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Supplemental Newsletter

December 2020

This is a special edition newsletter for December 2020.

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With the end of 2020 less than a week away, I have been getting a lot of information concerning tax strategies that may be of value to clients, family and friends. So, I have put together this newsletter to share the better ones with all of you. I hope you find this final newsletter of 2020 helpful. The format is a bit different from the prior newsletters.

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PPP Loans for $50,000 or Less

The Paycheck Protection Program (PPP) loan and its forgiveness process have been an ever-changing (*and often confusing*) ride so far.

With the new rules for PPP loans of $50,000 or less, you escape the most difficult part of the loan forgiveness if you had to consider employees. And you may even obtain more loan forgiveness than you would have otherwise.

Before

Before the $50,000-or-less rule, you had to either suffer a reduction in loan forgiveness or meet one of the many exceptions that allowed you to

- cut annual salaries or hourly wages by more than 25 percent, and/or
- reduce the average number of employees or average hours paid.

After

Now, with a PPP loan of $50,000 or less, you don't have to consider the myriad rules about employees. Regardless of what you did with your employees, you qualify for full forgiveness if

- your PPP loan is for $50,000 or less,
- you spent the PPP money on costs that are eligible for forgiveness, and
- at least 60 percent of the forgiveness is for qualified payroll costs (including defined payroll for owners).

Example. You obtain a PPP loan of $34,000 based on your 2019 Schedule C income and pay to your part-time employee. When COVID-19 hit, you laid off your part-time worker and have not rehired him. Using SBA Form 3508S and the 24-week covered period, you qualify for 100 percent forgiveness of your $34,000 loan because you spent $20,833 (61 percent) on the deemed payroll to yourself and the remainder on five months' rent and utilities.

Planning note. You are not an employee of your Schedule C business. You receive no W-2 income. But the PPP rules deem your 2019 Schedule C profits as your payroll for PPP loan purposes. The rules cap the Schedule C taxpayer's loan amount and forgiveness at a maximum of $20,833 when Schedule C income is $100,000 or more.

Four Things to Know When Hiring Your Spouse

If you own your own business and operate as a proprietorship or partnership (wherein your spouse is not a partner), one of the smartest tax moves you can make is hiring your spouse to work as your employee.

But the tax savings may be a mirage if you don't pay your spouse the right way. And the arrangement is subject to attack by the IRS if your spouse is not a bona fide employee.

Here are four things you should know before you hire your spouse that will maximize your savings and minimize the audit risk.

1. Pay benefits, not wages. The way to save on taxes is to pay your spouse with tax-free employee benefits, not taxable wages. Benefits such as health insurance are fully deductible by you as a business expense, but not taxable income for your spouse.

Also, if you pay a spouse only with tax-free fringe benefits, you need not pay payroll taxes, file employment tax returns, or file a W-2 for your spouse.

2. Establish a medical reimbursement arrangement. The most valuable fringe benefit you can provide your spouse-employee is reimbursement for health insurance and uninsured medical expenses. You can accomplish this through a 105-HRA plan if your spouse is your sole employee, or an Individual Coverage Health Reimbursement Account (ICHRA) if you have multiple employees.

3. Provide benefits in addition to health coverage. There are many other tax-free fringe benefits you can provide your spouse in addition to health insurance, including education related to your business, up to $50,000 of life insurance, and de minimis fringes such as gifts.

4. Treat your spouse as a bona fide employee. For your arrangement to withstand IRS scrutiny, you must be able to prove that your spouse is your bona fide employee. You'll have no problem if:

- you are the sole owner of your business,
- your spouse does real work under your direction and control and keeps a timesheet,
- you regularly pay your spouse's medical and other reimbursable expenses from your separate business checking account, and
- your spouse's compensation is reasonable for the work performed.

New IRS Efforts to Destroy Tax Deductions for PPP Paid Expenses

From what we know, when lawmakers originally passed the PPP they thought that under its provisions,

- you did not pay taxes on the forgiveness amount, and

- you also could deduct the expenses that you paid with the PPP money.

Obstacle

In late April, the IRS issued Notice 2020-32, which asserts that PPP loan recipients may not deduct business expenses paid using the PPP monies that gave rise to forgiveness (defined payroll, rent, utilities, and interest).

Lawmakers' Take

In a letter to Secretary of the Treasury Steven Mnuchin on May 5, 2020, Senator Chuck Grassley (chairman of the Committee on Finance), Senator Ron Wyden (*ranking member on the Committee on Finance),* and Congressman Richard E. Neal (*chairman of the Committee on Ways and Means*) jointly stated that the IRS got this wrong and that the intent of the CARES Act was for the PPP to be a tax-free grant.

The Do-Nothings

The IRS was unmoved by the lawmakers' letter. The IRS position was clear: no deduction for the expenses paid with the PPP money. The IRS understood that perhaps lawmakers didn't mean that to happen, but in the eyes of the IRS, the way that the lawmakers enacted the law created the problem. To fix it, lawmakers simply need to pass a new law.

Frankly, we thought that lawmakers would pass a new law and take care of this problem. But no, that has not happened.

New Nails in the Coffin

On November 18, 2020, the IRS drove two new nails into the coffin regarding deductions for PPP monies that were forgiven and spent on payroll, rent, interest, or utilities.

- **Nail 1.** In Revenue Ruling 2020-27, the IRS ruled that you may not deduct expenses paid with the PPP loan monies if you have received or expect to receive forgiveness of those loan monies.

- **Nail 2.** In Revenue Procedure 2020-51, the IRS set forth safe-harbor procedures to follow if your PPP forgiveness is subsequently denied or if you decide not to apply for forgiveness.

With the rulings described above, the IRS has clarified its position to lawmakers: if you don't like the non-deductibility of expenses paid with PPP monies, change the law.

**** UPDATE ****

Congress just passed the *Consolidated Appropriations Act, 2021*. A Section of that bill provides that deductions are allowable for otherwise deductible expenses paid with the proceeds of a Paycheck Protection Program (PPP) loan that is forgiven and that the tax basis and other attributes of the borrower's assets will not be reduced as a result of the loan forgiveness. This will override the IRS position on these expenses.

As noted above, the Bill has been passed by Congress but the President has not signed it. This is definitely an area to keep on top of if you received a PPP loan and part or all of it ends up being forgiven.

The IRS Goes Easy on Taxpayers Who Owe Back Taxes

Are you one of the over 11 million Americans who owe the IRS back taxes? The IRS temporarily suspended most collection efforts during the first

wave of the coronavirus pandemic through its "People First Initiative." This initiative expired July 15, 2020.

The IRS is now ready to go after delinquent accounts again. However, the agency recognizes that substantial numbers of taxpayers cannot pay what they owe right now. To help them, it has promulgated a new Taxpayer Relief Initiative.

The new Taxpayer Relief Initiative is relatively modest in scope, but it can be a big help if you owe the IRS.

Among other things, the new initiative gives you an extra 60 days to pay off a tax bill. You now have 180 days instead of 120 days to make a lump sum payment of all you owe.

The initiative also makes it easier to obtain, keep, and modify installment agreements with the IRS. These allow you to make monthly payments over several years.

If you owe $50,000 to $250,000, you may even be able to obtain an installment agreement without the IRS filing a tax lien on your property—something that has never been possible before.

The IRS is also stressing that it will help taxpayers who have already entered into installment agreements or offers in compromise with the agency and who are now having trouble making their payments.

You may also be able to get IRS penalties reduced or eliminated.

Whatever you do, don't ignore a tax bill from the IRS. And never feel you're helpless when confronted by the IRS collection juggernaut. You always have options, no matter how much you owe.

Tax-Smart College Savings Strategies for Parents

College is expensive. Data for the 2019–2020 academic year indicates that the average cost of tuition, fees, room, and board was $30,500. The tax law has provisions to help you cover the costs, including Coverdell accounts, Section 529 savings plans, and Section 529 tuition plans.

Contribute to a Coverdell Education Savings Account

You can contribute up to $2,000 per year to the child's Coverdell Education Savings Account (CESA). If you have several children, you can set up a CESA for each of them.

Contributions are non-deductible, but earnings are allowed to accumulate free of any federal income tax. You can then take tax-free withdrawals to pay for the account beneficiary's post-secondary tuition, fees, books, supplies, and room and board.

Maybe not for you. Your right to contribute is phased out between modified adjusted gross income (MAGI) of $95,000 and $110,000 if you are unmarried, or between $190,000 and $220,000 if you are a married joint filer.

Contribute to a Section 529 College Savings Plan

Section 529 college savings plans are state-sponsored arrangements named after the section of our beloved Internal Revenue Code that authorizes very favorable treatment under the federal income and gift tax rules.

You as the parent of a college-bound child begin by making contributions into a trust fund set up by the state plan that you choose. The money goes into an account designated for the beneficiary whom you specify (your college-bound child).

You can then make contributions via a lump-sum pay-in or via installment pay-ins stretching over

several years. The plan then invests the money using the investment direction option that you select.
When your child reaches college age, you can take federal-income-tax-free withdrawals to pay eligible college expenses, including room and board under most plans. Plans will generally cover expenses at any accredited college or university in the country (not just schools within the state sponsoring the plan). Community colleges qualify as well.

In essence, a Section 529 college savings plan account is a tax-advantaged way to build up a college fund for your child.

Don’t Confuse Savings Plans with Prepaid Plans

Don’t mix up Section 529 college savings plans with Section 529 prepaid college tuition plans—which we will give only a brief mention here. Both types of plans are properly called “Section 529 plans” because both are authorized by that section of the Internal Revenue Code. Both receive the same favorable federal tax treatment. But that’s where the resemblance ends.

The big distinction is that prepaid tuition plans lock in the cost to attend certain colleges. In other words, the rate of return on a prepaid tuition plan account is promised to match the inflation rate for costs to attend the designated school or schools—nothing more, nothing less. That’s okay if that’s what you really want.

No Kiddie Tax on Section 529 Plan

You don’t have to worry about the kiddie tax if you set up a custodial 529 plan in the child’s name. The 529 plan is an investment plan where the monies remain in the plan. You make contributions with after-tax dollars.

When the child takes the money out of the plan for college, he or she does so tax-free when the funds are used to pay for qualified higher education expenses.

Employing Your Spouse in Your Business

If you own your own business and operate as a proprietorship or partnership (wherein your spouse is not a partner), one of the smartest tax moves you can make is hiring your spouse to work as your employee.

But the tax savings may be a mirage if you don’t pay your spouse the right way. And the arrangement is subject to attack by the IRS if your spouse is not a bona fide employee.

Here are four things you should know before you hire your spouse that will maximize your savings and minimize the audit risk.

1. Pay benefits, not wages. The way to save on taxes is to pay your spouse with tax-free employee benefits, not taxable wages. Benefits such as health insurance are fully deductible by you as a business expense, but not taxable income for your spouse.

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4. Treat your spouse as a bona fide employee. For your arrangement to withstand IRS scrutiny, you

must be able to prove that your spouse is your bona fide employee. You'll have no problem if:

- you are the sole owner of your business,
- your spouse does real work under your direction and control and keeps a timesheet,
- you regularly pay your spouse's medical and other reimbursable expenses from your separate business checking account, and
- your spouse's compensation is reasonable for the work performed.

If a Loved One Passes Away

If a loved one passes away and you serve as the executor or inherit assets, you need to consider your duties and so some tax planning.

Filing the Final Form 1040 for Unmarried Decedent

If the decedent was unmarried, an initial step is to file his or her final Form 1040.

That return covers the period from January 1 through the date of death. The return is due on the standard date: for example, April 15, 2021, for someone who dies in 2020, or October 15, 2021, if you extend the return to that date.

Surviving Spouse May Be Able to Use Joint Return Rates for Two Years Following Deceased Spouse's Year of Death

The benefits of the married-filing-joint status are extended to a qualified widow or widower for the two tax years following the year of the deceased spouse's death.

In general, to be a qualified widow/widower for the year, the surviving spouse must be unmarried as of the end of the year.

If Decedent Had a Revocable Trust

To avoid probate, many individuals and married couples of means set up revocable trusts to hold valuable assets, including real property and bank and investment accounts.

These revocable trusts are often called "living trusts" or "family trusts." For federal income tax purposes, they are properly described as "grantor trusts."

As long as the trust remains in revocable status, it is a grantor trust, and its existence is disregarded for federal income tax purposes. Therefore, the grantor or grantors are treated as still personally owning the trust's assets for federal income tax purposes, and tax returns of the grantor(s) are prepared accordingly.

Basis Step-Ups for Inherited Assets

If the decedent left appreciated capital gain assets—such as real property and securities held in taxable accounts, the heir(s) can increase the federal income tax basis of those assets to reflect fair market value as of

- the decedent's date of death, or
- the alternate valuation date of six months after the date of death, if the executor of the decedent's estate chooses to use the alternate valuation date.

When the inherited asset is sold, the federal capital gains tax applies only to the appreciation (if any) that occurs after the applicable magic date described above. The step-up to fair market value can dramatically lower the tax bill. Good!

Co-ownership. If the decedent was married and co-owned one or more homes and/or other capital gain assets with the surviving spouse, the tax basis of the ownership interest(s) that belonged to the decedent (usually half) is stepped up.

Community property. If the decedent was married and co-owned one or more homes and/or other capital gain assets with the surviving spouse *as community property* in one of the nine community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), the tax

basis of the entire asset—not just the half that belonged to the decedent—is stepped up to fair market value.

This strange-but-true rule means the surviving spouse can sell capital gain assets that were co-owned as community property and only owe federal capital gains tax on the appreciation (if any) that occurs after the applicable magic date. That means little or no tax may be owed. Talk to your estate attorney about tax planning and owning all property as community property to ensure you get this full step-up basis.

Business Tax Planning for 2020

Here are seven business tax deduction strategies that you can easily understand and implement before the end of 2020.

1. Prepay Expenses Using the IRS Safe Harbor

You just have to thank the IRS for its tax-deduction safe harbors.

IRS regulations contain a safe-harbor rule that allows cash-basis taxpayers to prepay and deduct qualifying expenses up to 12 months in advance without challenge, adjustment, or change by the IRS.

Under this safe harbor, your 2020 prepayments cannot go into 2022. This makes sense, because you can prepay only 12 months of qualifying expenses under the safe-harbor rule.

For a cash-basis taxpayer, qualifying expenses include lease payments on business vehicles, rent payments on offices and machinery, and business and malpractice insurance premiums.

Example. You pay $3,000 a month in rent and would like a $36,000 deduction this year. So on Thursday, December 31, 2020, you mail a rent check for $36,000 to cover all of your 2021 rent. Your landlord does not receive the payment in the mail until Tuesday, January 5, 2021. Here are the results:

- You deduct $36,000 in 2020 (the year you paid the money).
- The landlord reports taxable income of $36,000 in 2021 (the year he received the money).

You get what you want—the deduction this year.

The landlord gets what he wants—next year’s entire rent in advance, eliminating any collection problems while keeping the rent taxable in the year he expects it to be taxable.

Don’t surprise your landlord: if he had received the $36,000 of rent paid in advance in 2020, he would have had to pay taxes on the rent money in tax year 2020.

2. Stop Billing Customers, Clients, and Patients

Here is one rock-solid, time-tested, easy strategy to reduce your taxable income for this year: stop billing your customers, clients, and patients until after December 31, 2020. *(We assume here that you or your corporation is on a cash basis and operates on the calendar year*.)

Customers, clients, patients, and insurance companies generally don’t pay until billed. Not billing customers and patients is a time-tested tax-planning strategy that business owners have used successfully for years.

Example. Jim Schafback, a dentist, usually bills his patients and the insurance companies at the end of each week; however, in December, he sends no bills. Instead, he gathers up those bills and mails them the first week of January. Presto! He just postponed paying taxes on his December 2020 income by moving that income to 2021.

3. Buy Office Equipment

With bonus depreciation now at 100 percent along with increased limits for Section 179 expensing, buy your equipment or machinery and place it in service

before December 31, and get a deduction for 100 percent of the cost in 2020.

Qualifying bonus depreciation and Section 179 purchases include new and used personal property such as machinery, equipment, computers, desks, chairs, and other furniture (and certain qualifying vehicles).

4. Use Your Credit Cards

If you are a single-member LLC or sole proprietor filing Schedule C for your business, the day you charge a purchase to your business or personal credit card is the day you deduct the expense. Therefore, as a Schedule C taxpayer, you should consider using your credit card for last-minute purchases of office supplies and other business necessities.

If you operate your business as a corporation, and if the corporation has a credit card in the corporate name, the same rule applies: the date of charge is the date of deduction for the corporation.

But if you operate your business as a corporation and you are the personal owner of the credit card, the corporation must reimburse you if you want the corporation to realize the tax deduction, and that happens on the date of reimbursement. Thus, submit your expense report and have your corporation make its reimbursements to you before midnight on December 31.

5. Don't Assume You Are Taking Too Many Deductions

If your business deductions exceed your business income, you have a tax loss for the year. With a few modifications to the loss, tax law calls this a "net operating loss," or NOL.

If you are just starting your business, you could very possibly have an NOL. You could have a loss year even with an ongoing, successful business.

You used to be able to carry back your NOL two years and get immediate tax refunds from prior years; however, the Tax Cuts and Jobs Act (TCJA) eliminated this provision. Now, you can only carry your NOL forward, and it can only offset up to 80 percent of your taxable income in any one future year.

What does this all mean? You should never stop documenting your deductions, and you should always claim all your rightful deductions. We have spoken with far too many business owners, especially new owners, who don't claim all their deductions when those deductions would produce a tax loss.

6. Thank COVID-19

Let's be real: there's little to be grateful for with COVID-19, with one of the several exceptions being the potential opportunities to turn NOLs into cash for your business.

Two NOL opportunities come from the Coronavirus Aid, Relief, and Economic Security (CARES) Act:

1. The CARES Act allows NOLs arising in tax years beginning in 2018, 2019, and 2020 to be carried back five years for refunds against prior taxes.
2. The CARES Act allows application of 100 percent of the NOL to the carryback years.

Before the CARES Act, you could not carry back your 2018, 2019, or 2020 losses, and your NOL could offset only up to 80 percent of taxable income before your Section 199A deduction.

7. Deal with Your Qualified Improvement Property (QIP)

In the CARES Act, Congress finally fixed the qualified improvement property (QIP) error that it made in the TCJA.

QIP is any improvement made by the taxpayer to the interior portion of a building that is non-residential real property (think office buildings, retail stores, and

shopping centers) if you place the improvement in service after the date you place the building in service.

If you have such property on an already filed 2018 or 2019 return, it's on that return as 39-year property. You now have to change it to 15-year property, eligible for both bonus depreciation and Section 179 expensing.

A Warning About Deferring Taxable Income

I need to add a word of warning about this strategy of deferring taxable income as discussed above. The new administration has plans to spend a lot of money on entitlements, immigrants, infrastructure and other items. *Where does money come from to pay for these costs?* Certainly, the U.S. Treasury can print more money, but that is not a practical solution as that results in inflation and devaluation of the U.S. dollar. Most likely, tax rates – *which the current administration reduced* – will be increased. If that occurs as many believe it will, you could find yourself actually paying *more* in taxes by accelerating deductions now in 2020 or deferring income to 2021. I equate this decision process as going to Vegas and tossing the dice. No one knows for sure what will happen. I think that corporate rates are very likely to increase, so clients who operate a regular (*not a Sub-S where the profits are taxed at individual tax rates*) need to seriously consider the potential consequences of deferring taxable income.

Summary

I hope that you find the information in this newsletter of value to you. Happy New Year – and my wish for all of us is that 2021 will be a better year without a pandemic!

Very truly yours,

Dick Norton

This newsletter is not intended or written by me to constitute written advice that you may rely upon to avoid penalties that may be imposed by any taxing authority. Selection of a tax entity may have considerations beyond simply its tax treatment. Therefore, I advise clients to always first consult with an attorney who is intimately familiar with business forms and their relevance to potential future tax and financial issues.