Butterfield + Co.
CPAs, Inc.

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To our Clients and Friends,

As the end of the year is fast approaching, we should consider last-minute strategies that might help reduce your 2020 tax bill. This letter presents a few tax-saving ideas to get you started. As always, you can call on us to help you sort through the options and implement strategies that make sense for you.

Tax Planning for Individuals

Due to the coronavirus pandemic (COVID-19) and the enactment of legislation to offset the economic burden wrought by COVID-19, as well as a legislation passed at the end of 2019, there is a lot to consider when reviewing year-end tax planning options that may be available to reduce your 2020 tax liability.

In December of 2019, the SECURE Act was signed into law. This legislation extended several expiring deductions and tax credits and provided some taxpayer-friendly changes to retirement-related rules. In 2020, the first piece of COVID-19 tax-related legislation signed into law was the Families First Coronavirus Response Act (Families First Act), which responded to the coronavirus outbreak by providing, among other things, four types of tax credits for employers and self-employed individuals. The Families First Act was followed by the biggest piece of legislation for the year - the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The CARES Act, as well as subsequent coronavirus-related legislation, will most likely impact your tax return in some way. The following are some of the considerations we should explore when discussing the tax breaks from which you may benefit, as well as the strategies we can employ to help minimize your taxable income and resulting federal tax liability.

Effect of CARES Act Rebate on Your 2020 Tax Return. Under the CARES Act, individuals with income under a certain level are entitled to a recovery rebate tax credit. These are direct payments (sometimes referred to as "stimulus checks") to individuals by the government. Most, but not all, of these stimulus checks have already been sent out to eligible individuals during 2020.

Single individuals and joint filers are entitled to a payment of $1,200 or $2,400, respectively, plus $500 for each qualifying child. The term "qualifying child" has the same meaning that it does for the child tax credit. Thus, a qualifying child can be no older than 16 on the last day of the tax year (December 31, 2020). The amount of the recovery rebate phases out for income over a certain level. The rebate is reduced by 5% of the amount by which the taxpayer's adjusted gross income exceeds (1) $150,000 in the case of a joint return, (2) $112,500 in the case of a head of household, and (3) $75,000 in the case of a single taxpayer or a taxpayer with a filing status of married filing separately.

The government issued the rebates based on 2019 income tax returns, or 2018 returns for individuals who had not yet filed their 2019 tax return. The calculation for the correct amount of the rebate will be part of your 2020 tax return. If your 2020 tax return indicates a rebate larger than your stimulus check (because, for example, your income went down or you had another child), any additional amount can be claimed as a credit against your 2020 tax bill. On the flip side, if the 2020 rebate calculation shows an amount in excess of what you were entitled to, you do not have to repay that excess.

Filing Status. Your tax return filing status can impact the amount of taxes you pay. For example, if you qualify for head-of-household (HOH) filing status, you are entitled to a higher standard deduction and more favorable tax rates. To qualify as HOH, you must be unmarried or considered unmarried (i.e., legally separated or living apart from a spouse) and provide a home for certain other persons. If you are in such a situation, we need to review whether you qualify for HOH filing status.

If you are married, you'll either be filing your return using the married filing jointly or married filing separately filing status. Generally, married filing separately is not beneficial for tax purposes, but in some unique cases, such as when one party earns substantially less or when one party may be subject to IRS penalties for issues relating to their tax reporting, it may be advantageous to file as married filing separately. Additionally, if one spouse was not a full-year U.S. resident, an election is available to file a joint tax return where such joint filing status would otherwise not apply, and this may help reduce a couple's tax liability.

Income from Repayment of Student Loan Debt. The CARES Act excludes from income certain student loan debt repaid by an individual's employer. Thus, if an employer repaid some or all of your student loan debt after March 27, 2020, and before 2021, that repayment, which would otherwise be taxable income to you, is not includible in your income.

Standard Deduction versus Itemized Deductions. The Tax Cuts and Jobs Act of 2017 (TCJA) substantially increased the standard deduction amounts, thus making itemized deductions less attractive for many individuals. For 2020, the standard deduction amounts are: $12,400 (single); $18,650 (head of household); $24,800 (married filing jointly); and $12,400 (married filing separately). If the total of your itemized deductions in 2020 will be close to your standard deduction amount, we should evaluate whether alternating between bunching itemized deductions into 2020 and taking the standard deduction in 2021 (or vice versa) could provide a net-tax benefit over the two-year period. For example, you might consider doubling up this year on your charitable contributions rather than spreading the contributions over a two-year period. If these contributions, along with your mortgage interest, medical expenses (discussed below), and state income and property taxes (subject to the $10,000 deduction limitation on such taxes that applies to both single individuals and married couples filing jointly; and the $5,000 limitation on such expenses for married filing separately returns), exceed your standard deduction, then itemizing such expenses this year and taking the standard deduction next year may be appropriate.

Medical Expenses, Health Savings Accounts, and Flexible Savings Accounts. For 2020, your medical expenses are deductible as an itemized deduction to the extent they exceed 7.5% of your adjusted gross income. To be deductible, medical care expenses must be primarily to alleviate or prevent a physical or mental disability or illness. They don't include expenses that are merely beneficial to general health, such as vitamins or a vacation. Deductible expenses include the premiums you pay for insurance that covers the expenses of medical care, and the amounts you pay for transportation to get medical care. Medical expenses also include amounts paid for qualified long-term care services and limited amounts paid for any qualified long-term care insurance contract. Depending on what your taxable income is expected to be in 2020 and 2021, and whether itemizing deductions would be advantageous for you in either year, you may want to accelerate any optional medical expenses into 2020 or defer them until 2021. The right approach depends on your income for each year, expected medical expenses, as well as your other itemized deductions.

You may also want to consider health saving accounts (HSAs) if you don't already have one. These are tax-advantaged accounts which help individuals who have high-deductible health plans (HDHPs). If you are eligible to set up such an account, you can deduct the amount you contribute to the account in computing adjusted gross income. These contributions are deductible whether you itemize deductions or not. Distributions from an HSA are tax free to the extent they are used to pay for qualified medical expenses (i.e., medical, dental, and vision expenses). For 2020, the annual contribution limits are $3,550 for an individual with self-only coverage and $7,100 for an individual with family coverage.

In addition, if you are not already doing so and your employer offers a Flexible Spending Account (FSA), consider setting aside some of your earnings tax free in such an account so you can pay medical and dental bills with pre-tax money. The maximum amount that the IRS will allow to be set aside in 2021 is expected to be $2,750. Since you don't pay taxes on this money, you'll save an amount equal to the taxes you would have paid on the money you set aside. FSA funds can be used to pay deductibles and copayments, but not for insurance premiums. You can also spend FSA funds on prescription medications, as well as over-the-counter medicines, generally with a doctor's prescription. Reimbursements for insulin are allowed without a prescription. And finally, FSAs may also be used to cover costs of medical equipment like crutches, supplies like bandages, and diagnostic devices like blood sugar test kits.

Several CARES Act provisions affect health care related rules. For example, under the CARES Act, an HDHP temporarily can cover telehealth and other remote care services without a deductible, or with a deductible below the minimum annual deductible otherwise required by law. The CARES Act also modified the rules that apply to various tax-advantaged health-related accounts so that additional health-related items are "qualified medical expenses" that may be reimbursed from those accounts. Under the new rules, which apply to amounts paid after 2019, over-the-counter products and medications are now reimbursable without a prescription.

Charitable Contributions. While the tax benefits of making charitable contributions and taking an itemized deduction for such contributions were tamped down as a result of the increase in the standard deduction in the TCJA, the CARES Act modified the charitable contribution rules for 2020 tax returns. As a result, an eligible individual can claim an above-the-line deduction of up to $300 for qualified charitable contributions made during 2020. The above-the-line deduction is not available for contributions made after 2020. An eligible individual is an individual who does not elect to itemize deductions. Thus, absent this provision, anyone taking the standard deduction would be ineligible to take a charitable contribution deduction. A qualified charitable contribution is a cash contribution paid in 2020 to an eligible charitable organization. Contributions of noncash property, such as securities, are not qualified contributions.

In addition, if you are itemizing your deductions and have substantial charitable contributions, the CARES Act modified the percentage limitation rules that could otherwise limit your charitable contribution deduction. Under the provision, for charitable contributions made during 2020, any qualified contribution is allowed as a deduction to the extent that the aggregate of such contributions does not exceed the excess of your charitable contribution base over the amount of all other charitable contributions. Excess contributions are eligible for a five-year carryover.

As in prior years, you can reap a larger tax benefit by donating appreciated assets, such as stock, to a charity. Generally, the higher the appreciated value of an asset, the bigger the potential value of the tax benefit. Donating appreciated assets not only entitles you to a charitable contribution deduction but also helps you avoid the capital gains tax that would otherwise be due if you sold your stock. For example, if you own stock with a fair market value of $1,000 that was purchased for $250 and your capital gains tax rate is 15%, the capital gains tax you would owe is $113 ($750 gain x 15%). If you donate that stock instead of selling it, and are in the 24% tax bracket, your ordinary income deduction is worth $240 ($1,000 FMV x 24% tax rate). You also save the $113 in capital gains tax that you would otherwise pay if you sold the stock; that amount goes to the charity. Thus, the after-tax cost of the gift of appreciated stock is $647 ($1,000 - $240 - $113) compared to the after- tax cost of a donation of $1,000 cash which would be $760 ($1,000 - $240). However, it's important to also keep in mind that tax deductions for contributions of appreciated long-term capital gain property may be limited to a certain percentage of your adjusted gross income depending on the amount of the deduction.

Finally, if you have an individual retirement account and are 70½ years old and older, you are eligible to make a charitable contribution directly from your IRA. This is more advantageous than taking a distribution and making a donation to the charity that may or may not be deductible as an itemized deduction. If your itemized deductions, including the contribution, are less than your standard deduction, then you receive no tax benefit from making the donation in this manner. By making the donation directly from your IRA to a charity, you eliminate having the IRA distribution included in your income. This in turn reduces your adjusted gross income (AGI). And because various tax-related items, such as the medical expense deduction or the taxability of social security income or the 3.8% net investment income tax, are calculated based on your AGI, a reduced AGI can potentially increase your medical expense deduction, reduce the tax on social security income, and reduce any net investment income tax.

Expenses Incurred While Working from Home. Although more people have been working from home this year due to the pandemic, related expenses are not deductible if you are an employee. TCJA eliminated the deductibility of such expenses when it suspended the deduction for miscellaneous itemized expenses that was available before 2018. However, if you are self-employed and worked from home during the year, tax deductions are still available. Thus, if you have been working from home as an independent contractor, we should discuss what expenses you have incurred that might reduce your taxable income.

Mortgage Interest Deduction. If you sold your principal residence during the year and acquired a new principal residence, the deduction for any interest on your acquisition indebtedness (i.e., your mortgage) could be limited. The mortgage interest deduction on mortgages of more than $750,000 obtained after December 14, 2017, is limited to the portion of the interest allocable to $750,000 ($375,000 in the case of married taxpayers filing separately). If you have a mortgage on a principle residence acquired before December 15, 2017, the limitation applies to mortgages of $1,000,000 ($500,000 in the case of married taxpayers filing separately) or less. However, if you operate a business from your home, an allocable portion of your mortgage interest is not subject to these limitations.

Interest on Home Equity Indebtedness. You can potentially deduct interest paid on home equity indebtedness, but only if you used the debt to buy, build, or substantially improve your home. Thus, for example, interest on a home equity loan used to build an addition to your existing home is typically deductible, while interest on the same loan used to pay personal expenses, such as credit card debt, is not.

Sale of a Home. If you sold your home this year, up to $250,000 ($500,000 for married filing jointly) of the gain on the sale is excludible from income. However, this amount is reduced if part of your home was rented out or used for business purposes. Generally, a loss on the sale of a home is not deductible. But again, if you rented part of your home or otherwise used it for business, the loss attributable to that portion of the home is deductible.

Discharge of Qualified Principal Residence Indebtedness: If you had any qualified principal residence indebtedness which was discharged in 2020, it is not includible in gross income.

Deductions for Mortgage Insurance Premiums: You may be entitled to treat amounts paid during the year for any qualified mortgage insurance as deductible qualified residence interest if the insurance was obtained in connection with acquisition debt for a qualified residence.

Child and Dependent Tax Credit. For 2020, you may claim as much as a $2,000 credit for each child under age 17. The amount of the credit is reduced for taxpayers with modified adjusted income over $200,000 ($400,000 for married filing jointly) and eliminated in full for taxpayers with modified adjusted gross income over $240,000 ($440,000 for married filing jointly). In addition, you may be eligible for a $500 credit for certain dependents. The $500 credit applies to two categories of dependents: (1) qualifying children for whom a child tax credit is not allowed (because, for example, you do not have a social security number for that child), and (2) certain qualifying relatives.

Education-Related Deductions and Credits. Certain education-related tax deductions, credits, and exclusions from income may apply for 2020. Tax-free distributions from a qualified tuition program, also referred to as a Section 529 plan, of up to $10,000 are allowed for qualified higher education expenses. Qualified higher education expenses for this purpose include tuition expenses in connection with a designated beneficiary's enrollment or attendance at an elementary or secondary public, private, or religious school, i.e. kindergarten through grade 12. It also includes expenses for fees, books, supplies, and equipment required for the participation in certain apprenticeship programs and qualified education loan repayments in limited amounts. A special rule allows tax-free distributions to a sibling of a designated beneficiary (i.e., a brother, sister, stepbrother, or stepsister). As a result, a 529 account holder can make a student loan distribution to a sibling of the designated beneficiary without changing the designated beneficiary of the account. In addition, if your modified adjusted gross income level is below certain thresholds, the following are also available for 2020: a deduction of up to $4,000 for qualified tuition and related expenses, an exclusion from income for education savings bond interest received; a deduction for student loan interest; and a lifetime learning credit of up to $2,000 for tuition and fees paid for the enrollment or attendance of yourself, your spouse, or your dependents for courses of instruction at an eligible educational institution.

Credit for Sick Leave for Self-Employed Individuals. Under the Families First Act, if you are considered an eligible self-employed individual, you may be eligible for an income tax credit for a qualified sick leave equivalent amount. You are an eligible self-employed individual if you regularly carry on any trade or business and would be entitled to receive paid leave during the tax year under the Emergency Paid Sick Leave Act added by the Families First Act. The calculation of the qualified sick leave equivalent amount is quite complicated but is generally equal to the number of days during the tax year that you could not perform services for which you would have been entitled to sick leave, multiplied by the lesser of two amounts: (1) $511, or (2) 100% of your average daily self-employment income. The number of days taken into account in determining the qualified sick leave equivalent amount may not generally exceed 10 days. Your average daily self-employment income under this provision is an amount equal to the net earnings from self-employment for the year divided by 260. In addition, if you have appropriate documentation, the credit is refundable.

Credit for Family Leave for Certain Self-Employed Individuals. Another income tax credit that may be available to you under the Families First Act is a credit for a qualified family leave equivalent amount. The qualified family leave equivalent amount is an amount equal to the number of days (up to 50) during the tax year that you could not perform services for which you would be entitled, if you were employed by an employer, to paid leave under the Emergency Family and Medical Leave Expansion Act, which was added by the Families First Act, multiplied by the lesser of two amounts: (1) 67% of your average daily self-employment income for the tax year, or (2) $200. Your average daily self-employment income under the provision is an amount equal to your net earnings from self-employment for the year divided by 260. This credit is also refundable.

Retirement Planning: CARES Act and SECURE Act Changes. Several taxpayer-favorable changes were made in the CARES Act and the SECURE Act with respect to retirement plans and distributions from those plans including the following:

(1) The required minimum distribution rules for 2020 are waived so no one is required to take such a distribution and include it in taxable income in 2020.

(2) The age limit for making contributions to a traditional individual retirement account (IRA), previously 70 ½ years old, was repealed in 2020. Thus, anyone who is otherwise eligible may make a contribution to a traditional IRA.

(3) A new type of retirement plan distribution was added to the list of early distributions that are excepted from the 10-% penalty for early withdrawals. You can now receive a distribution from an applicable eligible retirement plan of up to $5,000 without penalty if the distribution is either a qualified birth or adoption distribution.

(4) Taxpayers impacted by the coronavirus (which is essentially anyone) can withdraw up to $100,000 from a retirement plan without penalty and is generally includible in income over a three-year period and, to the extent the distribution is eligible for tax-free rollover treatment and is contributed to an eligible retirement plan within a three-year period, is not includible in income.

(5) The required beginning date for required minimum distributions has been increased to 72 years old from 70 ½ years old. The former rules apply to employees and IRA owners who attained age 70½ prior to January 1, 2020. The new provision is effective for distributions required to be made after December 31, 2019, with respect to individuals who attain age 70½ after December 31, 2019.

Retirement Plan Contributions. If you can afford to do so, investing the maximum amount allowable in a qualified retirement plan will yield a large tax benefit. If your employer has a 401(k) plan and you are under age 50, you can defer up to $19,500 of income into that plan for 2020. Catch-up contributions of $6,500 are allowed if you are 50 or over. If you have a SIMPLE 401(k), the maximum pre-tax contribution for 2020 is $13,500. That amount increases to $16,500 if you are 50 or older. The maximum IRA deductible contribution for 2020 is $6,000 and that amount increases to $7,000 if you are 50 or over.

Life Events. Life events can have a significant impact on your tax liability. For example, if you are eligible to use head of household or surviving spouse filing status for 2019, but will change to a filing tax status of single for 2020, your tax rate will go up. If you married or divorced during the year and changed your name, you need to notify the Social Security Administration (SSA). Similarly, the SSA should be notified if you have a dependent whose name has been changed. A mismatch between the name shown on the tax return and the SSA records can cause problems in the processing of tax returns and may even delay tax refunds. Let me know if you have been impacted by a life event, such as a birth or death in your family, the loss of a job or a change in jobs, or a retirement during the year. All of these can affect you tax situation.

Tax Planning for Businesses

Tax legislation enacted at the end of 2019, as well as new tax laws enacted in 2020 in response to COVID-19, will most assuredly affect your business's 2020 income tax return. The plethora of legislation contains many new provisions which are likely to minimize your business's 2020 tax liability. As a result, there are actions we may need to take before year end to ensure we take full advantage of all the opportunities introduced by these pieces of legislation. Additionally, amended returns, which could generate significant refunds to you, may be in order.

The SECURE Act extended certain expiring tax credits, such as the employer credit for paid family and medical leave, and also made favorable changes to certain provisions relating to employer-provided retirement plans. The Families First Act provided, among other things, payroll tax credits for leave required to be paid under the newly enacted Emergency Paid Sick Leave Act (EPSLA) and Emergency Family and Medical Leave Expansion Act (EFMLEA). The CARES Act included the Paycheck Protection Program (PPP), a program authorized by the Small Business Administration (SBA) to guarantee $349 billion in new loans to eligible businesses and nonprofits affected by COVID-19. Such loans may also qualify for tax-free loan forgiveness. We need to evaluate the changes made by the CARES Act, as well as subsequent coronavirus-related legislation, to determine their impact on your business's tax liability. The following are some of the considerations we need to review when deciding what year-end actions may be appropriate to reap the most benefit to you and your business's bottom line.

Depreciation Deductions. Among the many changes made by the CARES Act, the one which may have the most impact is the correction of a technical error made in the TCJA. That error resulted in the 15-year recovery period that applied to qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property being eliminated for such property placed in service after 2017. After the TCJA, the depreciation period for such property, now referred to as "qualified improvement property," was 39 years and, as a result, did not meet the requirements for additional first-year depreciation (i.e., bonus depreciation). Under the CARES Act, qualified improvement property is now depreciated over a 15-year life and meets the criteria for taking bonus depreciation. The change is effective as if it were included in the TCJA. Thus, if your business is affected by this change, we can file amended returns to claim refunds for the deductions that should have been available to you had the technical error not happened.

Relaxed Rules for Deducting Net Operating Losses. The CARES Act also temporarily removed the 80% limitation on taxable income for deducting net operating losses (NOLs) for 2020. In addition, the CARES Act amended the rules for NOLs to provide for a five-year carryback of any NOL arising in 2018, 2019, and 2020. As a result, if applicable, your business can take such NOLs into account in the earliest tax year in the carryback period and carry forward unused amounts to each succeeding tax year. Alternatively, you can waive this carryback period and instead carry forward any NOLs to offset income in future years. Depending on expected tax rates and cash flow in future years, this waiver option may make more sense than carrying back any NOLs.

Reduction in Business Interest Limitation. The CARES Act reduced the limitation on the deductibility of business interest. For tax years beginning in 2019 or 2020, 50% of a business's adjusted taxable income, rather than 30%, is used to determine the business interest limitation. A special rule is provided for partnerships. Under this special rule, the increase in the limitation to 50% of adjusted taxable income in determining the business interest limitation does not apply to a partnership for 2019, subject to certain rules relating to allocations to the partners. There is also an election under which a business can substitute its adjusted taxable income for its last tax year beginning in 2019 for its adjusted taxable income for 2020 in calculating the business interest limitation for 2020. Keep in mind that the business interest deduction limitation only applies if the gross receipts of your business exceed $26 million in 2019 and 2020; Additionally, certain types of businesses are exempt from the limitation.

Modification of Excess Business Loss Limitation Rules. The CARES Act eliminated certain limitations on excess farm losses of a business other than a corporation. This change applies to any tax year beginning after December 31, 2017, and before January 1, 2026. Thus, if you had such losses that were limited in 2018 and/or 2019, we may be able to obtain tax refunds with respect to those years. Further, excess business losses, previously disallowed for tax years beginning after December 31, 2017, and before January 1, 2026, are now allowed for tax years beginning after 2017 and before January 1, 2021. This also presents an opportunity for amended tax returns if it applies to your business.

Minimum Tax Credit Refund. The CARES Act modified the rules for the minimum tax credit for alternative minimum tax (AMT) incurred by a corporation in a prior tax year. Under this provision, the limitation on the credit for prior year minimum tax liability does not apply to a corporation's 2020 and 2021 tax years and the AMT refundable credit amount is 100%, rather than 50%, for tax years beginning in 2019. In addition, a corporation can elect to take the entire refundable credit amount in 2018. A corporation can apply for a tentative refund of any amount for which a refund is due by reason of this new election and, within 90 days, the IRS is required to review the application, determine the amount of the overpayment, and apply, credit, or refund the overpayment.

Retirement Plans and Other Employee Benefits. You can reap substantial tax benefits, as well as non-tax benefits, by offering a retirement plan and/or other fringe benefits to employees. Businesses that offer such benefits have a better chance of attracting and retaining talented workers. This, in turn, reduces the costs of searching for and training new employees. Contributions made to retirement plans on behalf of employees are deductible and you may be eligible for a tax credit for setting up a qualified plan. In addition, business owners can take advantage of the retirement plan themselves, as can their spouse. Where a spouse is not currently on the payroll of a business, consideration should be given to adding the spouse as an employee and paying a salary up to the maximum amount that can be deferred into a retirement plan. So, for example, if your spouse is 50 years old or over and receives a salary of $25,000, all of it could go into a 401(k), leaving him or her with a retirement account but no taxable income.

To help employees with medical expenses, your business might consider setting up a high deductible health plan paired with a health savings account (HSA). The benefits to a business include savings on health insurance premiums that would otherwise be paid to traditional health insurance companies and having employee wage contributions to the plan not being counted as wages and thus neither the employer nor the employee is subject to FICA taxes on the payroll contributions. As for employees, they can reap a tax deduction for funds contributed to the HSA, which they can invest the funds for future medical costs because there is no use-it-or-lose-it limit like there is for most flexible spending accounts; thus the funds can grow tax free and be used in retirement.

Your business might also consider establishing a flexible spending arrangement (FSA) which allows employees to be reimbursed for medical expenses and is usually funded through voluntary salary reduction agreements with the employer. The employer has the option of making or not making contributions to the FSA. Some of the benefits of an FSA include the fact that contributions made by the business can be excluded from the employee's gross income, no employment or federal income taxes are deducted from the contributions, reimbursements to the employee are tax free if used for qualified medical expenses, and the FSA can be used to pay qualified medical expenses even if the employer or employee haven't yet placed the funds in the account.

In addition, the SECURE Act made substantial changes to retirement plan-related provisions from which your business may benefit. For one, it increased the credit available for small employer pension plan startup costs. The credit is available for qualified startup costs of an eligible small employer that adopts a new qualified retirement plan, SIMPLE IRA plan, or SEP, provided that the plan covers at least one non-highly compensated employee. Qualified startup costs are expenses connected with the establishment or administration of the plan or retirement-related education for employees with respect to the plan. The credit, which applies for up to three years, was increased to the lesser of (1) a flat dollar amount of $500 per year, or (2) 50% of the qualified startup costs.

The SECURE Act also extended through 2020 an employer credit for paid family and medical leave. The credit allows eligible employers to claim a general business credit equal to an applicable percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave, provided that the rate of payment under the program is at least 50% of the wages normally paid to an employee.

The SECURE Act also extended the work opportunity credit through 2020. Under this provision, an employer can take a 40% credit for qualified first-year wages paid or incurred with respect to employees who are members of a targeted group of employees.

Qualified Business Income Deduction. If you participate in a business as sole proprietor, a partner in a partnership, a member in an LLC taxed as a partnership, or as a shareholder in an S corporation, you may be eligible for the qualified business income (QBI) deduction. The QBI deduction is generally 20% of qualifying business income from a qualified trade or business. A W-2 wage limitation amount may apply to limit the amount of the deduction. The W-2 wage limitation amount must be calculated for taxpayers with a taxable income that exceeds a statutorily defined amount (i.e., the threshold amount). For any tax year beginning in 2020, the threshold amount is $326,600 for married filing joint returns, $163,300 for married filing separate returns, and $163,300 for all other returns.

The QBI deduction reduces taxable income and is not used in computing adjusted gross income. Thus, it does not affect limitations based on adjusted gross income. The QBI deduction does not apply to a "specified service trade or business," which is defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. Engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

Some of the categories and fields listed as a specified service trade or business are fairly clear in their meaning. Others - such as "consulting" and "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees" - are more vague. If your business could be considered a specified service trade or business, we will need to document why it should not be considered such a business and is thus eligible for the QBI deduction.

Employee Payroll Tax Deferrals. In a Payroll Tax Memorandum issued in August, President Trump directed Treasury Secretary Mnuchin to use his authority to defer the withholding, deposit, and payment of employee social security taxes, as well as taxes imposed under the Railroad Retirement Tax Act (RRTA) on railroad employees, for the period of September 1, 2020, through December 31, 2020. Because these taxes are not forgiven, and must be repaid at the end of the year, such a deferral could result in numerous practical challenges, such as what happens if an employee leaves before he or she repays the payroll taxes.

Extension of Time to Pay Employment Taxes. Under the CARES Act, a business can delay payment of applicable employment taxes for the period beginning on March 27, 2020, and ending before January 1, 2021 (i.e., the payroll tax deferral period). Generally, under this provision, the business is treated as having timely made all deposits of applicable employment taxes that would otherwise be required during the payroll tax deferral period if all such deposits are made not later than the "applicable date," which is (1) December 31, 2021, with respect to 50% of the amounts due, and (2) December 31, 2022, with respect to the remaining amounts. For self-employed taxpayers, the payment for 50% of the self-employment taxes for the payroll tax deferral period is not due before the applicable date. For purposes of applying the penalty for underpayment of estimated income taxes to any tax year which includes any part of the payroll tax deferral period, 50% of the self-employment taxes for the payroll tax deferral period are not treated as taxes to which that penalty applies.

California Taxes

California Conformity and Nonconformity. As California maintains a separate set of tax and compliance laws, any year-end tax moves should be considered in light of California conformity or nonconformity to the federal income tax code.

While a handful of states mostly conformed to the changes made by the TCJA, California did not. However, on July 2, 2019, Assembly Bill 91, "Loophole Closure and Small Business and Working Income Tax Relief Act of 2019," was signed by the California Governor with the following major provisions:

Small Business Accounting Method Reform and Simplification. California generally conforms to the TCJA accounting method simplification requirements for small businesses, which apply a uniform $25 million gross receipts test for purposes of using the cash method of accounting, avoiding the inventory and uniform capitalization rules, and for contracts entered into after December 31, 2018, using the percentage of completion method for long-term contracts.

Section 529 Plans and ScholarShare Accounts. California conforms to TCJA and the Consolidated Appropriations Act of 2016 (CAA) provisions that:

- Expand the definition of "qualified higher education expenses" to include purchases of computer and computer software and internet access and related services;
- Allow individuals a 60-day nontaxable rollover period for nonqualified distributions;
- Allow nontaxable rollovers from Section 529 accounts to ABLE accounts if made within 60 days of the distribution and the ABLE account belongs to the same beneficiary or a member of the beneficiary's family; and
- Require that taxable income from distributions be calculated on a distribution-by-distribution basis, rather than aggregated.

California does not conform to the TCJA provision allowing nontaxable distributions from Section 529 plans to be used to pay private elementary or secondary tuition and requires that such amounts be included in the distributee's gross income.

Cancellation of Debt Income from Student Loans. California conforms to the TCJA provision allowing taxpayers to exclude the amount of student loan indebtedness discharged on or after December 31, 2011, due to the death or disability of the student. Unlike federal law, the California exclusion is available indefinitely. Currently, Federal law only allows the exclusion for the 2018 through 2025 tax years.

IRC Section 338 Elections. Taxpayers may not make a separate IRC Section 338 election relating to certain stock purchases treated as asset acquisition.

California Net Operating Losses. In contrast to the TCJA and CARES Act, California has suspended NOLs for the 2020 through 2022 taxable years. However, the suspension does not apply to taxpayers:

- Subject to the personal income tax if they have net business income or modified adjusted gross income of less than $1 million; or
- Subject to the corporation income tax if their business income subject to California taxation is less than $1 million.

California does not allow carrybacks and has never conformed to the 80% taxable income limitation under the TCJA. California's carryover period remains capped at 20 years. However, the carryover period is extended for any tax years in which taxpayers were precluded from claiming an NOL deduction due to any NOL suspension period.

California Tax Rates. California voters have passed several propositions over the years that have led to significant changes in California taxpayers' overall tax burden. Proposition 30, a Sales and Income Tax Increase Initiative, was passed by California voters in 2012 increasing both income and sales taxes. The passage of Proposition 55 in 2016 extended the personal income tax increases enacted by Proposition 30 through 2030. The following table summarizes California individual income tax rate increases under Proposition 30/55 effective for 2020:

10.3% (1% increase) on income of:	$295,508–$359,407 for single/MFS; $407,329–$488,796 for HOH; and $599,016–$718,814 for MFJ.
11.3% (2% increase) on income of:	$359,408–$599,012 for single/MFS; $488,797–$814,658 for HOH; and $718,815–$1,198,024 for MFJ.
12.3% (3% increase) on income of:	More than $599,012 for single/MFS; More than $814,659 for HOH; and More than $1,198,025 for MFJ.

Income in excess of $1 million is also subject to the 1% mental health surcharge, in accordance with Proposition 63 passed by California voters in 2004. Because Fiduciaries utilize the Single/MFS tax rate schedules, those entities as well as individual taxpayers are subject to these tax rates.

California Safe-Harbor Estimates for AGI over $1 Million. In order to avoid late payment penalties and interest, California taxpayers with current year adjusted gross income equal to or greater than $1 million/$500,000 MFS must figure and pay estimated tax based on at least 90% of their current year tax.

Taxation of Marijuana or Hemp, including Cannabis Resin. Regulation and taxation of marijuana or hemp, including cannabis resin, are vastly different for Federal and California purposes. If you have or are considering entering into a business venture which includes the sale of marijuana or hemp, including cannabis resin, please contact us to discuss.

Franchise Tax Board Website Access. The California Franchise Tax Board (FTB) allows tax preparers to view certain client information on their website (MyFTB) with authorization. This allows tax preparers the ability to access and verify California estimated tax, extension, and other payments, California wages and withholding, and 1099s issued by the State of California. It also allows the filing of California Power of Attorney forms. Please note that filing Power of Attorney forms with the California Franchise Tax Board may be initiated by our firm as a precautionary measure, primarily for those clients who have received or have the potential to receive substantial correspondence from the California Franchise Tax Board. Due to the FTB's concerns over taxpayer privacy, a multi-step process has been implemented by the FTB for preparers to view **new client** information on MyFTB. First, the preparer will request limited access, at which point the FTB will send a letter to the client requesting that they contact the FTB if they do not want to provide limited access to the preparer. The preparer will then request full access, at which point the FTB will send a second letter to the client with an authorization code that must be used to grant full access within a specified period. Client account access typically expires 13 months from the date added or renewed and will be added or renewed by our firm unless you instruct us otherwise. If you receive correspondence from the FTB or our office regarding our access to MyFTB, we strongly advise that you act on it immediately.

Estate Planning and Annual Gifting

Whittling your estate down by making annual gifts continues to be a tax-smart strategy. If you have some favorite relatives or unrelated persons, you can give each of them up to $15,000 this year without utilizing any of your lifetime exclusion. So can your spouse. These gifts will reduce your estate tax exposure without any adverse gift tax effects. Making multiple gifts over multiple years can dramatically reduce your exposure to the estate tax. The sooner you start an annual gifting program, the better. In addition, you can pay for tuition, dental and medical expenses on behalf of anyone without utilizing any of the annual gift exclusion of $15,000 so long as the payments are made directly to the providers of those services. If you simply reimburse the people who you are benefiting, those reimbursements are subject to the $15,000 annual gift exclusion - please note that most tuition deductions are available only to the taxpayer who claims the related student as a dependent. For 2021 the annual gift tax exclusion is also $15,000.

Under the TCJA, beginning after December 31, 2017, the unified federal gift and estate tax exemption is doubled from $5 million (adjusted for inflation after 2011) to $10 million, which will also be indexed for inflation, and the federal estate tax rate will remain at 40%. As a result of the TCJA, the 2020 and 2021 exclusion amounts (lifetime exclusion) were/are $11.58 million and $11.7 million, respectively. The unified federal gift and estate tax exemption is scheduled to revert to $5 million (adjusted for inflation after 2011) after December 31, 2025. Taxpayers and taxpayers' estates that take advantage of the increased unified federal gift and estate tax exemption will not be adversely affected by the post-2025 decrease in the unified federal gift and estate tax exemption. For those with large estates, gifting or transferring a portion of their assets out of their estate prior to January 1, 2026, utilizing their lifetime exclusion, may save considerable estate taxes.

Form 1099-Misc and 1099-NEC Reporting Requirements

The PATH Act, P.L. 114-113, Div. Q, sec. 201, accelerated the due date for filing Form 1099 that includes nonemployee compensation (NEC) from February 28 to January 31 and eliminated the automatic 30-day extension for forms that include NEC. You now must use Form 1099-NEC to report nonemployee compensation. You should review your records and ensure you have all the information necessary to properly and accurately file your Forms 1099-MISC and 1099-NEC for 2020. This includes obtaining the correct payee name, address and tax identification number by having a completed W-9, Request for Taxpayer Identification Number on file. Remember, if a sole proprietor provides you their social security number, make sure to report their individual name, not the business name on the 1099. Some of the important reminders concerning Forms 1099-MISC and 1099-NEC are listed below:

- Form 1099-NEC reporting is due to the Department of Treasury on or before February 1, 2021 if you file on paper or if you e-file.
- Form 1099-MISC reporting is due to the Department of Treasury by March 1, 2021 if you file on paper or March 31, 2021 if you e-file.
- Payments made to attorneys, even if incorporated, must always be reported on a Form 1099.

Keep in mind that reporting late or incorrect information can lead to additional IRS correspondence and penalties.

Conclusion

Through careful planning, it's possible your 2020 tax liability can still be significantly reduced, but don't delay. The longer you wait, the less likely it is that you'll be able to achieve a meaningful reduction. The ideas discussed in this letter are a good way to get you started with year-end planning, but they're no substitute for personalized professional assistance. Keep in mind that California has its own unique set of rules to consider and, as such, many of the strategies employed to reduce Federal taxes may not be applicable to California income taxes. In addition, it is unclear what, if any, tax legislation may be coming.

Please don't hesitate to call us with questions or for additional strategies on reducing your tax bill. We'd be glad to set up a planning meeting or assist you in any other way that we can.

Very truly yours,

Butterfield + Co. CPAs, Inc.

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