GattoMcFerson
Certified Public Accountants

October 25, 2022

Dear Friends and Colleagues,

As year-end approaches, we thought it would be helpful to discuss certain items that you should consider for tax-planning purposes, and other areas that are currently getting attention in the world of taxes.

Pass-Through Entity Payments due by December 31, 2022

As we have discussed before, several states, including California, enacted legislation that allows S-Corporations and partnerships to pay state income taxes at the business level via their Pass-Through Entity (PTE) tax return - Form 1120S or Form 1065. This treatment allows state taxes paid at the entity level to be deductible by the shareholder/partner for Federal income tax purposes. This "work-around" was designed to avoid the current $10,000 limitation on the deductibility of state and local taxes for Federal tax purposes.

The shareholder/partner will report their share of the corporate or partnership net income to the Internal Revenue Service, but this net will be reduced by the amount of the state tax paid at the entity level. For California, the state tax deducted on the federal return will be added back into net income on the California K-1, but the owners will receive a California tax credit for the tax paid.

Boiling it down, this allows the K-1 recipient to reduce their federal Adjusted Gross Income by the state tax paid, rather than having a limited state tax deduction on Schedule A. This type of workaround has been approved by the IRS (IRS Notice 2020-75).

The important piece here is that if you made the California required "down-payment" on the PTE (the greater of $1,000 or 50% of your 2021 PTE credit), then you'll want to pay the <u>FULL</u> estimated PTE credit by December 31, 2022. To get the full deduction on your 2022 tax return, the entire PTE credit needs to be paid in 2022. A calculation will likely need to be made at the end of the year, and the remaining payment made by December 31, 2022.

The California credit is claimed on the personal income tax return. The credit is applied to your taxes before withholding and estimated payments. So, if your PTE credit causes you to overpay your taxes, that amount will be refunded or applied to future years.

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Student Loan Repayment by Employers

One piece of legislation that doesn't get much attention is Section 2206 of the CARES Act, which allows employers to make up to $5,250 in tax-free annual payments directly to their employees' federal student loans.

These payments represent the best of both worlds. Employees don't pay tax on this added "income," and employers can still deduct these payments while not paying additional payroll taxes on these funds.

The provision has been extended until December 31, 2025. This potentially is a great employee recruiting/retention tool.

New 2023 Increases for Retirement Plans

The IRS has significantly increased the contribution limits for 2023 retirement plans, as follows:

IRA contributions have been increased to $6,500 (up from $6,000 for 2022). The $1,000 IRA catch-up contribution limit for those over 50 years old remains.

401(k) employee contribution limits have been increased to $22,500 (up from $20,500 for 2022) and the catch-up contribution limit for taxpayers above aged 50 has been increased to $7,500 (up from $6,500). The total 401(k) contribution for taxpayers age 50 and over will now be $30,000 for 2023 ($22,500 regular contribution + $7,500 catch-up contribution).

SIMPLE IRA contribution limit have been increased to $15,500 (up from $14,000)

SEP contribution limits have been increased to $66,000 (up from $61,000).

No Changes to Top Income Tax Rate

There are always rumblings about an increase to the top income tax rate from 37% to 39.6% for those with taxable incomes above $400,000. For the foreseeable future, ordinary income tax rates and their corresponding thresholds will remain the same.

Always remember, the taxable income rates and thresholds aren't all or nothing. You only pay tax at the higher rate on the income that exceeds the corresponding threshold.

Given that it now appears rates will remain the same next year, consider pushing income into 2023 and/or accelerating expenses in 2022.

No Changes to Long-Term Capital Gains/Qualified Dividends Tax Rate

There has also been talk about taxing capital gains and qualified dividends at ordinary income tax rates if the taxpayer's income was over $400,000, almost doubling the tax on this type of income. For the foreseeable future, these rates will remain the same.

Even though the stock market has been weak, consider pushing gains into 2023 and/or realizing losses in 2022.

Also, the rush to close a business sale by the end of the year has been greatly diminished. In fact, if capital gain rates do remain unchanged, then pushing a sale off to early 2023 might be the better play.

California "Fishing" Letters

The Franchise Tax Board has been sending Education Letters to certain taxpayers, asking them to review the expenses claimed on either their Schedule A (Itemized Deductions) or Schedule C (Self-Employed Business) for 2019 and/or 2020. These letters are understandably causing stress for their recipients.

These are basically "fishing" letters, meant to beat the bushes and get certain taxpayers to step forward and amend their tax returns.

The Franchise Tax Board has said that these letters are purely educational, and they do not represent any sort of audit nor do they increase your chances of being selected for an audit.

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Expanded (sort of) Vehicle and Solar Credits

The recently passed Inflation Reduction Act tweaked the vehicle credit amounts and limitations. New income limitations determine will disallow the credit for those taxpayers with modified AGI for the tax year in which the purchase is made or the preceding tax year above $300,000 for joint filers, or $150,000 for single filers. The credit applies only to vehicles with a suggested retail price below $80,000 for vans, sport utility vehicles, and pickup trucks, or $55,000 for other vehicles. The IRS and Treasury will determine where a given model fits into the different categories.

There was also an increase and extension of the tax credit for solar energy systems, which was set to decline and expire in 2024. Instead, the credit has been moved back up to 30% and extended until 2032.

That means that a homeowner who purchase a $40,000 solar system is eligible for a $12,000 credit. This is a tax credit–not a tax deduction–so it reduces the federal income tax you owe dollar for dollar.

These credits are nonrefundable, meaning you can’t get back more than you paid in income taxes. However, the portion of the tax credit that can’t be used in the year of installation can be carried forward to future years.

The credit is available for cash or financed purchases. However, a leased system is not eligible.

We will keep you posted on further developments and legislative updates. Please let us know if you have any questions.

Sincerely,

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