IRS HELP, INC.

2952 Seneca St.
West Seneca, NY 14224
(716) 827-1980
irshelp.com

Tax-Saving Tips

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Claim Your 2020 and 2021 ERC Now (Yes, in 2022)

During much of 2020 and 2021, you may have qualified for the Employee Retention Credit (ERC). Lawmakers created this tax credit in response to the COVID-19 pandemic.

With the ERC, you found (or could find) tax credits of up to $26,000 per employee. That's a lot. With 10 employees, that's $260,000.

Key point. If you have not claimed the ERC, you can amend your 2020 and 2021 payroll tax returns for the credit. (Amending the payroll is not difficult—so no sweat on that score.)

Three Ways to Qualify

1. Decline in gross receipts (on a quarterly basis, by more than 50 percent in 2020 compared with 2019, and by more than 20 percent in 2021 compared with 2019)
2. A COVID-19 government order that caused a full or partial shutdown (think physical space)
3. A COVID-19 government order that caused more than a nominal effect (think modification of activity)

Two Types of ERC Qualifications: Receipts and Government Orders

First, if you can qualify for the ERC under the gross receipts test, go that route. It's easy to prove. And you get the ERC for the full quarter.

With the shutdown or modification because of a government order, you get the ERC only for the days that you suffered a full or partial suspension or suffered more than a nominal effect on your business. For example, if you suffered for 27 days, you can qualify for the credit for those 27 days.

If you can't qualify under the 50 percent or 20 percent decline in gross receipts test, your only alternative is the government order.

What Government Order Creates the ERC for You?

If you can establish that your business was fully or partially suspended because of a COVID-19 federal, state, or local government order, you are eligible on a day-by-day basis for the ERC during those periods of full or partial suspension. Given the possibility of tax credits equal to $5,000 per employee in 2020 and $21,000 per employee in 2021, this is worth pursuing.

Remember 2020 and 2021. It's hard to think that your business did not suffer due to a federal, state, or local government order during this COVID-19

pandemic. Even if you are an essential business, you likely suffered to some degree.

Here's a short list of how a government order could have caused your full or partial shutdown:

- You had to limit your hours of operation.
- You had to temporarily shut down operations.
- You had to close your workplace to some or all of your employees.
- Your employees were subject to a curfew and could not work during normal work hours.
- Your business had to shut for periodic cleaning and disinfecting.
- The government order caused a supply chain disruption that caused you to cut back operations.

Full or Partial Shutdown Safe Harbor

You likely have no trouble identifying the full shutdown caused by a federal, state, or local government order. One thing to remember, as we mentioned before: when you qualify for the ERC under the full or partial shutdown, you earn the ERC only for the shutdown period.

To determine if your business suffered a partial suspension of operations from a government order, you need to have had more than a nominal portion of your business suspended. The question follows: "What is a nominal portion?" Say thanks to the IRS. Rather than rely on facts and circumstances, you can rely on the IRS safe-harbor 10 percent definition of nominal portion.

It works like this.

The effect of the government order is deemed to constitute more than a nominal portion of your business operations if either

1. the gross receipts from that portion of the business operations are not less than 10 percent of the total gross receipts (both determined using the gross receipts for the same calendar quarter in 2019), or
2. the hours of service performed by employees in that portion of the business are not less than 10 percent of the total number of hours of service performed by all employees in the employer's business (both determined using the number of hours of service performed by employees in the same calendar quarter in 2019).

Example. A 2020 government order requires Sam to shut down his bar and restaurant to sit-down service. Sam looks at his 2019 quarterly results and finds that his sit-down service was 73 percent of his gross receipts for that quarter. During the 61 days that Sam was shut down by this government order, he qualifies for the ERC.

The full or partial shutdown is about a physical space change. You can also qualify for the ERC if the government order caused a modification to your business.

Nominal-Effect Safe Harbor for a Modification to Your Business

Unlike the partial shutdown, where you can identify affected operations by physical space, the nominal-effect safe harbor comes into play when there's a modification required by a federal, state, or local COVID-19 governmental order that has more than a nominal effect on your business operations. For example:

- The government order limited your use of the physical space (e.g., keeping people and tables six feet apart).
- The government order limited the size of gatherings, which affected your business (e.g., no more than 10 people in the store).

Here, you are faced with a facts-and-circumstances situation.

But again, you can thank the IRS for another safe harbor. The IRS deems that the federal, state, or local COVID-19 government order had a more-than-nominal effect on your business if it reduced your ability to provide goods or services in the normal course of your business by not less than 10 percent.

Example. Linda's restaurant had to reduce its dining capacity from 100 to 60 patrons because of a government order. For this period, Linda qualifies for the ERC because she suffered more than a 10 percent reduction in the restaurant's ability to service customers.

Earn 9.62 Percent Tax-Deferred with Series I Bonds

Through October 2022, you can buy Series I bonds that pay 9.62 percent interest. And you receive that rate for six months from the time of purchase.

What happens after that? On November 1, 2022, the U.S. Treasury Department sets a new six-month rate equal to the fixed rate (currently zero) plus the Consumer Price Index inflation rate.

The interest you earn for the first six months gets added to the principal, and you earn interest on that interest during the next six months (think compound interest).

Sounds too good to be true. There's a trick, right? Not really, but the government keeps your money, both your principal and your interest, for at least one year.

Mechanics

It works like this: You are buying a 30-year bond. The interest rate changes every six months. You can cash out anytime after one year, but if you cash out before five years, you have to forfeit three months of interest (no big deal).

You don't pay taxes on the interest until you cash out. You get the compounding effect tax-free. It's like a Roth IRA without age limits and penalties.

Key point. You can't lose the money you invest or the interest you earn, other than the three months' interest, if you cash out before five years.

When you do cash out, you pay federal income taxes on the interest, but you don't pay state, county, or city income taxes.

It is possible (albeit unlikely for many of you) to avoid taxes on the interest altogether if you use the monies for qualified higher education expenses.

Okay, So What's the Downside?

You can't buy more than $10,000 per year, although if you buy from TreasuryDirect and also utilize your tax refund, you can acquire $15,000 of bonds per year. The I bond purchase limit on a tax return is $5,000—regardless of joint or single filing.

If you're married, your spouse can buy $10,000, so now you're up to $25,000 per year.

Now, let's add in your corporation or corporations. Such entities can purchase up to $10,000 of such bonds per calendar year.

Example. Jack, his spouse, and his two corporations are hot for the 9.62 percent of tax-deferred interest. He has not yet filed his 2022 tax return, which shows a tax refund. With Jack, his spouse, and his two corporations, Jack can buy $45,000 of I bonds in calendar year 2022.

He can do the same during calendar year 2023. The major downside to the bonds is that you cannot buy more than the annual limits above. There's no overall limit, just the annual limits.

Inflation and Deflation

The Series I bond is based on inflation. So if inflation drops to zero, cash out that bond. Meanwhile, ride this inflation wave. And remember, your Series I bond cannot go down in value. If your $10,000 I bond earned $985 in interest, the new principal balance is $10,985 and that principal balance never goes down. Deflation can't hurt it.

Investing in Treasury Inflation-Protected Securities (TIPS)

The Fed is finally taking aggressive action to fight inflation, but will it work? Where's the stock market headed? Who knows?

Real estate might be a good inflation hedge, but it's a non-liquid asset and no sure thing. Clearly, this is not a great environment for investors or retirement savers.

If you are thinking of investing conservatively but in a way that also offers some inflation protection, here's an option to consider.

Treasury Inflation-Protected Securities

U.S. Treasury Inflation-Protected Securities (TIPS) are a special variety of Treasury bonds that are adjusted for inflation.

Specifically, in times of inflation, TIPS principal balances are adjusted upward twice a year, based on changes in the Consumer Price Index. In contrast, significant inflation can punish the conservative investment strategy.

Okay, sounds interesting. How do TIPS work?

TIPS Basics

TIPS are sold at original issuance with terms to maturity of five, 10, and 30 years. They pay cash interest twice a year at a fixed rate that's set at issuance.

Also, as we mentioned above, during times of inflation, TIPS principal balances are adjusted upward twice a year.

You receive the following if you hold a TIPS bond:

1. Cash interest payments twice a year at the stated fixed rate. Each semiannual payment equals half the stated rate times the inflation-adjusted principal balance at the time of the payment. So, cash interest payments go up with inflation because they are based on the increasing inflation-adjusted principal balance.

2. At the date of maturity, you receive the inflation-adjusted principal balance.

Example

On July 15, 2022, you invest $200,000 in an original-issue, five-year TIPS bond with a face value of $200,000 that pays a fixed annual interest rate of 0.5 percent. If inflation over the next six months is 7 percent, the inflation-adjusted principal balance is increased by $7,000 to $207,000 ($200,000 x (7 percent ÷ 2)), and you will receive a $518 interest payment in cash for that six-month period ($207,000 x 0.5 percent x 0.5 = $518).

If the inflation rate for the following six months is 6 percent, the inflation-adjusted principal balance is increased to $213,210 ($207,000 x 1.03), and you will receive a $533 cash interest payment for that six-month period ($213,210 x 0.5 percent x 0.5).

If inflation then runs at exactly 4 percent for every six-month period for the following four years, your interest payments will increase based on the inflation-adjusted principal balance for each six-month period. You will receive $249,809 at maturity on July 15, 2027 ($213,210 x 1.02 to the eighth power = $249,809).

The Deflation Scenario

While deflation might seem highly unlikely at the moment, nothing is certain these days. Right?

During periods of deflation, TIPS principal balances are adjusted *downward* twice a year. The twice-yearly interest payments are also adjusted downward—because they are based on a declining adjusted principal balance. The stated fixed interest rate itself doesn't change.

But even in the worst-case scenario of significant deflation during your ownership period, the results of owning a TIPS bond won't be catastrophically bad, as long as you hold the bond to maturity. That's because you're guaranteed to receive at least the face value of the bond at maturity, even if the adjusted principal balance has fallen below that number. If the inflation-adjusted principal balance exceeds the face value, you'll receive the larger inflation-adjusted number.

Best Way to Invest in TIPS

You can purchase TIPS upon original issue directly from the government, through the online TreasuryDirect program. If you invest this way, your principal is never at risk.

The TreasuryDirect option is available only for TIPS purchased for taxable accounts. You cannot use a tax-favored retirement account, such as an IRA, to buy TIPS upon original issue via TreasuryDirect.

If you buy a newly issued TIPS bond via TreasuryDirect, you'll receive at least the face value of the bond if you hold it to maturity, even if there's significant deflation. In other words, if you buy $100,000 of bonds via TreasuryDirect and hold them to maturity, then you receive no less than $100,000. Your principal is never at risk.

TIPS Tax Considerations

Cash interest payments from TIPS and non-cash increases in the principal of TIPS are subject to federal tax at ordinary income rates, but exempt from state and local income taxes.

TreasuryDirect reports the TIPS amounts subject to the federal income tax on two information forms:

- Form 1099-INT shows the sum of the semiannual cash interest payments made to you in a given year.
- Form 1099-OID shows the amount by which your TIPS principal amount increased or decreased due to inflation.