# 21 Key Bookkeeping Changes in Current Tax Laws

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## 1. PPP loans revised

The Consolidated Appropriations Act, 2021, H.R. 133, reopened the Paycheck Protection Program (PPP) loan program to some small firms and established a new PPP program with new terms for others.

**Reopened PPP.** For firms that did not receive a 2020 PPP loan, the PPP reopened through Mar. 31, 2021. Firms that received original PPP loans and returned some or all of the proceeds can reapply to the re-opened PPP as though they were new applicants.

**New PPP.** Businesses that received loans under the original PPP and spent all the proceeds can apply for loans under the new PPP if they:

- have fewer than 300 employees—but lodging and food service (NAICS* codes beginning with "72") businesses can have fewer than 500 employees;
- had a 2019–2020 quarterly revenue decrease of more than 25% for any quarter. **Exception.** If a business was not in existence for all of 2019, the maximum loan amount is 2.5 × average monthly payroll costs; for lodging and food service firms, 3.5 × average monthly payroll costs.

There's a ceiling of $2 million, even for businesses with multiple locations.

* North American Industrial Classification System (NAICS) codes, like the Standard Industrial Classification (SIC) codes, identify a business's primary business activity. For example, SIC 571 applies to a business that primarily sells retail furniture. A firm with NAICS 311 is primarily engaged in food manufacturing.

**New rules.** Loans under the reopened or new PPP can be forgiven if loan proceeds are spent on certain items during the "covered period." Under both the new and reopened programs, the borrower can use PPP loans to pay allowed expenses during a covered period of 8 or 24 weeks—the borrower chooses which one.

Like the 2020 COVID-19 program, up to 40% of loan proceeds can be spent on certain nonpayroll expenses (e.g., rent and utilities) during the covered period—the remainder must be spent on payroll. Permitted non-payroll expenses now include 4 new categories:

1. personal protective equipment (PPE) as well as adaptive investments that help small firms comply with health and safety guidelines for both workers and customers (operating and capital expenditures are allowed);
2. operations expenditures, such as business software or cloud computing services, that facilitate business operations;
3. payments to suppliers essential to business operations, including for perishable goods and items purchased under an agreement in effect before the covered period; and
4. property damage from 2020 public disturbances not otherwise covered by insurance.

**Payroll expenses are redefined** to include group-term life, disability, vision, dental and certain other insurance.

Expect a simplified forgiveness process with a 1-page form for borrowers of up to $150,000.

**Special PPP loans.** Available for:

- firms of up to 10 employees;
- firms located in low-to-moderate income areas; and
- lending by small community lenders such as community banks.

## 2. ERC extended and expanded.

The 2020 CARES Act created the Employee Retention Credit (ERC) based on employee wages paid.

The new stimulus bill extends the ERC through the first half of 2021 with significant changes.

**Key changes:**

- A business can have up to 500 employees (formerly, 100). Year-to-year quarterly revenues must decline 20% (formerly, 50%); the decline can be from quarter to quarter, instead of from the same quarter as last year.
- Per-employee wages eligible to calculate the ERC credit are increased $10,000 per quarter (formerly, $10,000 per year).
- The credit: 70% of qualified wages (formerly, 50%).
- Bonuses to essential workers now qualify for the credit in addition to regular wages.

As before, the ERC is taken on the 941. A credit in excess of owned quarterly employment taxes can be claimed as a refund,

## 3. Telecommuter employees can change your state/local taxes and reporting.

Tax reporting and payments to a state or locality rise when a business has a nexus (physical connection) with the jurisdiction. Even one employee in that state or locality can create the nexus.

Many employees now work from their home, vacation home or a relative's home. When the new location is in a different state or locality from the employer's, it is crucial to identify changes in company tax obligations as soon as possible.

Most states say even one employee telecommuting from their state for weeks or months can be sufficient to establish the employer's physical presence in the state that the employee is telecommuting from. This makes the firm potentially responsible for filing SIT, gross receipts, personal property, franchise and other business taxes.

The telecommuter nexus may also create state and local sales tax obligations. An employee's physical presence in a state voids the remote seller exception to sales tax obligations, triggering the requirement that your firm register with the state and collect and remit sales taxes.

Details differ among jurisdictions, but during the pandemic they are essentially waiving the rule that one or more employees telecommuting from home in the state establishes a nexus with the state.

Some of the waivers have deadlines and others do not; all emphasize that the waivers are temporary and related to the pandemic.

Unfortunately, few states and localities have COVID-19 guidance on these issues, so check your state, county and/or city website.

### Crucial question for employers

Because employees working from home seems to be going pretty well, a crucial question for employers will be: Will telecommuting employees continue to be an exception to the nexus rules or, instead, impose tax obligations on a firm with even one telecommuting employee there? If not just one employee, then how many telecommuting employees will trigger a nexus?

### SIT problems

Some adjacent states have reciprocal agreements on SITW and payments (see page 3). Under these agreements, an employer's withholding obligations and state employment tax responsibilities can change when an employee works in an adjacent state. [Tax Notes Today]

**Bottom line.** Determine the short- and long-term consequences of telecommuting for your firm.

## 4. Reimburse remote employees tax-free with "working condition fringes."

Employees working from home often incur costs for computer and other equipment, furniture and office supplies, internet or phone services upgrades, etc.

How can your firm reimburse some or all of these expenses without triggering taxable income?

§132, *Certain fringe benefits*, permits as tax-free working condition fringes reimbursement of expenses that have a primary noncompensatory purpose.

Noncompensatory purposes include payment or reimbursement of costs associated with enabling an employee to work more effectively from home.

The amount paid or reimbursed must be for business use or benefit and must be small and infrequent —such as the cost of a computer, furniture, and office supplies used predominantly or entirely for business.

### Some expenses may or may not qualify

For example, upgrading internet or Wi-Fi capabilities would help the employee work more efficiently but also might be used a lot by the employee's family members or by the employee during non-work time.

Both the expense and its business use must be substantiated within a reasonable period after the expense is incurred.

If a reimbursed or paid-for product or service is used for personal activities, the personal portion must be returned by the employee within a reasonable period. [Leimberg Information Svcs]

## 5. Does your state have "reciprocal agreements" with adjacent states?

Reciprocal agreements allow employees who live in one state but work in another to request exemption from tax withholding in the work (nonresident) state. This saves employers and employees from having to file multiple state returns because of SITW.

Reciprocity is intended to simplify the reporting process for employees and employers. Such agreements are most common between states that share a border and have a significant number of commuters.

**Example.** Joe lives in Montana and works in North Dakota. These two states have a reciprocal agreement, so Joe can ask his employer not to withhold North Dakota taxes so he can file only a Montana state return. The reverse would also apply if Joe lived in North Dakota and worked in Montana.

If Joe has SIT withheld in his state of residence, Joe's employer avoids registering as an employer in his state of residence and filing SIT returns and taxes in that state.

**What to do.** You can let employees who reside in a reciprocal state know that if they would like to pay their SIT in that state, it will save them the time and expense of filing a SIT return in the work state.

**Important.** Have handy a W-4 from the employee's state of residence so that on each paycheck their SIT is withheld for thatstate.

**Freelancers.** If your client's employee works in a state that has a reciprocal agreement with their state, the client needs to register as an employer in that state. Or, the client can suggest that the employee submit a W-4 for the employee's state of residence.

**How to find out about your state.** On your state website search "state withholding reciprocal agreements."

## 6. Accountable plans restore tax breaks to owners and employees.

Before the Tax Cuts and Jobs Act (TCJA), owners and key employees might pay business expenses personally, then take deductions on their 1040 for unreimbursed employee expenses. But after the TCJA was passed, deductions for miscellaneous itemized expenses were eliminated.

**What to do.** Small firms, especially corporations, should have an accountable reimbursement plan. Under this plan, reimbursements to employees for business-related expenses are tax-free to the employee and deductible to the business. The rules for business expenses that are reimbursed remain the same as those for business expenses.

**Three requirements.** An accountable plan has the following three requirements:

1. Only expenses with a business connection can be reimbursed.
2. Employees must timely substantiate reimbursed expenses to their employer—this is automatic if substantiation is made within 60 days, but other substantiation schedules may be timely, based on the circumstances.
3. Substantiation must comply with tax regs for the type of expense. For example, substantiation of travel and business use of a vehicle needs to meet the higher substantiation requirements for deducting such expenses.

Excess advances to an employee must be repaid timely**. Safe harbor.** Pay advances within 30 days of when the expense is paid or incurred; return any excess within 120 days of the expense being paid or incurred. Other repayment dates may be acceptable, depending on the facts and circumstances.

An accountable plan can reimburse any employee or employee-owner business-related expenses. Common reimbursements include travel, meals, office supplies, equipment, and even tools and equipment used on that employee's job.

**Home office reimbursements.** Owner-employees might be reimbursed for a home office and related expenses or for business use of personal cellphones and vehicles, home internet, etc.

**Optional restrictions** include, but are not limited to:

- reimbursement only to designated employees;
- reimbursement for as many or as few types of expenses as the business wants. The plan also can be selective; and
- reimbursement of travel expenses for all employees but other expenses only to certain employees.

*continued*

**Caution.** An accountable plan must meet the IRS requirements. Reimbursements that don't will be treated as wages or other compensation subject to both income and payroll taxes. [kitces.com]

**AIPB tip.** Technically, an accountable plan does not have to be in writing, *but*—it is easier to prove that payments are reimbursements (not compensation) when there is a written plan that specifies who and what can be reimbursed and the rules for employee substantiation and repayment of excess advances.

## 7. Maximizing tax breaks for employee work-at-home expenses.

Employees working from home during the pandemic are likely to incur additional costs. Many do not have dedicated home offices but may still need additional furniture, technology or other business supplies, and their utility bills and other expenses may be higher.

**Do or die.** If your firm cannot arrange ways to get tax breaks for these expenses, employees won't get them.

Most employees working remotely cannot qualify for a home office deduction because they do not have an office area used exclusively for business.

But even those remote employees who meet the home office test have business expenses that no longer are deductible on the 1040. "Miscellaneous" itemized deductions, including home office expenses, were eliminated in the Tax Cuts and Jobs Act of 2017.

**What to do.** Provide reimbursements for the added costs of working at home. The employer can deduct the reimbursements as a business expense but avoid payroll taxes because the reimbursements are not compensation. For the same reason, the employee avoids income taxes on the amounts.

**No "accountable plan" required.** Your firm does not have to have an accountable reimbursement plan to provide tax-free reimbursements. Because the pandemic was declared a national disaster, your firm can take advantage of IRC §139, *Disaster relief payments,* which the IRS says in its ERTC FAQs (employer retention tax credit FAQs) can be used in the current environment. Tax pros are hoping for a more definitive statement, according to *The Wall Street Journal.*

**The rule.** §139, added after 9/11, allows employers to reimburse or pay for "reasonable and necessary personal, family, living, or funeral expenses" due to a disaster.

**The loophole.** This "reasonable and necessary" rule is much broader than the "ordinary and necessary business expense" rule because personal and family expenses qualify. With the terms not fully defined, reimbursable expenses under §139 likely include costs such as additional child care and utilities, in addition to direct business expenses.

**S and C corp owner-employees qualify** for the reimbursements—but it is unclear whether partners and board members are eligible.

**§139 substantiation requirements are fairly low.** Employers do not need full documentation of the expenses as long as reimbursements are expected to be reasonably close to actual payments. Nor do reimbursements to employees need to be reported on W-2s or other information returns. And the rules do not limit payments to higher-income workers.

**Cautions.** Make sure employees do not already receive a benefit—e.g., government reimbursement or child care tax credit. To be absolutely sure, cover on-ly out-of-pocket costs. [*The Wall Street Journal*]

**AIPB tip.** Your firm should have a written plan that states the period for which the reimbursement policy is in effect. The plan should specify the expenses that can be paid or reimbursed, who is eligible for benefits, and the maximum benefit. ***Do not provide excessive or overly generous benefits.*** If the IRS discovers these deductions in the future, your firm could lose them.

## 8. Most business meals are once again 100% deductible.

After many years, 100% deductions for business meals was renewed for 2021 and 2022 (but not 2020) by the Taxpayer Certainty and Disaster Tax Relief Act included in the Consolidated Appropriations Act.

The 100% deduction applies to "food or beverages provided by a restaurant" (entertainment expenses remain nondeductible). The IRS will have to issue guidance on the amount of the deduction.

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**"Restaurant" may be key.** For now, "restaurant" seems to be an important word. The Senate Finance Committee said the deduction applies to expenses for in-restaurant dining, takeout and delivered meals from restaurants. This seems to indicate 100% deductions for meals catered by a restaurant on the business's premises or other venue the business selects.

**Disallowed?** But the provision appears to disallow the 100% deduction for food and beverages provided by entities other than full-time restaurants, such as convention or meeting facilities. **Also unclear:** whether a 100% deduction is allowed for beverages purchased at a bar, coffee shop or other entity with little or no food service that might not be considered a restaurant. Still to be clarified: hotel room service or banquet service meals and beverages.

**Still 50% deductible?** Business meal expenses that do not qualify for the 100% deduction should qualify for a 50% deduction under the pre-existing rules.

Watch your monthly *General Ledger* IRS guidance.

## 9. Are employer-provided meals for business purposes still tax free?

Probably not. Employee meals provided occasionally, such as for holiday parties, are tax-free as a *de minimis* fringe benefit. But for employer meals that are provided for business purposes to be tax free, *they must be provided in an "eating facility."*

*The IRS believes snack areas and employee desks are not eating facilities.*

For example, say that your staff meeting runs late. You send out for sandwiches for everyone and pay for them. The cost of the sandwiches should be included in the attendees' compensation and deducted by your company as salary expense.

What about the cost of snacks?

The IRS now says that unlimited employer-provided snacks are tax free as a *de minimis* fringe benefit under §132. Under §132, employers do not have to prove the snacks were provided as a condition of employment and for the convenience of the employer. Instead, the cost only has to be small enough that accounting for it is unreasonable and impractical.

The IRS left this open. You can probably offer more than just coffee, soft drinks, popcorn and chips. But if snacks are in large portions, of high value or offered too often, the IRS might conclude they are more like meals and therefore not *de minimis*. [*Tax Notes Today*]

## 10. A C corp can deduct a home office—but . . .

XyCo, a C corp, had a sole shareholder: a doctor who worked in the local hospital ER as an IC with a contract. He performed medical services at the hospital and used the second story of his residence as a home office.

He used his home office, which had a separate entrance, exclusively for business—administrative tasks, streaming patient records and continuing education. His assistant also used the office area.

When XyCo made the physician's mortgage payments on the residence and deducted them as office rent on its income tax return, the IRS disallowed them.

Home office deductions under §280A, *Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.*, are for those using their residence for business—not for C corps.

For a C corp to take deductions, it must demonstrate that payments for the home office are ordinary and necessary business expenses under §162, *Trade or business expenses*. But payments for *leasing* home office space from an employee or owner are deductible.

In this case, the corporation failed to demonstrate that the home office was an ordinary and necessary business expense. For example, there was no *bona fide* rental arrangement, written rental agreement or other documentation to indicate the payments were rent. Nor was there any indication of how the amount of the rent was determined. The corporation simply paid the physician's mortgage each month.

Further, the physician treated the transactions as a lease, and his tax returns did not include a Sched. E that reported the rent payments as income or treated part of the residence as being rented to the corporation.

While the corporation was paying the shareholder's mortgage and paying rent to the shareholder, it did not file information returns reflecting these payments. [*Ng MD Inc. APC* v. *Comm.*, T.C. Memo. 2018-14]

## 11. IRS cautions on payroll services.

**Note.** Most payroll services are honest and ethical. The following is a warning about those that are not.

Despite efforts to clean up the industry, the IRS says there still are self-proclaimed "payroll service providers" (PSPs) who fail to deposit employment taxes. Instead, they shut down after taking money from employers.

In most instances, an employer cannot delegate its obligations and responsibilities to a third party such as a PSP. Thus, if a PSP absconds with the money, the employer still is responsible for the taxes, interest and penalties. Forwarding taxes to the PSP does not automatically fulfill the employer's responsibility.

There are 3 options for outsourcing payroll:

1. *A payroll service provider (PSP)* is the traditional third-party provider but, as mentioned, the PSP is not ultimately responsible to the IRS for paying the taxes—the employer is.
2. *A reporting agent (RA)* is a PSP that reported its relationship with a client to the IRS on Form 8655, *Reporting Agent Authorization*, signed by the client. RAs must deposit taxes using the electronic federal tax payment system (EFTPS) and are authorized to exchange client information with the IRS. Giving tax payments over to an RA does not mean giving responsibility for tax returns or payments to the RA.
3. *A certified professional employer organization (CPEO)* has met certain IRS requirements and registered with the IRS. In most instances, a CPEO is liable for paying its customer's employment taxes, filing returns, and making tax deposits and payments. As long as the employer deposits the money with a CPEO, the CPEO is responsible and the employer is relieved of responsibility.

**IRS advice.** If your firm uses any kind of payroll service, it should enroll in the EFTPS under its own name and EIN, insist that the third party make all tax payments through its EFTPS account—not the service's account—then regularly check its account to ensure that deposits are being made. **Also,** be sure that the address of record with the IRS is your firm's —not the service's—so your firm receives IRS bills, notices and other correspondence. [IR-2020-186]

## 12. Employee tax-free parking.

The Tax Cuts and Jobs Act prohibits employers from taking deductions for the cost of employer-provided tax-free parking and transportation benefits. This law also created some income problems for tax-exempt groups. When the problems for tax-exempt groups were solved by last-minute laws, some firms thought they could once again deduct the cost of employer-provided parking. Not true.

**2021 final regs on transportation fringe expenses**
Deductions for employer-provided transportation and commuting benefits incurred after 2017 are disallowed by The Tax Cuts and Jobs Act—but the benefits still are tax free to employees.

Under the final regs, payments to a third party for the qualified transportation fringe are nondeductible, regardless of whether employees use the benefit.

If your firm owns or leases a parking facility, the final regs allow your firm to use a general rule or any of the three simplified methods explained in the regs to determine the disallowed deduction for each tax year. In other words, consult your firm's tax advisor. [T.D. 9939; 85 F.R. 81391-810409]

**Bottom line.** Qualified transportation fringe benefits offered by a for-profit business are not deductible for the employer—but are tax-free to employees.

## 13. Mingled accounts can result in higher taxes.

**The case:** R's two businesses each had their own bank account; R and his wife had a joint account. R was not careful about depositing receipts in and paying expenses from a particular account and did not keep records identifying each business's income and expenses v. his personal financial transactions.

An IRS bank deposit analysis found one business's gross income to be substantially higher than reported on its income tax returns. R challenged the analysis.

**Held:** For the IRS. For a bank deposits analysis, the IRS totals all deposits for the year from all accounts associated with the business and taxpayer, subtracts deposits clearly identified as nontaxable income or tax-free transfers among related accounts and amounts

already listed as income on the business tax returns—and adds the remaining amount to business gross income. In this case, the result was a major increase in business gross income.

When a taxpayer's records are not adequate, the IRS can use bank deposit analysis to assess taxes. The burden is on the taxpayer to prove that the analysis overstates gross income and taxes. Because this taxpayer could not prove the deposits were *not* business gross receipts, the IRS bank deposit analysis prevailed. The business owed taxes based on its revised gross income. [*Rivera* v. *Comm.*, T.C. Memo. 2020-7]

**AIPB tip.** Remind owners to maintain separate bank accounts and credit cards for business v. personal transactions. If they don't, the IRS may assume that all deposits are gross business income and expenses are personal—and the owner must prove otherwise.

## *14. Deduct a theft or casualty loss in the right year.*

This case involves theft, but applies as well to casualty loss—damage, destruction or loss of property from any sudden, unexpected or unusual event such as fire, hurricane, flood, earthquake or tornado.

It illustrates how important it is to be sure the theft or casualty loss is deducted in the year it is incurred or, for certain investment losses, in the discovery year.

**The case:** G&G merged its financial services firm with a larger firm, receiving payment in stock. The new owner was found committing fraud. In 2009, federal regulators closed the firm; in 2010, the owner was indicted and, in 2011, convicted. G&G deducted the theft losses—the price of their stock went down—on their 2012 tax returns. The IRS denied the deductions.

**Held:** For the IRS. In Rev. Proc. 2009-20 the IRS says losses in some investments can be deducted if found to be criminally fraudulent—but must be deducted in the "discovery year," the year in which one or more of the lead fraudsters is indicted for fraud, embezzlement or a similar crime that meets the definition of theft.

In this case, the indictment was in 2010, so the taxpayers had to deduct the losses in 2010, even though the conviction was in 2011. And by the time the IRS denied their deductions, the statute of limitations for amending their 2010 return had passed, so the taxpayers could not deduct their losses.

**AIPB tip.** The IRS often challenges deductions taken in the wrong year. A taxpayer who becomes aware of a theft or casualty loss *must consult a tax advisor* about the appropriate year to deduct the loss. If the right year was missed, an amended return should be filed. [*Giambrone* v. *Commissioner*, T.C. Memo. 2020-145]

## *15. Send 1099s to most LLCs.*

Payments to an LLC are not exempt from Form 1099 reporting—unless the LLC elected to be taxed as a corporation for federal income tax purposes. If it does not make this election, the LLC is a partnership or a disregarded entity likely taxed as a proprietorship.

**AIPB tip.** Collect TINs from all the LLCs to which your firm makes payments. Issue 1099s to all those who receive more than $600 from you during the tax year.

**Exception.** If an officer or owner of the LLC states *in writing* that the LLC has elected to be taxed as a corporation for FIT purposes. [ILM 201447025]

## *16. "Our CPA did it" does not excuse late filing.*

**The case:** X used a CPA to prepare and file his 1040. Every year the CPA filed for an automatic extension, then filed that summer.

One year the CPA prepared the extension and sent a draft to X but, unbeknownst to X, never filed it. In August, the CPA filed the return and the IRS assessed X a penalty for late filing. X appealed.

**Held:** For the IRS. The taxpayer argued that he had a reasonable cause for failing to file on time because he believed the CPA had filed the extension and relied on the CPA to do so.

But taxpayers are personally responsible for returns and other documents being filed on time—a duty that cannot be delegated. Had the taxpayer acted on the CPA's incorrect advice on tax law, he might have gotten off. The taxpayer was liable for the missed deadline. [*Baer* v. *U.S.*, No. 19-1439, Claims Court]

## *17. SECURE Act offers $16,500 tax credit to start a retirement plan.*

Certain provisions of the Setting Every Community Up for Retirement Enhancement (SECURE) Act give employers—***especially small employers***—incentives to establish or expand retirement plans.

Key provisions include the following:

- Firms with up to 100 employees who create a new retirement plan can get a tax credit of up to $5,000 a year for 3 years (was $500)—plus another $500 a year for 3 years if you have automatic enrollment.
- The amount of the credit is the greater of $500 or the number of non-highly compensated employees covered x $250. So, the maximum credit is when at least 20 non-highly compensated employees are eligible for the new retirement plan.
- Multiple-employer pension plans are easier, even for employers not in the same industry. To cut costs, multiple employers can jointly form and operate a retirement plan (previously, employers generally had to be in the same industry to form a multiple-employer plan). Expect major financial services firms to roll out multiple-employer plans, probably in concert with industry associations and other business groups.
- A firm can increase the automatic retirement plan employee contribution rate from 10% to 15% of compensation. Employees can reduce or opt out of automatic enrollment and contributions.

Other key provisions in the SECURE Act:

- Long-term part-timers now must be allowed to participate in a retirement plan. Those who work more than 500 hours but less than 1,000 hours a year and have been with your firm for at least 3 years must be allowed to participate.
- It is now easier to offer annuities as a distribution option, but they must be transferable to the person or other plan without cost to the employee.
- The age for required minimum distributions from plans, including IRAs, is increased to 72 from 70½ for those turning age 70½ after 2019.
- Loans from retirement plans no longer can be made through credit cards or similar payment arrangements.

## *18. Did your firm issue refunds? Better have proof.*

**The case:** Z ran a driving school as a sole proprietor, reporting income and expenses on Schedule C. The IRS said he understated gross income and assessed additional taxes and penalties.

**Held:** For the IRS. The taxpayer said the IRS had not taken into account cash refunds issued to dissatisfied customers that reduced the business's net income. To substantiate this, he produced an income tracking sheet and some negative Yelp reviews.

But the income tracking sheet was not sufficient to establish the amounts refunded, there were no dates, and the figures on it did not match the tax return. Nor were there receipts, bank statements or other documentation to establish the refunded amounts or provide a reasonable way to estimate them. [*Lakew* v. *Commissioner*, T.C. Summ. Op. 2020-27]

**AIPB tip.** Like many small firms, the taxpayer used a third party's online system to make sales, collect payments and set up appointments. As required, the third party issued a 1099-K to the taxpayer and the IRS. The 1099-K's listed gross receipts processed for the year differed significantly from the taxpayer's Schedule C that was flagged for audit.

Always reconcile Schedule C gross receipts with 1099-Ks received from credit card processors or other third parties. Be prepared to explain and prove any differences between them.

## *19. IRS eyeing your ICs—what to do.*

To protect against expanded IRS reclassification of ICs as employees, tax lawyer Robert Woods, who specializes in employment tax issues, urges you to have a written agreement with all ICs that should include the following key items:

- **Names—*and* titles**: The agreement should clearly state that the worker is an IC, not an employee, and avoid words indicating an employment relationship.
- **Training instructions**: ICs largely get their own training and decide when, where and how work is done. You can set work standards, but avoid ongoing instructions.

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- **Delegation**: An IC who is permitted to delegate at least some work to his/her own workers and train them and who is then responsible for their results is likelier to hold up as an IC in an IRS or other worker classification audit.
- **Work periods**: Ideally a contract should be 1 year or less, with renewals, and not include employer-set work hours. Longer terms and employer-set hours indicate employment.
- **Exclusivity**: ICs who work exclusively and full time for one firm are likely to be deemed employees, regardless of other factors. True ICs are available to work for other companies.

  **AIPB tip.** The IRS searches IC contracts for non-compete clauses. By definition, an IC is *independ-ent* and should be allowed to offer services to others.
- **Periodic reports**: Requiring progress reports from ICs indicates control and thus employment. Be concerned only with the IC's final product.
- **Compensation**: When possible, base compensation on output. Time-based payment, hourly or other, generally indicates employment—but not always.
- **Expenses**: ICs usually pay their own overhead and expenses (except perhaps travel), so they should pay for their supplies and equipment. State this in the contract. If needed, increase the contract price rather than pay an IC's expenses.
- **Risk**: It should be possible for an IC to lose money—at least theoretically.
- **Termination**: Both parties should be able to terminate with 30 days' notice for any reason. [*Tax Notes Today*]

## *20. Employee or IC? State v. federal regs.*

If your state does not currently apply the "ABC" rule to worker classification, it may do so soon.

The 2020 California law AB-5 made it harder to treat workers as ICs instead of employees under state law. It presumed workers to be employees—the employer has the burden of proving that they are ICs.

The law adopts the ABC test, which requires employers to prevail on tests A, B and C for a worker to be treated as an IC, as follows:

**A.** The workers must *clearly* be free from the hiring entity's direction for the work in both the terms of the contract and in the conduct of the relationship.

**B.** The IC's work is outside the entity's usual business—i.e., they should not be truck drivers who work for a trucking company because truck driving is not outside the hirer's business, making them employees. A plumber doing work at a retail store is doing work outside the hiring entity's usual business.

**C.** The worker must customarily be engaged in an independently established trade, occupation or business of the same nature as the work performed for the hiring entity.

**Update.** The November 2020 Uber IC referendum does not affect small businesses in California or elsewhere. It narrowly applies to firms that employ drivers through apps. When certain conditions are met, such firms can treat the drivers as independent contractors.

Other California employers still must classify most workers using the ABC test, which requires employers to prevail on tests A, B and C for a worker to be treated as an IC. The ABC Test is used by both the U.S. Department of Labor and the following states:

| | | | |
|---|---|---|---|
| ✓ AK | ✓ IN | ✓ NH | ✓ TN |
| ✓ CA | ✓ KS | ✓ NJ | ✓ UT |
| ✓ CT | ✓ LA | ✓ NM | ✓ VT |
| ✓ DE | ✓ MA | ✓ NV | ✓ WA |
| ✓ GA | ✓ MD | ✓ OH | ✓ WV |
| ✓ HI | ✓ ME | ✓ OR | |
| ✓ IL | ✓ NE | ✓ RI | |

The following states use A and C of the ABC test:

| | | | |
|---|---|---|---|
| ✓ CO | ✓ MT | ✓ PA | ✓ WY |
| ✓ ID | ✓ OK | ✓ WI | |

OK and VA use A and B or A and C of the ABC test.

The test may vary slightly from state to state. In some states, working on company premises may make employee status more likely. Check your state regs.

**Key point.** The California law does not affect worker status under federal law—only worker claims under state wage and benefit laws. For federal employment tax purposes, IRS IC rules apply. Nor has every state been successful in applying the ABC test. Companies have won IC classification cases in some states.

## *21. Multi-state sales tax compliance.*

Of the roughly 45 states with sales taxes, 42 plus the District of Columbia now have statutes requiring out-of-state businesses to collect and pay sales tax under some conditions. Most go into effect after a minimum number of transactions or sales dollars.

At least 30 states have “market facilitator” laws that require such (Amazon, eBay, etc.) to withhold and pay the sales taxes for the small firms whose products they sell, instead of putting the onus on the small firms. In most states, thresholds for sales tax obligation are the same for businesses and facilitators.

The market facilitator rules for each state tell you whether that state requires the facilitator or your firm to report the sales tax and, if your firm must, then when, how and at what thresholds to report them.

In addition, over 23 states have joined what is known as the streamlined sales tax organization, which allows a business to register on its website and easily file sales tax returns and pay the taxes.

The website also has a complete list of remote seller sales tax obligations, including states that do not belong to the group. [*Tax Notes Today*]



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