



Butterfield + Co.
CPAs, Inc.

November 15, 2022

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 2022 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

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 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, Deductions, and Credits

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 2022, the standard deduction amounts are: \$12,950 (single); \$19,400 (head of household); \$25,900 (married filing jointly); and \$12,950 (married filing separately). If the total of your itemized deductions in 2022 will be close to your standard deduction amount, we should evaluate whether alternating between bunching itemized deductions into 2022 and taking the standard deduction in 2023 (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 2022, 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 2022 and 2023, and whether itemizing deductions would be advantageous for you in either year, you may want to accelerate any optional medical expenses into 2022 or defer them until 2023. 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 a health saving account (HSA) 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 2022, the annual contribution limits are \$3,650 for an individual with self-only coverage and \$7,300 for an individual with family coverage. Please note that if you already have an HSA account, you will not be able to contribute if you are enrolled in Medicare.

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. 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.

Charitable Contributions. 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. More people are forgoing itemized deductions as their standard deduction is more favorable.

If you are itemizing deductions, you can maximize the tax benefit of making a charitable contribution by donating appreciated assets, such as stock, instead of cash. Doing so generally allows you to deduct the fair market value of the asset while also avoiding the capital gains tax that would otherwise be due if you sold the asset. 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.

In addition, if you have an individual retirement account and are 70 1/2 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). Also 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 are working from home these days, the related expenses are not deductible if you are an employee. The 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 principal 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. However, if you rented part of your home or otherwise used it for business, the loss attributable to that portion of the home is deductible. Please note that special consideration should be given to the married filing joint gain exclusion in divorce situations prior to arriving at a settlement agreement.

Discharge of Qualified Principal Residence Indebtedness. If you had any qualified principal residence indebtedness which was discharged in 2022, 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.

Deductions for Excess Business Losses. Taxpayers other than corporations can deduct excess farm losses and excess business losses through 2028. An excess business loss for the tax year is the excess of aggregate deductions attributable to your trades or businesses over the sum of your aggregate gross income or gain plus a threshold amount. The threshold amount for 2022 is \$270,000 or \$540,000 for joint returns.

Qualified Business Income Deduction. If you are conducting your business as a sole proprietorship, a partner in a partnership, a member in an LLC taxed as a partnership, or as a shareholder in an S corporation, the qualified business income (QBI) deduction can significantly help reduce taxable income. The QBI deduction allows eligible taxpayers to deduct up to 20% of their QBI, plus 20% of qualified real estate investment trust dividends and qualified publicly traded partnership income. 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 2022, the threshold amount is \$340,100 for married filing joint returns and \$170,050 for all other returns.

Since the QBI deduction reduces taxable income, and is not used in computing adjusted gross income, it does not affect limitations based on adjusted gross income such as the medical expense deduction or the calculation of social security income that is includible in income. However, 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.

Child Tax Credit. The enhanced child tax credit (CTC) that was available last year was not renewed. Thus, for 2022, for each child under age 17, a CTC of up to \$2,000 is available, depending on your modified adjusted gross income. In addition, a \$500 nonrefundable credit is available for qualifying dependents other than qualifying children. Where the credit exceeds the maximum amount of tax due, it may be refundable. The maximum amount refundable for 2022 is \$1,500 per qualifying child. The \$500 credit applies to two categories of dependents: (1) qualifying children for whom a child tax credit is not allowed, and (2) qualifying relatives. The amount of the credit is reduced for taxpayers with modified adjusted gross 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).

Earned Income Credit. The earned income tax credit (EITC) is determined by multiplying your earned income for the year (but only up to a maximum amount of earned income) by a credit percentage that varies depending on whether you have any qualifying children and, if so, the number of qualifying children. The EITC is also subject to a limitation based on your adjusted gross income. For 2022, the maximum amount of the EITC is (1) \$560 for a taxpayer with no qualifying children, (2) \$3,733 for a taxpayer with one qualifying child, (3) \$6,164 for a taxpayer with two qualifying children, and (4) \$6,935 for a taxpayer with three or more qualifying children. In addition, the EITC cannot be claimed if your investment income (including interest, dividends, capital gain net income, and net rental income) exceeds \$10,300 for 2022.

Dependent Care Credit. If you incurred expenses to care for a child or another dependent so that you can work, you may be eligible for the child and dependent care credit. This credit is available to individuals who, in order to work or to look for work, have to pay for childcare services for dependents under age 13. The credit is also available for amounts paid for the care of a spouse or a dependent of any age who is physically or mentally incapable of self-care. The credit is not available for amounts paid to a dependent or a taxpayer under age 19. The amount of the credit is a specified percentage of your total employment-related expenses - generally, 35% reduced (but not below 20%) by 1% for

each \$2,000 by which your adjusted gross income for the tax year exceeds \$15,000. Employment-related expenses incurred during any tax year which may be taken into account cannot exceed \$3,000 for one qualifying individual or \$6,000 for two or more qualifying individuals.

Premium Tax Credit. A health insurance subsidy is available in the form of a premium assistance tax credit for eligible individuals and families who purchase health insurance through the Health Insurance Marketplace, also known as the “Exchange.” The provision is the result of the Patient Protection and Affordable Care Act (PPACA). This credit is refundable and payable in advance directly to the insurer on the Exchange. In the past, individuals with incomes exceeding 400% of the poverty level were not eligible for these subsidies. However, as a result of the American Rescue Plan (ARP) Act, the cap was eliminated for tax years beginning in 2021 or 2022 and therefore, anyone can qualify for the subsidy. In addition, the percentage of your income paid for a health insurance under a PPACA plan is limited to 8.5% of income. Thus, if you buy your own health insurance directly through an Exchange, you can receive increased tax credits to reduce your premiums.

Education-Related Deductions and Credits. Certain education-related tax deductions, credits, and exclusions from income may be available for 2022. For example, 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.

Depending on your modified adjusted gross income for the year, you may also qualify for: (1) an American Opportunity Tax Credit of up to \$2,500 per year for each eligible student; (2) a Lifetime Learning credit 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; (3) an exclusion from income for education savings bond interest received; and (4) a deduction for student loan interest.

If you qualified for student loan forgiveness under the plan announced by the Biden administration earlier this year, the forgiven amount will generally be excludible from your income for federal tax purposes. However, you may be liable for state or local income taxes as a result of the discharge.

Clean Energy Credits. For 2022, the clean energy tax credits available include (1) residential energy property credits (the nonbusiness energy property credit and the residential clean energy property credit) and (2) vehicle-related credits (the qualified plug-in electric drive motor vehicle credit and the alternative fuel refueling property credit). These credits were significantly expanded by the Inflation Reduction Act, generally beginning after December 31, 2022. However, as described in more detail below, a change to the credit for purchasing an electric vehicle, requiring the final assembly of the vehicle in the United States, takes effect on August 17, 2022.

For years before 2023, the nonbusiness energy property credit (renamed the energy efficient home improvement credit by the Inflation Reduction Act) is a credit for: (1) 10% of the cost of qualified energy efficiency improvements installed during the year; and (2) the amount of the residential energy

property expenditures paid or incurred during the year. Qualified energy efficiency improvements include the following qualifying products: (1) energy-efficient exterior windows, doors and skylights; (2) roofs (metal and asphalt) and roof products; and (3) insulation. Residential energy property expenditures generally include: (1) energy-efficient heating and air conditioning systems, and (2) water heaters (natural gas, propane, or oil). There is a lifetime limit of \$500 on the total amount of non-business energy property credits that may be claimed. In addition, the amount of the credit taken with respect to windows is limited to \$200. The following additional limitations also apply to the non-business energy property credit: (1) \$300 for any item of energy-efficient building property; (2) \$150 for any furnace or hot water boiler; and (3) \$50 for any advanced main air circulating fan.

Beginning in 2023, this credit is increased to 30% of the costs of all qualified energy efficiency improvements and residential energy property expenditures made during the year. In addition, the lifetime credit limitation is replaced with an annual limit of \$1,200. The annual limits for specific types of qualifying improvements are (1) \$250 for any exterior door (\$500 total for all exterior doors), (2) \$600 for exterior windows and skylights, (3) \$600 for other qualified energy property (including central air conditioners; electric panels and certain related equipment; natural gas, propane, or oil water heaters; oil furnaces; water boilers), and (4) a higher \$2,000 annual limit for heat pumps and heat pump water heaters, biomass stoves, and boilers. The Inflation Reduction Act also added a credit of up to \$150 per year for home energy audits. Roofs no longer qualify for the credit beginning in 2023.

The residential energy efficient property credit (renamed the residential clean energy credit by the Inflation Reduction Act) equals 30% of the cost of certain qualified property installed on or used in connection with your home. For 2022, qualifying properties are: (1) solar electric property, (2) solar water heaters, (3) fuel cell property, (4) small wind turbines, (5) geothermal heat pumps, and (6) biomass fuel property. Biomass fuel property expenditures no longer qualify after December 31, 2022. However, battery storage technology expenditures qualify beginning in 2023.

The qualified plug-in electric drive motor vehicle credit may be available if you acquired a qualified electric vehicle and placed it in service this year. For 2022, the amount of the credit is \$2,500, plus an amount based on the battery capacity of the vehicle if the vehicle draws propulsion energy from a battery with at least 5 kilowatt hours of capacity. The credit begins to phase out for a manufacturer's vehicles when at least 200,000 qualifying vehicles have been sold for use in the United States. For instance, Tesla and GM vehicles purchased in 2022 are not eligible for tax credits since those manufacturers have exceeded the 200,000-vehicle threshold.

The Inflation Reduction Act significantly modified the electric vehicle credit. After August 16, 2022, the credit is generally available only for qualifying electric vehicles for which final assembly occurred in North America. However, under a transition rule, if you entered a written binding contract to purchase an electric vehicle on or before August 16, 2022, but took possession of the vehicle after that date, you would not be subject to the final assembly requirement. The Inflation Reduction Act also increased the amount of this credit, effective after December 31, 2022. Beginning in 2023, the total credit amount is \$7,500, consisting of \$3,750 for vehicles meeting a critical minerals requirement and \$3,750 for vehicles meeting a battery component requirement. In addition, price limits apply depending on the vehicle type (\$80,000 for vans, SUVs, and pickup trucks; \$55,000 for other vehicles). The credit is not available to taxpayers with adjusted gross income over \$300,000 (married filing jointly), \$225,000 (head of household), and \$150,000 (single). Other requirements apply beginning after 2023.

The alternative fuel vehicle refueling property credit is a credit for 30% of the cost of purchasing qualified alternative fuel vehicle refueling property. This credit initially expired at the end of 2021 but was extended through 2032 by the Inflation Reduction Act. The amount of the credit is limited to a certain dollar amount, which depends on whether the property is used for business or personal purposes. The amount of the credit for business-use property (i.e., depreciable property) is limited to \$30,000. The amount of the credit for personal-use property (i.e., non-depreciable property) is limited to \$1,000.

Beginning next year, the credit allowed with respect to any single item of qualified alternative fuel vehicle refueling property placed in service during the tax year cannot exceed (1) \$100,000 in the case of depreciable property, and (2) \$1,000 in any other case. In addition, the definition of qualifying property is expanded to include bidirectional charging equipment and the credit can also be claimed for electric charging stations for two- and three-wheeled vehicles that are intended for use on public roads.

Retirement Planning

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 \$20,500 of income into that plan for 2022. 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 2022 is \$14,000. That amount increases to \$17,000 if you are 50 or older. The maximum IRA deductible contribution for 2022 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 2022, but will change to a filing tax status of single for 2023, 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 us 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 your tax situation.

Tax Planning for Businesses

Section 179 Expensing and Depreciation Deductions. The two business tax deductions that present the best opportunities for reducing your business's taxable income are the Section 179 deduction, where your business can elect to deduct the entire cost of certain property acquired and placed in service during the year, and the bonus depreciation deduction, where 100% of the cost of business property may be expensed. Under the Section 179 expensing option, your business can immediately expense the cost of up to \$1,080,000 of "Section 179" property placed in service in 2022. This amount is reduced dollar for dollar (but not below zero) by the amount by which the cost of the Section 179 property placed in service during 2022 exceeds \$2,700,000.

The bonus depreciation rules apply to all businesses unless the business specifically elects out of these rules. An election out might be preferable where a business expects a tax loss for the year and the

bonus depreciation would just increase that loss or where it might be advantageous to push depreciation deductions into future years. For example, if the owner of a pass-thru entity to whom these deductions would flow expects to be in a higher tax bracket in future years, such deductions might be of more use in those future years. When applying both the Section 179 deduction and the bonus depreciation deduction to an asset, the Section 179 deduction applies first.

If you need a vehicle for your business, purchasing a sport utility vehicle weighing more than 6,000 pounds, can trigger a bigger deduction than if a smaller vehicle is purchased. This is because vehicles that weigh 6,000 pounds or less are considered listed property and the related first-year deduction is limited to \$19,200 for cars, trucks and vans acquired and placed in service in 2022. For vehicles weighing more than 6,000 pounds, however, up to \$27,000 of the cost of the vehicle can be immediately expensed.

It's worth noting that if you leased a passenger automobile in 2022 with a value of more than \$56,000, the deduction available for that lease expense is reduced. In such cases, you must include in gross income an amount determined by a formula the IRS issues each year.

Rental Real Estate. If you have any rental real estate activities, it's important to determine if the activity will be considered a passive activity by the IRS. Generally, losses from passive activities are only deductible against passive activity income. However, a deduction of up to \$25,000 (\$12,500 if married filing separately) may be allowed against nonpassive income to the extent you actively participate in the rental real estate activities. This deduction is subject to a phaseout for individuals with modified adjusted gross income above \$100,000 (or \$50,000 if married filing separately). Additionally, you may be eligible for a qualified business income deduction if certain criteria are met, such as the rental activity qualifying as a Section 162 trade or business.

Substantiation of Vehicle-Related Deductions. In audits, the IRS tends to focus on deductions taken for vehicle expenses. If not properly substantiated, such deductions are disallowed. Thus, if vehicles are used in any part of your business or business-related activities, your tax records with respect to each vehicle should include the following:

- (1) the amount of each separate expense with respect to the vehicle (e.g., the cost of purchase or lease, the cost of repairs and maintenance, etc.);
- (2) the amount of mileage for each business or investment use and the total miles for the tax period;
- (3) the date of the expenditure; and
- (4) the business purpose for the expenditure.

The IRS will consider the following as adequate substantiation for such expenses: (1) records such as a notebook, diary, log, statement of expense, or trip sheets; and (2) documentary evidence such as receipts, canceled checks, bills, or similar evidence.

It's important to note that records are considered adequate to substantiate the element of a vehicle expense only if they are prepared or maintained in such a manner that each recording of an element of the expense is made at or near the time the expense is incurred.

Pass-Thru Entity Considerations. If you are operating a business through a pass-thru entity such as a partnership or S corporation, your basis in the entity must be high enough to allow for any loss

deduction, if you have one for the year. In such a situation, we should consider the options available for increasing your basis in such entity.

If you are an S corporation shareholder, it's important to ensure that you and other shareholders involved in running the business are paid an amount that is commensurate with the work being done. The IRS scrutinizes S corporations which distribute profits instead of paying compensation subject to employment taxes. Failing to pay arm's length salaries can lead to tax deficiencies, interest, and penalties. The key to establishing reasonable compensation is showing that the compensation paid for the type of work an owner-employee does for the S corporation is similar to what other entities would pay for similar work. An S corporation needs to adequately document the factors that support the salary an S corporation owner is being paid.

Also, because there are stringent requirements for who may be an S corporation shareholder, if the number of shareholders have changed or increased during the year, we should review the residency or citizenship status of the S corporation's shareholders and S corporation stock beneficiaries (including contingent and residuary beneficiaries).

Energy Efficient Commercial Building Deduction. If your business owns a commercial building, a deduction is available for an amount equal to the cost of energy efficient commercial building property placed in service during the tax year. The maximum deduction with respect to any building is the excess (if any) of (1) the product of \$1.88, and the square footage of the building, over (2) the aggregate amount of the deductions for all prior tax years.

Additional Energy Investment Tax Credits. In addition to the new and extended tax credits created by the 2022 Inflation Reduction Act, the energy investment tax credit was extended and could reduce your business's federal tax liability by a percentage of the cost of a solar system installed during the tax year. Solar systems placed in service in 2022 or later, and that began construction before 2033, are eligible for a 30% investment tax credit or a production tax credit based on a kilowatt-hour formula if they meet certain labor requirements or are under 1 megawatt in size.

Research and Development Deductions and Credits. The provision allowing a deduction for research and development (R&D) expenses expired at the end of 2021. Such expenditures must now be amortized over 5 years. However, under the 2022 Inflation Reduction Act, businesses that engage in certain types of research may qualify for an income tax credit based on its qualified research expenses. The credit is calculated as the amount of qualified research expenditures above a base amount that is meant to represent the amount of research expenditures in the absence of the credit. Because some small businesses may not have a large enough income tax liability to take advantage of their research credit, the law allows that small business (i.e., a business with less than \$5 million in gross receipts and that is under 5 years old) to apply up to \$250,000 of the research credit toward its social security payroll tax liability. The 2022 Inflation Reduction Act expanded the amount available for the credit from \$250,000 to \$500,000 for tax years beginning after 2022.

It's worth noting that there is a slim chance that the R&D expensing provision that terminated at the end of 2021 may be restored. There have been ongoing discussions between Republicans and Democrats about a potential last-minute end-of-year tax deal regarding a reinstatement of the R&D credit, which expired at the end of 2021 and which businesses are anxious to see reinstated, in exchange for an enhanced child tax credit that is similar to the 2021 enhanced child tax credit enacted as part of the American Rescue Plan Act of 2021.

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.

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 2022:

10.3% (1% increase) on income of:	\$338,640–\$406,364 for single/MFS; \$460,548–\$552,658 for HOH; and \$677,279–\$812,728 for MFJ.
11.3% (2% increase) on income of:	\$406,365–\$677,275 for single/MFS; \$552,659–\$921,095 for HOH; and \$812,729–\$1,354,550 for MFJ.
12.3% (3% increase) on income of:	More than \$677,275 for single/MFS; More than \$921,095 for HOH; and More than \$1,354,550 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.

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.

California Passthrough Entity Elective Tax Payments. California Assembly Bill 150 (AB 150) established the Small Business Relief Act which allows qualified passthrough entities to elect to pay and deduct a California passthrough entity tax (PTE) of 9.3% on qualified net income. This is the long awaited “work around” to the federal income tax limitation on state and local income taxes (SALT) and pertains to taxable years beginning on or after January 1, 2021 and before January 1, 2026.

Passthrough entity tax payments are due by the original due date of the tax return (March 15, 2023 for calendar year 2022 tax returns), and are deductible on the passthrough entity’s federal tax return in the year paid. Thus, estimating the remaining amount of passthrough entity tax due for 2022 and making a payment relative to all remaining estimated passthrough entity tax due for 2022 on or before December 31, 2022, could yield significant federal tax savings for 2022. In order to qualify to make the 2022 California passthrough entity elective tax payments, a passthrough entity must have submitted at least 50% of its 2021 PTE or a \$1,000 minimum estimated tax payment on or before June 15, 2022.

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 \$16,000 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 \$16,000 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 \$16,000 annual gift exclusion - please note that most tuition deductions are available only to the taxpayer who claims the related student as a dependent. For 2023 the annual gift tax exclusion is \$17,000.

Under the Tax Cuts and Jobs Act of 2017 (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 2022 exclusion amount (lifetime exclusion) is \$12,060,000 and the 2023 exclusion amount is \$12,920,000. 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.

It is uncertain, what, if any changes current tax legislation being considered by Congress will have on the 2022 exclusion amount or future exclusion amounts. Due to this uncertainty, consideration should be given to utilizing the entire 2022 exclusion amount of \$12.06 million prior to January 1, 2023.

Using a Revocable Living Trust as part of an Estate Plan. The establishment, funding and use of a revocable living trust should also be considered as part of your overall estate plan. Some of the advantages of utilizing a revocable trust as part of your estate plan are as follows:

- (1) Probate avoidance.
- (2) Planning for incapacity or incompetency.
- (3) Avoiding an ancillary administration (in another state) when real property is located in another state.
- (4) Ability to treat eligible revocable trusts as part of the estate (for income tax purposes) and, thus, the assets held are eligible for a step-up in basis.
- (5) Privacy.
- (6) Avoiding potential will contest.
- (7) Flexibility for amending terms or revoking the trust.

Please note that the use of a revocable living trust can be an effective tool in your estate plan, however, if you fail to fund the trust or fail to transfer assets to the trust sufficient to avoid probate, then the usefulness of the revocable living trust could be significantly diminished.

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 file your Forms 1099-MISC and 1099-NEC properly and accurately for 2022. 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 January 31, 2023 if you file on paper or if you e-file.
- Form 1099-MISC reporting is due to the Department of Treasury by January 31, 2023 if you file on paper or 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 2022 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.

Butterfield + Co. CPAS, Inc.