a minimum of eight tax years — 2021 through 2028.

Applying the excess business loss limitation

EBLs are calculated by determining the amount by which a taxpayer’s aggregate trade or business deductions or losses exceed their gross trade or business income or gain. The ability to deduct the losses, to the extent they exceed income, is limited to an annual threshold amount indexed for inflation. In 2021, the threshold was $262,000 for most taxpayers ($524,000 for joint filers). In 2022 and 2023, the amounts increased to $270,000 ($540,000 for joint filers) and $289,000 ($578,000 for joint filers), respectively."

The limitation is applied at the pass-through entity owner level for reporting on their individual income tax returns. The limitation applies after the outside basis, at-risk, and passive activity loss limitations. Net trade or business losses that exceed the annual threshold amount are carried forward as a net operating loss (NOL) which the taxpayer may use to offset taxable in a subsequent tax year, subject to NOL rules.
To illustrate the concept, consider a single taxpayer who owns an S corporation that generates $7 million in losses in 2022. In the same tax year, the taxpayer receives their regular $500,000 of annual compensation and sells securities for a total gain of $9 million. In this scenario, the taxpayer may only deduct $270,000 of the $7 million business loss in 2022. As a result, the taxpayer will have $9.23 million of taxable income ($500,000 of compensation plus $9 million gain on the sale of stock less $270,000 allowable business loss deduction). The taxpayer will have a $6.73 million NOL carryover to 2023 ($7 million in business loss less the $270,000 allowed in the current year).

Planning for the excess business loss limitation

Since the EBL limitation became effective in 2021, incorporating its application has become critical to tax planning for owners of pass-through entities. The timing of recognizing both business income and losses, as well as non-business income and losses, can have a drastic effect on a taxpayer’s ultimate tax liability. A lack of proper planning for the EBL limitation when making extension and estimated tax payments can also lead to significant penalties and interest. As interest rates increase, the cost of underpayment and failure to pay will become more burdensome.

To illustrate the need for planning, let’s return to our example above with the single taxpayer who has $7 million of business losses, $500,000 of regular annual compensation and $9 million in gains from the sale of stock in 2022. If the taxpayer does not have a regular and/or substantial source of income, it could be years or decades before the $6.73 million NOL is fully utilized. If the taxpayer only has $500,000 of compensation in 2023 and no other gains or losses, the taxpayer may only utilize $400,000 of the NOL (the NOL may only offset 80% of taxable income in any given year). At the end of 2023, the taxpayer will still have an NOL carryover of $6.33 million going into 2024.

Consider instead, the taxpayer understood and planned for the excess business loss limitation by deferring the sale of stock generating the $9 million gain until the following tax year. In that case, the taxpayer would have recognized $230,000 of taxable income in 2022 ($500,000 of compensation less $270,000 allowable business loss deduction) and an NOL carryover of $6.73 million to 2023. If the taxpayer then recognized the $9 million gain on the sale of stock in 2023, in addition to the taxpayer’s regular $500,000 in annual compensation, the taxpayer could fully utilize the EBL generated NOL in 2023. The taxpayer would only recognize $2.77 million of income and would have no remaining NOL going into 2024.

This example highlights the importance of planning for EBL limitations. The taxpayer has the same amount of economic income over 2022 and 2023 but spreading the income differently yields vastly different tax results. In the first iteration, the taxpayer recognizes $9.33 million of taxable income over the two-year period ($9.23 in 2022 and $100,000 in 2023). After adjusting the timing of the stock sale in the second iteration, the taxpayer only recognizes $3 million of taxable income over the same period ($230,000 in 2022 and $2.77 million in 2023).

Outstanding questions

Several areas of uncertainty surrounding the EBL limitation remain outstanding, including:

- Is gain or loss from the disposition of an interest in a pass-through entity conducting an active trade or business considered trade or business income for purposes of section 461(l)?
- Are guaranteed payments considered trade or business income for purposes of section 461(l)?
- How do EBLs interact with self-employment and net investment income tax calculations?
Aside from several clarifications provided by Congress in the CARES Act, taxpayers and practitioners have not received any direct guidance on the EBL limitation. Furthermore, there is no clear congressional intent that speaks to the unresolved issues noted above. Though the IRS has given no indication that issuing guidance on the application of EBL limitations is a priority, practitioners are hopeful the recent extension of the limitation will highlight the need for additional direction from the IRS.

Applying the EBL limitation can be complex. It’s important to explore any outstanding questions and how the EBL limitation applies to your specific situation before it’s time to make extension and estimated payments and file your return. Some situations will require research and thoughtful planning or may require disclosure. We advise you to contact your Baker Tilly advisor on the application of the EBL limitation to your tax situation.

The future of the excess business loss limitation

The EBL limitation has been used as a revenue-raising provision on three occasions: in the TCJA of 2017, the ARPA of 2021 and the IRA of 2022. It’s important to note that these pieces of legislation were passed by Congresses of Republicans-only, a bipartisan group, and Democrats-only, respectively. Reports from Capitol Hill in response to the Democrat-passed IRA was that Republicans were upset with the EBL limitation extension, as they had unofficially earmarked an EBL extension as a revenue-raiser they intended to use in a future legislation.

Congressional Democrats did attempt to make significant changes to the EBL limitation as part of the Build Back Better (BBB) package. The proposal would have made the EBL permanent and, more importantly, would have changed how excess business losses are treated in subsequent years. Rather than converting disallowed EBLs into NOLs, the drafted provision would have treated EBLs as an aggregate deduction subject to testing in subsequent years. Ultimately, Democrats were unable to pass BBB, opting instead for the much-narrower IRA. Suffice it to say, making changes to the provision appears to be a go-to for lawmakers to fund both Democratic and Republican priorities.

At this point, there seems to be a possibility the EBL limitation will continue to be extended or become a permanent provision. The fact that it can be viewed as a revenue-raiser without actually having to raise rates makes it politically appealing. It is further possible that additional modifications will be made over the course of its life cycle, however long it may be. Again, we encourage you to reach out to your Baker Tilly tax advisor regarding how the EBL limitation may impact your situation, and we will continue to keep you apprised of any related developments.
The employer shared responsibility (“pay or play”) mandate still requires applicable large employers (ALEs) to offer health insurance to full-time employees. The IRS is actively proposing employer shared responsibility payments (ESRPs) whenever it suspects that an ALE may not have complied with this coverage mandate. ALEs that do not offer qualified health coverage to substantially all full-time (FT) or full-time equivalent (FTE) employees may be liable for ESRP penalties. A timely, well-documented response is the best way to reduce or argue away a proposed ESRP.

**Background**

An ALE is an employer with at least 50 FT or FTE employees. An ESRP is owed when:

1. an ALE fails to offer minimum essential coverage to substantially all (95% or more) of its FT and FTE employees (as well as dependents) and at least one FT or FTE employee is offered a premium tax credit; or
2. an ALE offers minimum essential coverage to substantially all FT and FTE employees (as well as dependents) but at least one FT or FTE employee was allowed a premium tax credit because the coverage offered was not affordable by Affordable Care Act (ACA) calculus, did not provide minimum value or the individual was not offered coverage.

FT or FTE employees are those who work at least 30 hours per week or 130 hours in a month. ACA coverage is deemed affordable for 2022 if the employer’s lowest cost, self-only plan costs less than 9.61% of the employee’s annual household income (based on the federal poverty level) and is estimated to drop to 9.12% for 2023 coverage. The ESRP penalties for 2022 range between $2,750 and $4,120 per FT or FTE employee depending on the ACA provisions in violation. The penalty range for 2023 is projected to be between $2,880 and $4,320.

**Reporting**

All of this coverage information must be provided to employees and to the IRS. The draft 2022 forms and instructions currently have few, if any, changes from prior years. 2022 reporting is to be issued to employees by March 2, 2023 (for Form 1095-C). The IRS requires these forms to be submitted to it on or before March 31, 2023, if electronically filed (required for 250 or more forms) or Feb. 28, 2023, if paper forms are filed. Requisite filings include:
• Form 1094-B – Transmittal of Health Coverage Information Returns. Includes the filer’s name, address, employer identification number, contact information and the total number of Forms 1095-B being transmitted to the IRS.
• Form 1094-C – Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns. Includes the filer’s name, address, employer identification number, contact information and the total number of Forms 1095-C being transmitted to the IRS.
• Form 1095-A – Health Insurance Marketplace Statement. Filed by health insurance marketplaces on individuals enrolled in a qualified health plan through government exchanges.
• Form 1095-B – Health Coverage. Filed by health insurance issuers and carriers, this form discloses those individuals covered by minimum essential coverage.
• Form 1095-C – Employer-Provided Health Insurance Offer and Coverage. Filed by ALEs to verify employer-sponsored health coverage, disclose those individuals covered by minimum essential coverage and used in conjunction with the 1094-C to determine whether the ALE owes an ESRP.

IRS inquiries

While the IRS has not yet begun auditing ACA reporting in earnest, it has been active in issuing notices and assessing penalties on those employers that filed incorrect or inaccurate information or failed to file the required forms altogether. Currently assessing penalties for the 2019 reporting year and with 2020 reporting notices set to be released this fall and winter, the IRS commonly issues the following types of notifications to taxpayers:

• Letter 226J – Generally, the initial letter issued to ALEs that proposes ESRPs for employers who may have failed to provide offers of insurance to at least 95% of FT or FTE employees (as well as their dependents). This letter is being issued for 2019.
• Letters 5698 and 5699 – Typically, the precursor to assessing an ACA penalty related to not complying with the reporting requirement. These notices request information from the employer to confirm its name, employer identification number and address as well as information about how and when it filed its ACA forms. Penalties are subsequently assessed using Form W-2 counts when these letters go without a timely response. Letter 5699 is now being issued for the 2020 tax year; however, the IRS is still accepting remedial filings made now that tie back to the 2018 tax year.
• Letter 5005A – Sent when an ALE fails to annually file Forms 1094-C and 1095-C with employees and the IRS.
• Letter 972CG – Sent to employers that filed ACA forms after the published deadlines as well as those who filed these forms in the wrong format (e.g., via paper when the volume of forms required electronic submission).

Employers generally have 30 days to respond to these letters. The IRS recently ended its good-faith relief from these accuracy-related penalties so employers should be vigilant in maintaining their ACA records and correspondence. The IRS is now looking for proof, per employee, of actions taken in offering coverage, the types of coverage offered, waiver documentation, total annual of hours worked plus average monthly hours per employee, affordability calculations (including rate of pay and W-2 wages) per employee and so on. In addition, an incorrectly prepared ACA reporting form could also trigger one of the aforementioned IRS letters. With these letters running two to three years behind current-year reporting, employers must preserve careful records in order to support their filings.

The letter period is the most taxpayer-friendly area in which to work with the IRS. If the initial notice is not responded to within the 30-day period, the IRS will move the assessment forward; ultimately into IRS collections where it is more difficult for the taxpayer to explain any reporting deficiencies.

State-based reporting

California, Massachusetts, New Jersey, Rhode Island, Vermont and the District of Columbia have each implemented individual coverage mandates, with most also requiring employers to report offers of
coverage. The deadlines and filing requirements vary from the federal provisions and vary by state. Privacy is a significant concern here, since some states will accept the entire federal reporting even though only a small subset of employees may actually be subject to that specific state’s coverage and reporting requirements.

Action steps

Recall, in 2021, the American Rescue Plan expanded subsidy eligibility and marketplace enrollment deadlines, thereby increasing ACA penalty exposure. Variability in workforce hours and pay adjustments driven by the pandemic and economic conditions could continue to impact affordability and full-time status determinations. Finally, rehires within 13 weeks of layoffs or furlough must be treated as ongoing employees which can also impact affordability and coverage restoration.

Employers also face challenges to processing responses to IRS inquiries into ACA reporting. This is particularly true for missing prior-year filings where the path to abatement requires submission of the forms in the here and now. Time, resource allocations, system and personnel changes (i.e., human resources, reporting vendors), acquisitions or divestitures of business lines or entities and lack of documentation can all cause delays and frustrations in the original reporting or notice responses.

In order to more readily comply with any IRS inquiry into ACA reporting, employers should be highly attentive to the following:

- Understanding the reporting codes used internally or by an outside provider
- Documenting full-time status measurement records and determinations since penalties apply on a monthly basis
- Safeguarding ACA information and location (including reporting forms, IRS AIR transmittal files, transmittal confirmations, benefits enrollment records, affordability computations, etc.)
- Incorporating ACA compliance into risk assessments as well as periodic vendor and other strategic change initiatives
- Soliciting qualified assistance if an IRS ACA-related notice is received

The IRS continues to improve its operating ability to police ACA compliance. At the same time, it is openly broadening its infrastructure to make a greater impact in this area. For these reasons, it is important to view the “pay or play” dynamic as one that will continue for the foreseeable future.
This article summarizes key accounting method areas for businesses to focus on in 2022. The topics addressed include high-dollar items affecting a wide array of industries such as revenue recognition timing, small business simplified methods and lease accounting income and expenses.

New automatic change procedures to comply with the final revenue recognition regulations

The Tax Cuts and Jobs Act of 2017 (TCJA) amended the revenue recognition timing rules to add a fourth prong to the “all events” test. Accordingly, under the new standard, income is recognized at the earliest of when it is received, due, earned or recognized in the financial statements.

The final regulations issued pursuant to the TCJA refer to this as the “AFS income inclusion rule,” and it generally applies to an accrual basis taxpayer with an applicable financial statement (AFS) such as a certified, audited financial statement issued under Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

The procedures to comply with the final regulations are lengthy (70 pages), complex and contain multiple method changes, options and terms and conditions to consider. This discussion addresses common issues related to the new AFS income inclusion rule only. Affected taxpayers that have not implemented the final revenue recognition regulations, or have taken a position contrary to the rules, should act quickly to review their methods of accounting and file any necessary accounting method changes (Form 3115) because the final rules are now mandatory for all covered income items, with the exception of certain “specified fees.”

Notably, the automatic change to comply with the AFS income inclusion rule is particularly time sensitive because this change is only available temporarily (i.e., for tax years 2021 through 2023). Thereafter, the change must be made under the more onerous and costly nonautomatic change procedures. Taxpayers should review revenue recognition methods, which can be a time-consuming process depending on the number and type of revenue streams, customer contracts and variations in terms and conditions (e.g., performance obligations, revenue offsets, contingency provisions).

Common exposure items to be aware of include improperly deferring income from overlooked liabilities, misapplication of the “enforceable right” standard, impermissible use of the now-repealed “two-year” deferral method for advance payments and long-term contracts accounted for using noncompliant book percentage of completion methods. In particular, the issue of overlooked liabilities is common for
taxpayers that make a tax revenue recognition method change in connection with implementing the new revenue recognition financial standard under ASC 606. Under ASC 606, the adjustment to financial statement revenue is determined based on net income rather than gross revenue. Conversely, the AFS income inclusion rule used to determine taxable income applies to gross income, without any offset for costs other than the limited exception provided for sales of certain goods under the optional cost offset method. Consequently, taxpayers need to carefully analyze AFS income and addback liabilities and cost offsets in accordance with the AFS income inclusion rule. Additionally, issues have arisen in connection with applying the new “enforceable right” standard that are discussed further below.

IRS raises issues with the enforceable right standard

As noted above, under the amended “all events test,” an item of income is recognized at the earliest of when it is due, received, earned or reported in the AFS. Significantly, the final revenue recognition regulations provide that income “reported in the AFS” does not include amounts the taxpayer does not have an “enforceable right” to recover if the customer were to terminate the contract at the end of the tax year (regardless of whether the customer actually terminates the contract).

IRS officials at a recent ABA tax conference noted that the enforceable right standard may not cover common situations, such as the three scenarios noted below:

- **State tax refund claims** – The enforceable right standard appears inapplicable because the tax authority is not the taxpayer’s customer and there is no contract between the parties. This situation raises the issue of whether a taxpayer might be required to include the refund in income (e.g., because it was reported in the AFS) even though the amount is not realized as of year-end (e.g., because the government has not approved the refund), which appears contrary to the TCJA.

- **Volume purchase discounts received by a purchaser** – According to the IRS, the enforceable right standard may be inapplicable to discount income received by a purchaser from a vendor because the discount is a purchase price adjustment rather than a revenue item, and the party paying the discount is a vendor and not a customer of the purchaser. Consequently, guidance might be necessary to address the treatment of this income (e.g., where discount income is included in the AFS but the contract may be terminated before the discount is earned).

- **Insurance policy renewal commissions received by insurance agent from insurance company** – The IRS noted this type of arrangement falls outside the traditional customer relationship contemplated under the enforceable right standard and questioned whether the enforceable right standard was properly applied in an example in the final regulations. Under the facts in the example, the taxpayer (insurance agent) receives a renewal commission from the insurance company if a policy is renewed. The example concludes that the taxpayer does not have an enforceable right to a renewal commission for a particular policy because the carrier could cancel the policy prior to renewal.

The IRS indicated that it plans to study situations not addressed in the enforceable right standard rules and will consider providing a broadly defined definition of the term “customer.” The IRS also requested input from commentators to assist it in formulating additional guidance addressing more fact patterns that may be eligible for the enforceable right exception.

New lease accounting standard

Taxpayers required to adopt the new financial standard for lease accounting under ASC 842 in 2022 (e.g., privately held businesses) may need to devote considerable tax resources to address the tax implications of the standard.
Under ASC 842, book lease accounting changed significantly in areas such as lease classification, lease acquisition costs, lease termination payments and sale/leaseback transactions. In particular, the new standard substantially modified the treatment of operating leases by a lessee. Under the new standard, the lessee is required to account for these leases on the balance sheet as right of use (ROU) assets with an offsetting liability, rather than as “true” leases (rent expense) under the previous accounting principles.

Although the tax lease accounting rules remain unchanged and, as in the past, do not follow book treatment, significant effort may be required to address the tax implications of the new financial accounting standard.

Taxpayers impacted in 2022 by the lease accounting standard should consider the following action steps:

- Review book and tax lease methods, which can require extensive lead time, depending on the volume and complexity of lease agreements, general ledger accounts and items affected and data availability. In particular, taxpayers that implemented new lease accounting systems and processes will need to ensure that these new enhancements capture the information needed to maintain the historical tax methods and calculations.
- Where the tax treatment does not follow the book lease accounting standard, taxpayers will need to create new or revise existing book/tax adjustments for various lease-related income and expenses such as rent, interest, depreciation, amortization, lease acquisition costs and sale/leaseback transactions.
- Determine whether method changes (Form 3115) are required for noncompliant or non-optimal lease accounting methods. Fortunately, automatic changes are available for many common lease-related items such as lease classification changes, tenant improvement costs, lease acquisition expenses, lease termination payments, rent income and expenses under section 467 rent agreements and rent income subject to the new AFS income inclusion rule discussed above.

New procedures for small business taxpayer simplified method changes

The TCJA increased the gross receipts threshold for favorable small business simplified accounting methods, including the cash overall method, inventory accounting and uniform capitalization (UNICAP) method exceptions, and the exemption from percentage of completion method (PCM) for certain "small" construction contracts. The expanded eligibility provided in the TCJA and the final regulations issued thereunder resulted in wide adoption of these small business simplified methods by taxpayers looking to save cash and simplify their tax compliance.

Procedures issued to implement the final small business taxpayer regulations favorably add automatic changes to accommodate common situations, such as permitting taxpayers with inventory to automatically change to or from the cash and accrual overall methods.

Significantly, the procedures also facilitate taxpayers needing to make frequent automatic changes to or from the small business simplified methods by providing a permanent waiver of the eligibility rule that prohibits a taxpayer from making the same automatic change within five tax years. However, the waiver is subject to a key restriction that requires the taxpayer to change from the small business taxpayer method(s) in the first year it becomes a “former small business taxpayer” and is disqualified from using the small business simplified methods (e.g., taxpayer exceeds the gross receipts threshold or becomes a tax shelter). Consequently, small business taxpayers using the simplified method(s) will need to carefully monitor their gross receipts levels and tax shelter status and be prepared to file Form 3115 timely if they require the waiver to make an automatic change to a different permissible method. Conversely, changes that fail to satisfy the eligibility rules must generally be made under the more onerous and costly nonautomatic method change procedures.
A pass-through entity that is typically profitable but expects to incur a net operating loss for 2022 (e.g., due to COVID, inflation or supply chain issues) should consider making an election to use the prior year’s (2021) taxable income to avoid disqualification as a syndicate (tax shelter) and remain qualified for the favorable small business taxpayer methods. Under the final regulations, the election is made on an annual basis (not permanently), thus providing added flexibility for pass-through entities to benefit from the favorable small business simplified methods.

Additionally, a former small business taxpayer required to implement a UNICAP method change should allow sufficient time to comply with the final UNICAP rules, which may require significant effort, particularly for producers with intricate or complex book inventory accounting practices (e.g., numerous standard cost calculations, significant uncapitalized direct costs or variances, intercompany inventory transactions).

**Updated list of automatic method changes issued**

The IRS recently issued an updated list of automatic accounting method changes that replaces the existing list and includes numerous modifications. Taxpayers filing automatic accounting method change applications (Form 3115) for 2022 are required to use the updated procedures.

The new list incorporates recent guidance issued to implement legislative amendments (e.g., TCJA, Coronavirus Aid, Relief and Economic Security (CARES) Act), comply with final regulations under the TCJA for items such as the revenue recognition timing provisions and small business taxpayer simplified methods discussed above, and make various depreciation changes (bonus, qualified improvement property, 30-year alternative depreciation system (ADS) life for residential rental property placed in service by an electing real property trade or business, certain late or revoked depreciation elections, ADS depreciation changes for a controlled foreign corporation (CFC) under global intangible low-taxed income (GILTI) rules).

Other significant modifications include deleting obsolete provisions (e.g., temporary transition relief to implement depreciation changes and to revoke or make late elections), prohibiting automatic changes for section 174 research and experimental expenditures and software development costs subject to the capitalization provisions under the TCJA, and providing important clarification in certain situations regarding the automatic change eligibility rule that precludes filing an automatic change if the same item was changed within the five prior tax years. See the separate article above for an update on the TCJA amendments to section 174 research and experimental expenditures.

Because many taxpayers will need to file automatic method changes in 2022 (e.g., to comply with TCJA final regulations or in connection with ASC 842 lease accounting standard adoptions discussed above), taxpayers and their advisors should be aware of the new guidance and ensure that 3115 filings comply with the updated procedures.
Inflation Reduction Act: energy provisions

Authored by Mike Schiavo and Michael Wronsky

The Inflation Reduction Act (IRA) includes a wide range of credits designed to facilitate the transition to cleaner energy production, promote advanced manufacturing, encourage the adoption of clean vehicles (CVs) and reduce greenhouse gas emissions through the use of alternative fuels and energy-efficient technologies. This article focuses on four broad areas of credits: clean energy production and investment, advanced manufacturing, CVs and alternative fuels, and energy efficiency. We also discuss the unique structure of the credits, many of which start with a base amount and can be increased by a factor of five if a project pays prevailing wages and employs apprentices, which is obviously a huge incentive to meet those requirements. There are also kickers for domestic content and projects located in energy communities. Finally, we conclude with a brief overview of the provisions in the Act that are designed to help taxpayers monetize the credits.

That said, the tax credit rules are extremely complicated, and it is all too easy to get lost in the weeds. There are detailed definitions and technical requirements, specific construction start date and placed-in-service date cutoffs, phase-in and phase-out dates, domestic content requirements, tax-exempt financing rules, and many other nuances. In addition, various technologies may be eligible for multiple credits, but there are rules to prevent double dipping – for example, if a facility gets a credit under the section 45 production tax credit, it is not eligible for the section 48 investment tax credit. Careful analysis is required to choose the right mix of credits and to maximize tax benefits.

This article provides a general overview. Please consult your Baker Tilly advisor for the specific requirements applicable to your projects.

I. Clean energy production and investment

The extension and expansion of the production tax credit (PTC) and the energy component of the investment tax credit (ITC) are major elements of the IRA. The legislation also extends and modifies the carbon oxide sequestration credit (CSC) and adds new credits for clean hydrogen production and zero-emission nuclear production. This article will focus on the PTC and ITC.

Production tax credit – current section 45 and new section 45Y

The section 45 PTC provides a per kilowatt hour (kWh) credit for electricity produced from certain renewable resources, including wind, closed and open-loop biomass, geothermal, solar, municipal solid waste, hydropower and marine/hydrokinetic energy. The credit applies for a 10-year period to energy produced by the taxpayer from qualified resources at a qualified facility and sold to an unrelated party.
Under prior law, the PTC generally was not available for projects that started construction after Dec. 31, 2021. The IRA extends the construction start deadline through the end of 2024. The Act also restructures the credit to a two-tier system — a base amount (0.3 cents per kWh) and bonus amount (1.5 cents per kWh) depending on whether the taxpayer meets prevailing wage and apprenticeship requirements (see discussion below). There are also incentives for domestic content and for locating facilities in energy communities (see below).

After the existing PTC phases out at the end of 2024, the new section 45Y clean electricity production credit will come online. This new credit has the same two-tier structure and 10-year credit period as the existing PTC. However, the credit is technology neutral — if the greenhouse gas emissions rate at the facility producing the electricity is not greater than zero, the facility will be a “qualified facility” for purposes of the credit.

**Investment tax credit – current section 48 and new section 48E clean electricity investment credit**

Under the section 48 energy credit, which is a component of the investment tax credit, taxpayers get a credit for the “energy percentage” of the basis of energy property placed in service during the taxable year. In contrast to the PTC, the ITC provides an upfront credit for investment in energy property (versus an annual credit during the production period).

While there is a lot of overlap between the technologies eligible for the PTC and the ITC, “energy property” for purposes of the ITC does not include any property which is part of a facility that produces electricity, and which is allowed a credit under the section 45 PTC. However, taxpayers may make an irrevocable election to treat a PTC qualified facility as a qualified investment credit facility (construction must begin before Jan. 1, 2025).

The IRA made numerous changes to the ITC rules, including extending the construction start deadline for several types of projects, restructuring the credit to a two-tier system and expanding the list of technologies eligible for the credit. The legislation also introduced a new technology-neutral clean electricity investment credit (section 48E) for property placed in service after 2024. The new clean electricity investment credit applies to qualified facilities and energy storage technologies with greenhouse gas emissions rates not greater than zero.

For most energy property, the baseline energy credit percentage is 6%, and the bonus energy credit percentage is 30% (if prevailing wage and apprenticeship requirements are met, see discussion below). The kickers for domestic content and energy communities also apply.

**II. Advanced manufacturing**

**Advanced energy project credit (section 48C)**

The advanced energy project credit is a competitive application-based program run by the Treasury Department and the Department of Energy. The IRA allocated $10 billion in new funding for these credits, $4 billion of which is reserved for projects located in energy communities. Taxpayers who win an allocation award and receive project certification will get a credit based on their investment in qualifying advanced energy projects. The credit is 30% of the qualifying basis if the project meets the prevailing wage and apprenticeship requirements discussed below. The term “qualifying advanced energy project” means a project which re-equip, expands or establishes an industrial or manufacturing facility which is used to produce or recycle a wide range of clean energy technologies; which re-equip an industrial or manufacturing facility with equipment designed to reduce greenhouse gas emissions by at least 20%; or which re-equip, expands or establishes an industrial facility for the processing, refining or recycling of critical materials.
Advanced manufacturing production credit (section 45X)

The new advanced manufacturing production credit applies to components produced and sold after Dec. 31, 2022. The amount of the credit varies by the type of component and depends on a host of technical factors (for example, capacity of a photovoltaic cell, size in square meters of a photovoltaic wafer, capacity of a completed wind turbine project). The credit covers a wide range of components used in solar energy, wind energy, certain inverters (related to solar and wind), qualifying battery components and applicable minerals. While the prevailing wage and apprenticeship bonus amounts are not available for this credit, taxpayers can utilize the direct pay and transferability options (see discussion below on monetizing credits). The credit phases down for components sold after Dec. 31, 2029.

III. Electric vehicles and alternative fuels

Clean vehicle credit (section 30D)

The Act overhauls the credit under section 30D for new qualified plug-in electric drive motor vehicles, resulting in the CV credit. Broadly, a CV is a motor vehicle that, among other requirements:

1. Is purchased new and placed in service by the taxpayer for use or lease (not for resale),
2. Is made by a qualified manufacturer (generally, one that enters into an agreement with the Treasury secretary to provide periodic information regarding the vehicles it manufactures),
3. Has a gross vehicle weight rating less than 14,000 pounds,
4. Is propelled to a “significant extent” by an electric motor that draws electricity from a battery with a capacity of at least 7 kWh and is capable of being recharged, and
5. The final assembly of which occurs in North America.

Critical limitations: The credit is unavailable for vehicles with manufacturers’ suggested retail prices that exceed certain thresholds ($80,000 for vans, SUVs and pickup trucks; $55,000 for any other vehicle). Additionally, no credit can be claimed by a taxpayer whose modified adjusted gross income (MAGI) exceeds certain amounts ($300,000 for joint filers, $225,000 for head of household, $150,000 for all other filers).

Similar to the previous electric vehicle credit, the maximum CV credit remains $7,500, though the manner in which it is computed has changed. The first $3,750 is contingent upon the percentage of the vehicle’s battery that is made up of critical materials (i.e., aluminum, lithium, zinc, etc.) that were either:

1. Extracted or processed in the U.S. or any country with which it has a free trade agreement, or
2. Recycled in North America.

For vehicles purchased and placed in service prior to 2024, at least 40% of the critical materials making up the vehicle’s battery must meet one of these two requirements for the first $3,750 of credit to be available. This percentage threshold increases annually up to a maximum threshold of 80%, for all vehicles placed in service after 2026. Presumably, this is to accommodate the need to develop the critical materials supply chain within North America, as currently, the vast majority are exported from overseas.

The second $3,750 depends on the percentage of the vehicle battery’s remaining components (other than critical minerals) that are manufactured or assembled in North America. For vehicles purchased and placed in service before 2024, at least 50% of the components must be manufactured or assembled in North America. This percentage threshold increases annually by 10% up to 100% for vehicles placed in service after 2028.

For purchases of CVs after 2023, a taxpayer can make an election to transfer the credit to the dealership, in exchange for cash or a credit toward payment for the CV. This creates neither an income event for the purchaser nor a deduction for the dealership. However, if the credit ultimately is not allowable under the provision’s numerous rules (for instance, if the buyer’s AGI is too high), the purchaser’s tax liability for the
tax year they placed the vehicle in service would be increased by the amount of payment they received from the dealership.

The Act eliminates the per manufacturer limitation on the number of credit-eligible vehicles, effective for those sold after 2022. After 2023, a vehicle’s battery components must not have been manufactured or assembled by a “foreign entity of concern,” for vehicles placed in service after 2024, no credit is available for any vehicle whose battery’s critical minerals were extracted, processed or recycled by a “foreign entity of concern.” The credit expires after 2032.

Previously owned CVs (section 25E)

A new credit is available under section 25E for certain used CVs acquired after 2022 and before 2033, equal to the lesser of $4,000 or 30% of the vehicle’s sales price. In addition to other requirements, the CV must have a model year at least two years older than the year in which the taxpayer purchases it from a licensed dealer, at a price of $25,000 or less. The CV must also not have been previously resold since the passage of the Act. Eligibility for the used CV credit is not contingent upon the vehicle’s place of final assembly or the source of its battery’s critical materials or other components.

Taxpayers whose MAGI for the year of purchase or the preceding year exceeds $150,000 in the case of a joint filer or surviving spouse, $112,500 for a head of household, or $75,000 for others, are ineligible for the credit.

New credit for qualified commercial CVs (section 45W)

Businesses are now eligible for a credit for qualified commercial CVs placed in service after 2022 and before 2033. The credit is the lesser of:

1. 15% of the CV’s basis (30%, if the CV is not powered by a gasoline or diesel internal combustion engine), or
2. The CV’s “incremental cost” — broadly, the amount by which the CV’s purchase price exceeds the price of a comparable vehicle, defined as a vehicle similar in size and use that is powered solely by a gasoline or diesel internal combustion engine).

The maximum credit for a CV with a gross vehicle weight rating of less than 14,000 pounds is $7,500; for all other vehicles, $40,000.

Alternative fuel vehicle refueling property (section 30C)

The Act extends the credit for 30% of alternative fuel refueling property placed in service through 2032. The credit is reduced to 6% for depreciable property used in a trade or business unless it satisfies wage and apprenticeship requirements discussed below. The credit is limited to $100,000 per property placed in service after 2022 if used in a trade or business, and $1,000 if installed for personal use (the credit limit applies on a per location basis for property placed in service prior to 2023). To be credit-eligible, property placed in service after 2022 must be either in a low-income or rural area.

Biodiesel and renewable diesel used as fuel credit (section 40A)

The credits for biodiesel and diesel fuel mixtures, and biodiesel used or sold by a taxpayer in their trade or business, and the production of qualified agri-biodiesel are extended through 2024.

Alcohol fuel, biodiesel and alternative fuel mixtures credit (section 6426)

The excise tax credits for alcohol fuel, biodiesel and other alternative fuels sold or used by the taxpayer in their trade or business are extended through 2024.
New sustainable aviation fuel credit (section 40B)

The Act creates a new credit for the mixture of sustainable aviation fuel and kerosene produced by the taxpayer in the U.S. and sold or used in its trade or business in 2023 or 2024. The credit is calculated by multiplying the number of gallons of sustainable aviation fuel the mixture contains by a $1.25 base, with the base amount increasing up to an additional 50 cents if certain greenhouse gas emissions reductions are met.

New clean fuel production credit (section 45Z)

A new credit is available for clean fuel produced by the taxpayer at a qualified facility (which notably excludes any facility on which the credits for the production of clean hydrogen or carbon oxide sequestration are claimed) from 2025 through 2027. The credit is computed by multiplying a 20-cent base amount (35 cents in the case of sustainable aviation fuel) per number of gallons sold for qualifying uses by certain emissions reduction factors. The base amount increases to $1 ($1.75 in the case of sustainable aviation fuel) if certain prevailing wage and apprenticeship requirements discussed below are met.

IV. Energy efficiency

Many of the credits in the energy efficiency category will be familiar to individual taxpayers, particularly those in the real estate industry.

Nonbusiness energy property credit (section 25C)

The personal credits for energy-efficient improvements a taxpayer makes to their principal residence have been extended and enhanced. Under prior law, the available credit for exterior windows and doors, insulation material, electric heat pumps, high-efficiency central air conditioners and other property meeting specified energy efficiency standards a taxpayer placed in service prior to 2022 was generally subject to a lifetime limitation of $500. The IRA extends the credit for such property placed in service prior to 2033 and replaces the $500 lifetime limit with a much more favorable $1,200 annual limit. The credit is broadly calculated as 30% of the sum of the taxpayer’s qualifying expenditures made during the year, now to include amounts paid for home energy audits and certain biomass and renewable fuels used as heat sources and, for certain fuels produced after 2024, transportation. Additional limitations are placed on credit-eligible amounts by property types. Changes are effective for property placed in service after 2022, and the credit as calculated under prior law is available for property placed in service prior to 2023. The credit expires after 2032.

Residential clean energy credit (section 25D)

The Act extends through 2034 the residential energy-efficient property credit and retitles it as the residential clean energy credit. The preexisting credit of 26% of qualifying expenditures for solar electric, solar water heating, fuel cell, small wind energy, geothermal heat pump and biomass fuel property placed in service in connection with the taxpayer’s residence remains available through 2021. The residential clean energy credit remains largely unchanged from its predecessor, with the exception of replacing eligible expenditures for biomass fuel property with expenditures for qualified battery storage. The credit percentage for qualifying expenditures increases to 30% for property placed during 2022 through 2032, reverts to 26% for property placed in service during 2033, and drops to 22% for property placed in service during 2034, the last year the credit is available.

New energy-efficient home credit (section 45L)

The credit available to eligible contractors for newly built energy-efficient homes acquired for use as a personal residence is extended through 2032. For homes acquired after 2022, the maximum credit is increased to $5,000 from $2,000, and the energy saving requirements a home must meet are changed.
Under previous law, a home must be certified to provide a level of heating and cooling energy consumption that is at least 50% below that of a particular “reference” home to be eligible for the maximum $2,000 credit. The Act updates the energy saving requirements to conform to certain Energy Star national program requirements, and the zero-energy ready home program of the Department of Energy.

**Energy-efficient commercial buildings deduction (section 179D)**

Prior section 179D allows, subject to limitation, a deduction equal to the cost of energy-efficient commercial building property (EECBP) placed in service during the taxable year. To qualify as EECBP, property must be:

1. Depreciable, or amortizable in lieu of depreciation,
2. Installed on or in any building both located within the U.S., and within the scope of specified energy standards for buildings issued by the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE),
3. Installed as part of the building’s interior lighting systems, the heating, cooling, ventilation and hot water systems, or envelope, and
4. Certified in accordance with certain rules prescribed by the IRS and Treasury, that among other things, the property is part of a plan to reduce the building’s energy consumption by 50% or more relative to the aforementioned ASHRAE standards.

The maximum deduction allowed with respect to any building for a taxable year is the building’s square footage multiplied by $1.80, less the total deductions claimed with respect to that building in all previous tax years. For example, consider a taxpayer who in 2020 installed $50,000 of EECBP in a building with a square footage of 100,000 feet. If the same taxpayer claimed deductions for EECBP installed in the same building in all previous years totaling $150,000, the taxpayer’s 2020 deduction would be limited to $30,000 as follows: 100,000 building square footage multiplied by $1.80 equals $180,000; less the $150,000 total deductions claimed in all previous tax years. Partial deductions are available in certain instances in which property installed meets the first three of the four above-listed requirements.

A special provision allows for the deduction attributable to EECBP installed on or in government property to be allocated to the taxpayer primarily responsible for designing the property, in lieu of the property’s owner.

The IRA makes several significant permanent changes to the section 179D deduction, including (but not limited to):

1. Reducing the energy consumption reduction percentage qualifying property must satisfy to 25% from 50%.
2. Reducing the dollar amount multiplied by the building’s square footage to determine the allowable deduction to a base 50 cents amount from $1.80. This base figure can be increased up to $1 per square foot, by 2 cents for each percentage point the building’s energy and power costs are reduced by a percentage greater than the aforementioned 25%.
3. The 50-cent base amount is increased to $2.50 if the property is placed in service in connection with a project that meets the prevailing wage and apprenticeship requirements discussed below. Further, the $1 per square foot maximum for such projects is increased to $5, by 10 cents for each percentage point the building’s energy and power costs are reduced by a percentage greater than 25%.
4. The per property lifetime cap on the maximum deduction allowed is replaced with a three-year cap (i.e., the deduction claimed in a given year will only be reduced by the total deductions claimed with respect to the property over the three previous tax years, rather than all previous tax years).
5. Taxpayers can elect to claim an alternative deduction for energy-efficient retrofit building property, in the tax year the retrofitting plan is certified as reducing the building’s energy usage intensity by...
at least 25% (in lieu of the reduction of energy consumption required by the standard 179D deduction).

6. Providing tax-exempt entities owning eligible property the ability to allocate the deduction to the property’s (or qualified retrofit plan’s) designer.

7. Allowing a REIT’s earnings and profits to be reduced by the full amount of the 179D deduction (previously, it was deductible from earnings and profits ratably over a five-year period).

These changes apply to taxable years beginning after 2022, with the exception of the alternative deduction, which is effective for property placed in service after Dec. 31, 2022, pursuant to a retrofit plan established after such date.

V. Credit structure

The Act completely revamps the structure of many of the energy credits to include a base amount and a bonus amount equal to five times the base. The legislation also includes “kickers” for domestic content and energy communities.

To qualify for the bonus credit, taxpayers must comply with prevailing wage requirements and apprenticeship requirements. This new structure is designed to encourage competitive wages and job growth in the renewable energy sector and applies to most of the clean energy production credits as well as the advanced energy project credit (section 48C), clean fuel production credit (section 45Z), the energy-efficient commercial buildings deduction (section 179D) and several other credits.

Perhaps recognizing the urgency of the climate situation, Congress included a big incentive to get more clean energy projects off the drawing board and under construction as soon as possible. Specifically, projects that begin construction before 60 days after Treasury and the IRS issue guidance are automatically deemed to meet the prevailing wage and apprenticeship requirements, and thus will be eligible for the bonus credit. There are several methods under existing guidance to determine the construction start date, such as starting “physical work of a significant nature” or meeting a safe harbor for a percentage of total costs incurred.

Note: Given global supply chain issues and inflationary pressures, it remains to be seen how much this incentive will do to accelerate these projects.

Projects involving qualified facilities with a maximum net output of less than 1 megawatt will also be automatically deemed to meet the prevailing wage and apprenticeship requirements (regardless of when construction begins).

Prevailing wage and apprenticeship requirements

Prevailing wage requirement. Any laborers or mechanics employed by the taxpayer during construction of the energy project must be paid prevailing wages for the locality in which the project is located. The prevailing wage rate is determined by the Department of Labor. Further, prevailing wages must be paid for repairs or alterations to the facility for a period after the project is placed in service, for example, five years for the section 48 ITC and 10 years for the section 45 PTC. If a taxpayer fails to pay prevailing wages, they can correct the deficiency by making the workers whole (plus interest) and paying a $5,000 per worker penalty to the IRS (increased to $10,000 per worker for intentional disregard of the rules).

Apprenticeship requirement. To meet this requirement, taxpayers must ensure that an applicable percentage of total labor hours for construction, repair or alteration of an energy facility is performed by qualified apprentices. The term qualified apprentice means an individual who is employed by the taxpayer or by any contractor or subcontractor and who is participating in a registered apprenticeship program. The applicable percentage increases over time: 10% for construction that begins before 2023, 12.5% for construction that begins during 2023 and 15% for construction that begins after 2023. If a taxpayer fails to
meet the apprenticeship requirements, the penalty is $50 multiplied by the shortage in hours ($500 per hour for intentional disregard).

**Domestic content.** The domestic content bonus credit or “kicker” applies to the existing PTC (section 45) and ITC (section 48) and the new clean energy production (section 45Y) and investment (section 48E) credits. To be eligible for the kicker, the taxpayer must certify that any steel, iron or manufactured product which is a component of a qualified facility was produced in the U.S. Manufactured products are deemed to meet the domestic content requirement if a certain percentage of the total cost of all manufactured products in the facility are attributable to products that are mined, produced or manufactured in the U.S. Note that there are special domestic content rules for offshore wind projects.

The kicker is 10% for the PTCs and either 2% (for projects that don’t meet the prevailing wage and apprenticeship requirements) or 10% for the ITCs and applies to projects placed in service after 2022.

**Energy communities.** The energy community applicable credit rate increase applies to the same credits as the domestic content bonus. The kicker is 10% of the PTCs and either 2% or 10% for the ITCs. The term “energy community” means brownfield sites; communities involved in the extraction, processing, transport or storage of coal, oil or natural gas; communities with an unemployment rate at or above the national average for the previous year; a census tract (or adjoining tract) where a coal mine closed after 1999 or a coal-fired electric generating unit was retired after 2009.

**VI. Monetizing the credits**

Sponsors or developers often cannot fully utilize the credits generated by clean energy projects because they do not have sufficient taxable income. Rather than let excess credits go to waste, many projects utilize tax equity financing structures to bring in a third-party owner such as a bank or insurance company. Tax equity investors can efficiently apply the credits — as well as accelerated depreciation deductions — against their taxable income.

While tax equity transactions such as partnership flips, inverted leases and sale-leasebacks get the tax credits to parties who can use them, these structures may be time-consuming, costly and complicated to implement. The IRA contains several important provisions designed to help taxpayers monetize clean energy credits without forming a partnership or executing a complex leasing transaction. These new rules may also help broaden the pool of potential investors in energy credits.

**Direct pay.** New section 6417 allows applicable entities to make a direct pay election, which treats certain credits as taxes paid on a return — essentially, generating refundable credits. The election is available for the PTC, ITC, CSC, the manufacturing credits and certain vehicle and alternative fuel related credits. Applicable entities are limited to tax-exempt organizations, state and local governments, the Tennessee Valley Authority, tribal governments, Alaska native corporations and certain rural electric cooperatives. The election applies to taxable years beginning after 2022.

The Act includes an important exception to the applicable entity rules: Any taxpayer can make the direct pay election for the clean hydrogen production credit (section 45V), the advanced manufacturing credit (section 45X) and the CSC (section 45Q). This exception applies for the first five years of the clean hydrogen production credit and the CSC, and for any five years within the credit period for the advanced manufacturing credit.

**Transferability.** For taxable years beginning after 2022, new section 6418 allows a one-time transfer of certain credits to unrelated taxpayers for taxpayers who are not eligible to make the direct pay election. This new provision will provide additional flexibility for clean energy project developers looking to monetize tax credits (although, unlike tax equity arrangements, this option will not monetize accelerated depreciation deductions). The transferability rules apply to the PTC, ITC, CSC, the manufacturing credits
and certain alternative fuel related credits. Consideration must be paid in cash, is not included in income of the seller and is not deductible by the buyer.

**Carryback and carryforward provisions.** Finally, the IRA modifies the credit carryback and carryforward periods. The carryback period is extended to three years and the carryforward period is extended to 22 years for numerous credits, including the ITC, CSC, clean hydrogen production credit, manufacturing credits and several other credits. These changes apply to tax years beginning after 2022.
Federal issues surrounding state pass-through entity tax regimes

Authored by Michael Wronsky and Kasey Pittman

Overview

The Tax Cuts and Jobs Act (TCJA) imposed a $10,000 limit ($5,000 for married taxpayers filing separately) on individual taxpayers’ itemized deductions for state and local tax (SALT) payments for the 2018 through 2025 tax years. In response, legislatures of states with high individual income tax rates began introducing pass-through entity tax (PTET) regimes in 2018, to circumvent the limit at the individual level. By allowing partnerships and S corporations to make an election that would subject them to an entity-level state income tax, a PTET regime shifts the deduction from the individual level, where it would be subject to the SALT cap, to the entity level, where it can likely be deducted in full.

Speculation ensued over whether the IRS would respect these arrangements for federal purposes or invalidate them on the grounds they were abusive, in place solely to avoid the statutory SALT cap. Finally, in November 2020, the IRS released Notice 2020-75 (Notice) announcing its intent to issue proposed regulations addressing the treatment of such payments. In advance of the proposed regulations, the Notice permits pass-through entities to deduct “specified income tax payments” in computing their federal non-separately stated income or loss. While welcome news to taxpayers and practitioners, the Notice left many questions unanswered, and to date the proposed regulations have not been released, nor has any further guidance.

PTET mechanics, prevalence

The defining characteristic of a pass-through entity (PTE), for tax purposes, is how it “passes” its income through to its owners to be taxed on their respective returns, rather than at the entity level. This is generally true for both federal and state purposes. An owner would thus pay both federal and state tax on their distributive share of the PTE’s income. Prior to the TCJA, the PTE owner could claim a federal itemized deduction for the full amount of state taxes paid (unless the taxpayer’s income was high enough to subject them to limitations on the total amount of itemized deductions they could claim or was subject to the alternative minimum tax).

A state adopting a PTET regime provides PTE owners a workaround to the SALT cap as follows: Electing PTEs pay state income tax at the entity level, which the PTE may then deduct without limitation. The allowable PTET deduction reduces the PTE’s reportable federal taxable income; in turn, the PTE’s owners’ distributive share of federal taxable income will be lower due to the deduction of the PTET. This
effectively creates the benefit of a state income tax deduction for PTE owners. Lastly, the state typically provides for the owner either to receive a credit against their state tax liability in the amount of their share of the PTET, or their state adjusted gross income to be reduced by their share of the PTET, preventing the income from being taxed by the state twice.

In the years following their introduction, the majority of states have followed suit in enacting PTET legislation; 29 states currently have regimes in place. Nine states do not impose any owner-level taxes on PTE income, leaving 12 states that tax PTE income exclusively at the partner or shareholder level. Note, however, that three of the remaining 12 states have proposed legislation that would install an entity-level tax, if enacted.

**Important considerations**

While on the surface it would seem apparent that owners have much to gain if their PTE elects to be subject to a PTET regime, there are many complicating factors to consider. In addition to the open federal items discussed below, state-related concerns include, but are not limited to (see the SALT article for additional discussion):

- The applications of the rules vary widely by state. While most regimes are elective, Connecticut’s, for example, is mandatory. Some states require the election be made prior to the end of the applicable tax year, while others don’t allow it to be made until after year-end.

- Is the state’s PTE election irrevocable? If so, it could create an unnecessary compliance burden upon the expiration of the SALT cap (currently set for Dec. 31, 2025) as additional filings, estimated payments and other planning may be required of the PTE, but not carry any associated benefit as the SALT cap would no longer be in place at the individual level.

- Do the owners’ resident states allow credits for PTET paid to other states? If not, an owner’s distributive share of the PTET can effectively become taxable, as most states require payments to other jurisdictions be “added back” in determining state taxable income.

Generally, the only straightforward instance involves a PTE with a filing requirement solely in its resident state, of which all of its owners are also residents. This is not to suggest that this is the only scenario in which making the election is beneficial; however, in all cases, a careful cost/benefit analysis must be conducted before a decision is reached.

**Outstanding federal tax issues**

As the release of Notice 2020-75 approaches its two-year anniversary, it remains the only guidance from the IRS on the federal treatment of PTET payments. Further, there have been no indications from the IRS regarding the timing of the release of the proposed regulations the Notice announced. Among several others, open issues include:

- Confirmation of the treatment of PTET payments made by PTEs engaged in investment activities. Notice 2020-75 specifically provides for PTET payments to be deducted from trade or business income. As such, it is unclear how an entity not engaged in a trade or business should report these payments.

- Confirmation of whether deductions for PTET payments should be considered passive or nonpassive at the owner level. Intuitively, this would simply be dictated by the owner’s level of participation in the PTE’s activity(ies); however, passive activity loss regulations specifically provide that deductions for SALT payments are nonpassive in character. To the extent that a PTE has passive owners, this conflict can place additional reporting burdens on the PTE.
• Interaction with S corporation rules. To remain an S corporation, federal rules require the corporation make distributions and allocate all tax items to its shareholders, based on their pro rata share of stock ownership. If an S corporation makes a PTE election in a state where some shareholders do not wish or are ineligible to participate, adhering to the pro rata ownership rules for distributions and allocations of the PTET payment deduction would create inequities among the owners.

Future of the SALT cap

The limitation under current law will expire after the 2025 tax year. However, there is a faction of Democratic lawmakers from both chambers of Congress (known as the SALT Caucus) that have banded to make repealing the cap a top priority and have previously threatened to vote against any legislative iteration of President Joe Biden’s agenda that did not eliminate or provide some form of relief from the limitation. While they ultimately backed off of this ultimatum to ensure passage of the Inflation Reduction Act, the group remains active and could continue to influence future proposed legislation depending on the results of the midterm elections.

Alternatively, many Republicans support extension of the TJCA’s individual provisions past their sunset dates (most expire after Dec. 31, 2025), including the SALT cap. Recently, several Republican lawmakers introduced the TCJA Permanency Act, which, if enacted, would make the SALT cap permanent at the current level of $10,000 ($5,000 for married taxpayers filing separately).

We encourage you to reach out to your Baker Tilly advisor regarding how any of the above may impact your tax situation.
Connect with us.

For more information or questions regarding any of the topics in this planning letter, please contact your Baker Tilly advisor or visit bakertilly.com/contact.

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