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Year End Tax Planning Strategies for Businesses

December 2nd 2020

Welcome! Today's agenda is as follows:

1. PPP loan - accounting and income tax considerations

2. Payroll tax credit and a little more!

3. Tax legislation, Wisconsin entity election, potential future legislation

4. Q&A

PPP Loan – Accounting and Income Tax Considerations

PPP Loan – Accounting and Tax Considerations

Important info/ disclaimer!

- The PPP information presented in this webinar is designed to assist traditional "for-profit" businesses. If you represent a nonprofit organization, please note that nonprofit rules will differ from these rules, and nonprofit accounting rules will not be covered in this webinar.
- The PPP information in this webinar will be limited to GAAP accounting and income tax reporting issues. General PPP loan and loan forgiveness rules will not be covered. If you have general PPP loan questions, please contact your Wegner representative, or visit our COVID resource page at https://www.wegnercpas.com/wegner-resources/covid-19/
- Rules and regulations related to the PPP program have been changing frequently. The information contained in this webinar is information that is known as of today's date. Please watch the Wegner email updates for additional changes in the future!

GAAP Accounting for PPP Loans – Two Possibilities

Debt Model

- Initially record the cash inflow from the loan as a liability (i.e., debt)
- Accrue interest at the stated interest rate
- Continue to record the loan and accrued interest as a liability until either:
  - The loan is partly or wholly forgiven and debtor has been legally released, or
  - The debtor pays off the loan
- If partly or wholly forgiven, reduce the liability by the amount forgiven and record a gain on extinguishment.
- The Debt Model can be used by any business; beware may affect loan covenants such as debt to equity ratio

In-substance Government Grant Model

- Entity expects to meet the PPP's eligibility criteria and concludes the loan represents, in substance, a grant that is expected to be forgiven
- Initially record the cash inflow from the loan as a liability (i.e., deferred income)
- Subsequently reduce the liability and recognize the earnings impact systematically over the period(s) in which the entity recognizes as expenses the related costs for which the grant is intended to compensate
- Earnings impact may be presented as either other income on the income statement or as a reduction of the related expenses. *Recommendation: Best to show separately as "other income" since it is an unusual item!*

In-substance Government Grant Model (continued)

- The In-substance Government Grant Model may only be used by a borrower if it is *probable* that the loan forgiveness criteria will be met for all or substantially all of the PPP loan
- If, in a subsequent year, some or all of the loan is not forgiven, then it will be treated as a change in estimate in the subsequent year

Financial Statement Disclosures

- All businesses with material PPP loans should adequately disclose their accounting policy for such loans and the related impact on the financial statements
- Disclosure should also be made alerting the financial statement user of the SBA 6 year audit requirement contingency (e.g. the possibility that, upon SBA audit, some or all of the PPP loan may need to be paid back)

Tax Treatment for PPP Loans

- If the PPP loan is truly a loan that will need to be paid back, there is no income tax effect other than deducting interest expense incurred
- If the PPP loan is forgiven, or is expected to be forgiven:
  - The forgiveness of the loan itself is NOT taxable income (per Sec 1106(i) of the CARES Act); however…
  - The expenses that the forgiven PPP funds were used for are not deductible (per IRS Notice 2020-32); therefore…
  - The forgiveness acts as an increase to taxable income, contrary to the “spirit” of the CARES Act
  - But, <u>when</u> does this hit taxable income? What happens if forgiveness isn’t known until 2021?

Tax Treatment for PPP Loans (continued)

Per Rev. Rul. 2020-27:

A taxpayer that received a covered loan guaranteed under the PPP and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of the CARES Act may not deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan… even if the taxpayer has not submitted an application for forgiveness of the covered loan by the end of such taxable year.

- Bottom line: For most calendar year businesses that fully used the PPP loan for qualified expenses in 2020 (and therefore expect full forgiveness), the taxable income for 2020 will be increased by the amount of the PPP loan.

Tax Treatment for PPP Loans (continued)

- If, in a subsequent year, some or all of the loan is *not* forgiven, the IRS allows the expenses to be deducted on:
  - The 2020 tax return (if not filed yet), or
  - An amended 2020 return (if 2020 return already filed), or
  - The timely filed tax return for the subsequent year in which it became known that some or all of the loan would not be forgiven

Other tax treatment considerations

- For PPP loans solely based on self-employment income (e.g. sole proprietors, partnership partners subject to SE tax), there are no expenses to add back
- Watch for changes! Congress could enact further legislation to allow deductible expenses, and/or IRS could clarify/modify rules!

Payroll Tax Credit and a Little More

Employee Retention Credit

– Available if:

- Operations are affected by a government suspension order,

  OR

- Gross receipts for the current quarter declined by > 50% from the

  same quarter in the prior year

  – Controlled group test applies

Employee Retention Credit

- Refundable on IRS Form 941
  - 50% of the first $10,000 paid, per employee including health insurance costs
    - Wages for periods 03/12/2020 – 12/31/2020
    - Can't include wages paid under FFCRA
    - No credit if business received a PPP loan

- Report qualified wages and related health insurance on 941
  - Beginning with 2nd quarter 2020
  - Credit taken against employer's share of social security (6.2%)
  - Excess credit is refundable

Families First Coronavirus Response Act (FFCRA)

- Two weeks (up to 80 hours) of paid sick
  - Employee regular rate of pay – *up to $511 per day*
    - Quarantined
    - Experiencing COVID-19 symptoms and seeking medical diagnosis
  - Two-Thirds of employee regular rate of pay – *up to $200 per day*
    - Providing care for individual under quarantine
    - Care for a child (under 18) whose school or childcare provider is closed or unavailable due to COVID-19

- Additional 10 weeks of paid expanded family and medical leave - *up to $200 per day*
  - Two-Thirds of employee regular rate of pay
  - Care for child whose school or childcare provider is closed or unavailable due to COVID-19

- *$12,000 aggregate over a 12 week period*

Families First Coronavirus Response Act (FFCRA)

– Covered Employers
  - Fewer than 500 employees
  - Small business with fewer than 50 employees may be exempt from requirement to provide leave due to school closings and childcare unavailability
    - » **Only if jeopardizes business continuation**

– Covered Employees
  - All employees are eligible for two weeks for specified reasons related to COVID-19
  - Employees employed for at least 30 days are eligible for up to an additional 10 weeks to care for child under certain circumstances related to COVID-19.

Families First Coronavirus Response Act (FFCRA)

- Employer Credit
  - Wages paid with respect to periods 04/01/2020 – 12/31/2020
    - Fully refundable tax credit equal to 100% of qualified wages
    - Plus employer share of health insurance
    - Employer portion of Medicare tax (1.45%)
  - Wages are not subject to employer FICA 6.2%

- May reduce 941 deposits by qualified wages, health insurance and employer portion of Medicare tax <u>(Employer FICA already deducted from wages)</u>

- Reconcile wages, health insurance and employer Medicare on quarterly 941 forms

Delayed 941 Deposits (Not Recommended)

- EMPLOYER DEFERRAL OF 6.2%
  - Allows 2-year delay on employer (only) FICA
    - Applies to payments due 03/27/20 -01/01/2021
    - 50% to be repaid 12/31/2021
    - 50% to be repaid 12/31/2022
    - No interest or penalty charged
- EMPLOYEE DEFERRAL OF 6.2%
  - 9/1/2020 – 12/31/2020
  - Not forgiven
  - Becomes due in 2021
  - Employee earnings below $104,000
  - If employee leaves – Employer becomes responsible for repayment

Year-End W-2 Additions

- Personal Use of Auto
- S – Corp health insurance
- Other fringe benefits

Helpful tip: Refer to IRS Publication 15-B
https://www.irs.gov/pub/irs-pdf/p15b.pdf

New 1099-NEC

- New form to report nonemployee compensation
  - Formerly reported on 1099-MISC box 7
  - Now reported on 1099-NEC box 1
  - Late filing fee $50 per 1099 form
  - Due to IRS and recipient by 1/31/2021.

Tax Legislation, Wisconsin Entity Election, Potential Future Legislation

Depreciation changes

- Modification for qualified improvement property (QIP) - improvements made to the interior of a commercial real property. Improvements must be placed into service after the building's date of service and explicitly exclude expansion of the building, elevators and escalators, and changes made to a building's internal structural framework.
- Change is effective back to beginning of 2018.
- Improvements that are QIP can get some great depreciation benefits. Depreciation life changes from 39 years to 15 years. It also allows for bonus depreciation and Section 179. These are methods to accelerate depreciation into one year instead of spreading out over the 15-year period.
- Can amend returns or file a change in accounting method form and apply adjustment in 2020.

Example

Example

- You made a $195,000 improvement to your business building while doing a remodel in 2018. It meets all qualifications for qualified improvement property. Under old rules this would be depreciated over 39 years at $5K/year. Under the new rules, you can accelerate the depreciation and could take bonus depreciation to fully deduct the $195,000.

Depreciation limits for 2020

Section 179 –

- The maximum Section 179 deduction per year is $1,040,000. If your business spends more than $2,590,000 on fixed assets, the amount you are eligible to deduct starts to decrease.
- Cannot reduce business income below zero
- Wisconsin has same limits as federal depreciation

Bonus depreciation –

- No annual limit
- Can reduce business income below zero
- Must apply to all assets in asset class. Ex: All 5-year, 7-year, 15-year assets. Cannot pick and choose the assets like Section 179
- Wisconsin does not allow bonus depreciation – this creates a federal and Wisconsin difference.

Net operating loss changes

- This applies for C-Corporations (pay tax as an entity)
- Individuals
- Losses occurring in 2018, 2019 or 2020 can be carried back to get refunds from tax paid in prior years.
- Carryback period is five years.

Interest expense modifications for larger companies

- Only applies to businesses in excess of $26M average gross revenue over past three years.
- Changed business interest expense deductibility from 30% to 50%.
- Only applies to larger and highly leveraged companies with a lot of debt.

Wisconsin Entity Tax Election

- S-Corporations and Partnerships
- Company pays the Wisconsin income tax at the entity-level. Shareholders/Partners do not pay income tax on these amounts individually.
- Pros –
  - The entity-level tax paid is deducted on the company's federal tax return, therefore reducing the company's federal income.
  - The individual does not pay tax on this income
  - Annual election - not mandatory once you start, can do it one year and skip the next year depending on your tax situations.
- Cons –
  - The entity-level tax rate is higher in Wisconsin than the individual tax rate.
  - The entity-level tax does not allow charitable contributions
  - The entity-level tax only allows tax credits for out-of-state tax paid.
  - Different shareholders/partners have different tax brackets with multiple owner situations. It is made for the entire company and cannot choose only for shareholders/partners that get benefits from the election.

Wisconsin Entity Tax Election

When does it make sense to make this election?

- Married filing jointly filers with over $400,000 and single/head of household filers with over $200,000 of adjusted gross income generally start receiving these benefits. Typically about two cents on the dollar are saved after your income is past these thresholds. There are several factors to consider, so please make sure to run some tax projections to see if this makes sense for your business.

When do we make this election?

- This election is made on the S-Corporation or Partnership tax return (including extensions).

Wisconsin Entity Tax Election

Does my method of accounting matter?

- Yes, if you file your taxes on a cash basis, then you should make an estimated tax payment to get the entity-level tax deduction before 12/31 if you plan on making the election, otherwise you won't get benefit from the tax deduction. If you are on an accrual basis, you do not need to pay before 12/31 to get the deduction but should still be making estimated tax payments to avoid any underpayment penalties.

Are there ways to project these benefits?

- Yes, we can run comparative tax projections to see what your benefits would be for making an entity-level election.

Biden Tax Plan

Firstly, this was the plan with the election, typically there are changes and modifications before anything gets passed into law.

- Impose a 12.4% Social Security tax for wages above $400K.
- Individual top tax rate increase from 37 to 39.6%
- Corporate tax rate increase to 28%
- Corporate minimum tax on book income (Corporations with book profit $100M or higher)
- Temporary increase of child tax credit and dependent tax credit
- Reduce estate tax exemptions to 2009 levels ($3.5M)

Year-end tax planning and Cash flow planning

- Defer income, accelerate expenses
- Update equipment/vehicles if necessary
- Entity Level Tax to Wisconsin
- Retirement plan contributions
- Method of accounting
- Depending on how seasonal your business is, cash flow planning is oftentimes involved as well with tax planning.

Q&A

Thank You!

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