The Norton Tax Bulletin

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New Developments; Home Office Expenses; Payroll Protection Plan Forgiveness; Record Retention Period; Stimulus Payments

Payroll Tax Deferral

It appears these unprecedented times are affecting us all—even those in the White House. In early August, President Trump officially issued an executive order for a payroll tax deferral to begin September 1. In this letter, I want to try to fill in the blanks, answering: *Just what is the new payroll tax deferral, and who does it help?*

Let me begin by clarifying a few things:

- Payroll tax relief only applies to those with a biweekly pre-tax paycheck of less than $4,000.
- The deferral only applies to those on a payroll. The relief will not aid millions of those unemployed or furloughed due to COVID-19.
- The relief only addresses the employee's 6.2% share of Social Security taxes, not the 1.45% Medicare taxes.
- The employee is expected to repay the deferred payroll tax through ratable payroll withholding between January 1, 2021, and April 30, 2021.

Trump's executive order calls for a payroll tax deferral from Sep. 1 – Dec. 31, 2020. The Order suspends the collection of 6.2% Social Security tax through Dec. 31. This is a deferral, <u>not a forgiveness.</u> Relief only applies to those with a biweekly pre-tax income of less than $4,000. <u>Unemployed or furloughed receive no benefit Trump's Executive Order.</u>

On August 8, 2020, the President issued four executive orders extending unemployment bonuses and postponing payroll taxes. Payroll tax deferral is the order of interest to most of us. Basically, from September 1 - December 31, employees will <u>*not*</u> have to pay their 6.2% Social Security earnings. Although in theory, this makes workers 6.2% better off, employees receiving this benefit will be expected to pay this back to the government over the first four months of 2021. In other words, it is more like a loan with a deferred repayment plan.

Who Qualifies for Payroll Tax Relief?

It sounds generous on the surface, but payroll tax deferral only aids those on a payroll. Because unemployment levels have soared this year, fewer people will qualify. Basically, any form of payroll relief will not aid those without jobs. The President's deferral also does not apply to the self-employed (*or gig economy workers*). President Trump's payroll tax relief only applies to people who earn a pre-tax income of less than $4,000 biweekly - approximately $104,000 annually. The maximum deferral is $2,149 ($8,666 x 4 months x .062).

On August 28, 2020, the IRS issued Notice 2020-65 in which Secretary Mnuchin determined that employers that are required to withhold and pay an employee's share of social security tax under Code Sec. 3102(a), or the railroad retirement tax equivalent under Code Sec. 3202(a), are affected by the COVID-19 emergency for purposes of the relief described in the Presidential Memorandum (Affected Taxpayers).

For these Affected Taxpayers, the Notice provides that the due date for the withholding and payment of the taxes eligible for deferral is postponed until the period beginning on January 1, 2021, and ending on April 30, 2021. This would thus allow employees to repay their social security taxes and railroad tax equivalent amounts that were deferred in 2020 ratably, through employer withholding, over the first four months of 2021 rather than in one lump sum at the end of the year. Interest, penalties, and additions to tax will begin to accrue on May 1, 2021, with respect to any unpaid taxes. The Notice does state that, if necessary, the employer may make arrangements to otherwise collect the total taxes deferred from the employee.

Keep in mind that neither the Presidential Memorandum nor Notice 2020-65 require employers to allow deferral of these payroll taxes; instead, the deferral is voluntary. Employees cannot demand the deferral in the absence of an employer providing it.

One thing the deferral has done, at least, is bring Republicans and Democrats together. Both sides have criticized the President's move, probably because they prefer to legislate, rather than have the President use his executive powers.

The Effects of the Election

A further thing to consider is the upcoming election. Should President Trump win a second term, he has said his administration would work toward forgiveness of the deferred payroll tax and ask Congress for appropriate legislation. In my opinion, unless the House flips red this next election, I would not count of such legislation becoming a reality.

Further on the potential forgiveness matter, in an August 18 letter to McConnell, Pelosi, and Treasury Secretary Mnuchin, the U.S. Chamber of Commerce, along with over 30 industry trade groups, raised concerns regarding the uncertainty associated with the payroll tax deferral. The letter noted that the deferral creates a significant tax liability for employees at the end of the deferral period and that, without Congressional action to forgive this liability, serious hardships may be imposed on employees who will face a tax bill as a result of the tax deferral. As a result, the letter stated that many employers were unlikely to implement the deferral. I would be surprised if Congress deals with this matter before the election.

Finally, you may remember that the CARES Act provided a similar deferral of the *employer's share* of OASDI.

Home Office Expenses

Many taxpayers who thought, back in March 2020, that the relocation of their workplace from somewhere "downtown" to home was merely a temporary circumstance are continuing to work remotely. For some, this is due to the ongoing pandemic or the need for their workspace to be reconfigured in light of the virus. And while it was a disruption in their work life to begin with, many have decided they prefer to continue their work out of a home office.

Any significant change in one's life can have tax consequences, and that is also true when shifting to working from home. Taxpayers who are now working from home due to the COVID-19 pandemic may be confronted with a number of issues affecting their taxes. These include what to do with home office expenses, differing nexus rules for state taxation, and the special rule for teachers out-of-pocket expenses on their federal returns.

The home office deduction

Prior to the Tax Cuts and Jobs Act (TCJA), unreimbursed employee business expenses were deductible as a miscellaneous itemized deduction on Form 1040, Schedule A subject to the 2% AGI limitation. Beginning in 2018, no employee business expenses were allowed on Federal returns, although many states (*including California)* did not conform with the TCJA. This change in the law did not impact self-employed individuals who were still allowed to claim home office expenses (*assuming they met the basic rules of "exclusive use" and "principal place of business*"). There is a provision that allows employees who incurs home office expenses to seek reimbursement from their employer. Providing there is adequate documentation and an accountable reimbursement plan, such reimbursements are NOT taxable to the employee. Reimbursement for expenses is always preferable to claiming a deduction (*a deduction only covers a portion of the expenses incurred by means of providing a tax reduction*).

Many taxpayers are not aware that nine states and the District of Columbia have passed laws that require employers to reimburse employees if they have incurred job-related expenses. The employee has the challenge of proving the actual amount of the expenses and that the expenses were actually necessary for doing their job. California was one of the nine states.

State Issues

Many states have statutes that require non-residents to pay state income tax on earnings made within the state. Most all states (*with state income taxes*) also tax its residents on ALL income earned regardless of where work was performed, or the income earned. Generally, taxpayers who live in one state (*like CA*) and are taxed on all income can get a credit against the CA tax for income taxes paid to another state. For example, a CA resident who works for six months in Colorado and is taxed by Colorado for that income can take a credit on their CA return for the CO taxes paid. This avoids double taxation of the income for those 6 months in this example.

There are a limited number of states - mainly in the Northeast and Midwest - that have reciprocity agreements under which the taxpayer is only taxed in their state of residence. Currently, in response to the pandemic, 14 states have passed laws that mandate taxpayers are only taxed on their income by their state of residence. I read that there is a proposal in Congress to nationally limit (*temporarily*) states to tax income only in the taxpayer's state of residence.

Teacher expenses

The Internal Revenue Code permits teachers to claims a $250 above-the-line deduction for out-of-pocket expenses. Above-the-line means that the taxpayer can take the deduction and still use the standard deduction in lieu of itemizing (*medical, charitable, mortgage interest, taxes,*

etc). As pointed out by other professionals, the actual language states that the equipment and materials must be 'used by the *eligible educator in the classroom.*' However, this is fairly consistent agreement that that this language could apply to a virtual classroom as well as a physical classroom. That could cover expenses relative to being able to provide virtual classroom instruction. I would suggest that the expenses must clearly be linked to the virtual classroom instruction. One example might be a $100 HD webcam required for the actual virtual instruction – *and it is used exclusively for the Zoom communication with students.*

Payroll Protection Plan (PPP) Forgiveness

Many have been waiting for an update of the rules for PPP loan forgiveness that would be easier to follow. While Congress has not come up with a clear plan, the U. S. Treasury Department and the SBA have agreed on new rules and procedures for smaller loans (*under $50,000*). This process involves the submission of SBA Form 3508S. This application form is a page and a half. The "*interim final rule"* was issued on October 8th.

You may be interested to learn that there are approximately 3.57 million outstanding PPP loans of $50,000 or less, totaling $62 billion of the $525 billion in PPP loans. A little less than half of the total PPP loans of $50,000 or less were made to businesses with no employees.

A borrower of a PPP loan of $50,000 or less, other than any borrower that, together with its affiliates, received loans totaling $2 million or greater, may use SBA Form 3508S (*or a lender's equivalent form*) to apply for loan forgiveness. The borrower, or authorized representative, must initial seven representations and certifications, and sign and date the first page of the form.

A borrower that uses SBA Form 3508S (*or lender's equivalent form*) is exempt from any reductions in the borrower's loan forgiveness amount based on reductions in full-time equivalent (FTE) employees or reductions in employee salary or wages that would otherwise apply.

It is also important that documentation of payroll and non-payroll costs be submitted to the lender. The specifics as to what documentation must be submitted is covered in the instructions to the SBA Form 3508S. With reference to payroll costs, the documentation verifying the eligible cash compensation and non-cash benefit payments from the Covered Period or the Alternative Payroll Covered Period consisting of each of the following:

1. *Bank account statements or third-party payroll service provider reports documenting the amount of cash compensation paid to employees.*
2. *Tax forms (or equivalent third-party payroll service provider reports) for the periods that overlap with the Covered Period or the Alternative Payroll Covered Period:*
    - *Payroll tax filings reported, or that will be reported, to the IRS (typically, Form 941); and*
    - *State quarterly business and individual employee wage reporting and unemployment insurance tax filings reported, or that will be reported to the relevant state.*
3. *Payment receipts, canceled checks, or account statements documenting the amount of any employer contributions to employee health insurance and retirement plans that the Borrower included in the forgiveness amount.*

As for non-payroll documentation verifying the existence of the obligations/services before Feb. 15, 2020, and eligible payments from the Covered Period, the following relates to the documentation required:

1. <u>Business mortgage interest payments</u>: *Copy of lender amortization schedule and receipts or canceled checks verifying eligible payments from the Covered Period; or lender account statements from Feb. 2020 and the months of the Covered Period through one month after the end of the Covered Period verifying interest amounts and eligible payments.*
2. <u>Business rent or lease payments</u>: *Copy of current lease agreement and receipts or canceled checks verifying eligible payments from the Covered Period; or lessor account statements from Feb. 2020 and from the Covered Period through one month after the end of the Covered Period verifying eligible payments.*
3. <u>Business utility payments</u>: *Copy of invoices from Feb. 2020 and those paid during the Covered Period and receipts, canceled checks, or account statements verifying those eligible payments*

Record Retention Period

Periodically, I get calls or e-mails from clients asking about how long to keep certain records or returns. I thought I would share my recommendations in this newsletter. The overriding guideline is that returns and supporting documents should be kept as long as they may be material in any sort of tax agency inquiry or other financial concern.

- **<u>Returns</u>** – the IRS has three (3) years to audit a return; the FTB and may states have four (4) years to audit a return. As a very minimum, copies of returns should be kept for four years. Taxpayers who have a self-employed business may have a longer need due to the operation of a tax concept referred to as a net operating loss (NOL). An NOL occurs when a company's tax deductions exceed its taxable income within a given tax period. An NOL can be carried forward over future tax periods and used to offset taxable income to reduce a company's <u>total tax liability</u>. An NOL can be carried back for up to five years (*due to the CARES Act legislation*) to receive a refund for taxes paid in that prior year. A taxpayer will need a copy of their prior return if they are going to take advantage of an NOL. I advise taxpayers who have a business (*typically reported on a Schedule C)* or on a partnership or corporation return to keep returns for a minimum of six (6) years.

- **<u>Real Property Records</u>** – records relating to purchase price, improvements, casualty losses claimed and other aspects affecting cost or basis should be kept for at least three years AFTER disposition of the property. This is for both personal (*like a primary residence or vacation home*) as well as business real property. When real property is sold (*or even exchanged under Section 1031*), the cost basis is critical in determining what gain (*or loss*) needs to be reported. If you have trashed key documents that help establish the cost-basis of the property, then you could end up paying more tax than would be owed (*or losing part of the loss on the disposition of business/rental real property)* because you cannot prove basis.

  Remember this as well: *property inherited* gets a new basis (called a "stepped up basis") which is its fair market value at time of the death of the decedent. It is critical

that if you inherit a property, you need to get it appraised or at least a broker's comparative analysis of value as of the date of death – and KEEP that document safeguarded as it will be needed when the property is disposed.

Property received as a gift has the same basis in the hands of the person receiving the property as it was in the hands of the donor. In other words, if a parent purchased a home in 1980 for $50,000, and he or she quit-claimed it to a son as a gift in 2020 when it was worth $400,000, the son's basis would be the original $50,000 purchase price. That means if the son immediately sold the property for the $400,000, he would have a $350,000 gain. By contrast, if dad died and the son inherited the property when it was worth $400,000, then the basis to the son would be $400,000 and if immediately sold for that amount, there would be NO TAX DUE. This illustrates why estate planning is important for seniors contemplating what to do with their real property later in life. The method of transfer can significantly impact the tax consequences to a beneficiary.

- **Security Transactions** – similar to real estate transactions, records concerning the purchase of stocks, mutual funds, bonds and the like should be kept for at least three years AFTER disposition (sale) of the securities. In the year of sale, a taxpayer must include the purchase date and price paid for the securities. If that is unknown, then the purchase price will be deemed to be $0, and the holding period (*which determines whether the gain if long term or short term)* will be deemed short term. The loss of basis and being stuck with a short-term holding period can result in a substantial tax liability. Be sure to also keep records that document stock splits, dividend reinvestments and nontaxable distributions.

- **Non-deductible Contributions to IRAs and Other Retirement Accounts** – the general rule is that all distributions from traditional IRAs and other retirement accounts (*like 401 accounts*) are taxable. If you are unable to prove that some of the contributions to the account were post-tax (*meaning that the receipt of that money in later years should be tax-free*), then you will be paying taxes on that amount!

- **Payroll Records** – the general thinking is that records of wages earned, employment taxes paid, returns filed, W-2, W-3 and W-4 forms and all related payroll data should be kept for at least four (4) years after the due date for filing the 4th quarter form 941 (*IRS payroll reporting form)* for the tax year. Employment tax audits are on the rise as the IRS and state governments focus on whether payments to individuals classified as independent contractors should really be treated as employeepayments. In that regard, if you have a business and are considering paying an individual as an independent contractor, be sure you are on solid ground for NOT treating them as an employee. I also suggest that companies obtain an outside opinion regarding the proper classification of individuals providing services to a company. If you opt to not pay someone as an employee, be sure to keep supporting documents to establish true independent contractor status – otherwise, the tax agencies (*IRS and EDD in CA*) will assert that they are, in fact, an employee.

- **Assets Used in Business** – companies are entitled to take depreciation deductions for assets purchased and placed in service for their business (*such as machinery and equipment).* It is important to retain information on the purchase price of the assets, improvements made, depreciation claimed, and any other financial transactions that

impact the adjusted basis of the property. These documents should be retained for at least four years after the disposition of the asset.

Stimulus Payments Taxability

Finally, I wanted to address a question about the stimulus payments and how they factor into your 2020 return. The stimulus payment/rebate is really an advance payment of a credit that would apply on your 2020 return. Most taxpayers will have their advance payment equal the credit for which they are ultimately entitled. However, there can be some events that could change that. As an example, a couple that has a baby after they received their stimulus payment would be entitled to an additional credit on their 2020 return. On the other hand, someone whose adjusted gross income went up so much in 2020 that they would not be entitled to as much a credit for which they received a stimulus payment, there is no provision in the law requiring a repayment of the excess. However, a taxpayer who received a credit based in part on someone (dependent) who died later in the year would have to repay the credit.

I hope that you find the information in this newsletter of value to you.

Very truly yours,

Dick Norton

> ***This newsletter is not intended or written by me to constitute written advice that you may rely upon to avoid penalties that may be imposed by any taxing authority. Selection of a tax entity may have considerations beyond simply its tax treatment. Therefore, I advise clients to always first consult with an attorney who is intimately familiar with business forms and their relevance to potential future tax and financial issues.***