

# Southern California Veterinary Medical Association Webinar

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# CAA 2021

The Consolidated Appropriations Act of 2021 (CAA) was signed into law on December 27, 2020.

Along with stimulus checks, increased unemployment benefits, and a variety of other items meant to help those in need, the law also provided some clarity on key issues relating to the Paycheck Protection Program (PPP).

# Topics Today

- PPP Loan Forgiveness and Expense Deductibility
- PPP Second Draw
- What else is in the New Stimulus Bill?
- What tax changes could be coming in the Biden years?
- And more...

# PPP Update

## Deductibility of PPP Expenses

- CAA provides that payroll and other allowable expenses paid for with PPP loan proceeds will be deductible for federal income tax purposes.
- This provision, which was the original intent of Congress when PPP was first introduced, effectively nullifies the IRS ruling from earlier this year which would have disallowed deductible business expenses paid for with PPP loan proceeds.

# PPP Update

## Deductibility of PPP Expenses

- This piece of the legislation has massive tax implications for PPP borrowers, all positive.
- As an example, a \$300,000 PPP loan could have resulted in additional taxes of \$90,000 for the borrower, assuming a 30% tax rate.
- Now, not only will the borrower likely have the PPP loan forgiven, but they also will be able to deduct the related expenses. Without question, this is a win-win.

# PPP Update

## Deductibility of PPP Expenses

### California/New York/Other States to Follow?

CAA applies to federal taxes only. However, it is expected, but not guaranteed, that most state taxing authorities will follow suit and allow the same deductions.

# PPP Update

## Deadline to Apply for Forgiveness

- Confusion as to when the deadline is to submit the PPP Forgiveness Application.
- As long as the borrower submits its loan forgiveness application within ten months of the completion of the Covered Period, the borrower will not be required to make any principal or interest payments to the SBA.

# PPP Update

## Deadline to Apply for Forgiveness

- So, as an example, if your Covered Period ended August 31, 2020, then your deadline is June 30, 2021.
- If the loan is fully forgiven, the borrower will not be responsible for any payments. If only a portion of the loan is forgiven, or if the forgiveness application is denied, any remaining balance due on the loan must be repaid by the borrower on or before the maturity date of the loan.



# PPP Update

## What to expect with forgiveness

In preparation of the forgiveness process, there are basically three “tests” that your business needs to pass to get loan forgiveness.

Test 1 - Involves proving that the funds you received were spent correctly. At least 60% needs to have been used on payroll related items, and under 40% needs to have been spent on non-payroll related costs.

Test 2 - Involves proving that your employee head count stayed the same or increased over this period.

# PPP Update

## What to expect.

In preparation of the application process, there are basically three “tests” that your business needs to pass to get loan forgiveness.

Test 3 – Proving that you didn’t cut salaries or hourly rates for any of your employees during this period. So far, this doesn’t seem to be a problem for anyone.

# PPP Update

## Easier Forgiveness Process for Smaller Loans

- CAA creates a simplified forgiveness process for loans of \$150,000 or less.
- Application must still be submitted, but it will essentially be a one-page certification.
- Required to submit:
  - # of employees retained
  - \$ spent on payroll costs
  - \$ of the original loan.

# PPP Update

## Easier Forgiveness Process for Smaller Loans

- No supporting documentation will need to be submitted, but you must retain these records for up to four years.
- The SBA has been ordered to create the simplified form within 24 days of the bill's signing, which would be middle of January.

# PPP Update

## Easier Forgiveness Process for Smaller Loans

Why?

Loan Size	Loan Count	Net Dollars	% of Count	% of Amount
\$50K and Under	2,943,201	\$54,321,982,874	64.9%	10.6%
>\$50K - \$100K	655,007	\$46,652,835,938	14.5%	9.1%
>\$100K - \$150K	284,657	\$34,851,771,625	6.3%	6.8%
>\$150K - \$350K	369,737	\$83,081,546,207	8.2%	16.2%
>\$350K - \$1M	197,098	\$112,146,690,696	4.3%	21.9%
>\$1M - \$2M	52,578	\$72,838,506,833	1.2%	14.2%
>\$2M - \$5M	24,788	\$73,686,354,483	0.5%	14.4%
>\$5M	4,817	\$33,802,483,324	0.1%	6.6%

“Rubber Stamping” forgiveness for all loans under \$150,000 would reduce application process for close to 3.9 million loans (about 86% of total), while only covering about 27% of the funds lent.

# PPP Update

## Forgiveness for Loans over \$150,000

Use the “simplified” SBA Form 3508EZ Forgiveness Application, if one of these three statements applies:

1. The borrower is a self-employed individual, independent contractor, or sole proprietor who had no employees at the time of the PPP loan application and did not include any employee salaries in the computation of average monthly payroll in the original PPP loan application;

# PPP Update

## Forgiveness for Loans over \$150,000

Use the “simplified” SBA Form 3508EZ Forgiveness Application, if one of these three statements applies:

2. The borrower did not reduce the annual salary or hourly wages of any employee by more than 25 percent during the Covered Period; and the borrower did not reduce the number of employees or the average paid hours of employees between January 1, 2020 and the end of the Covered Period. (Reductions can be ignored if employees refused to come to work, were terminated for good cause, left voluntarily, or cut their hours voluntarily;

# PPP Update

## Forgiveness for Loans over \$150,000

Use the “simplified” SBA Form 3508EZ Forgiveness Application, if one of these three statements applies:

3. The borrower did not reduce annual salary or hourly wages of any employee by more than 25 percent during the Covered Period; and the borrower was unable to operate during the Covered Period at the same level of business activity as before February 15, 2020, due to compliance with safety or governmental requirements (such as the closing of a non-essential business, or reduction in services because social distancing requirements).



# PPP Update

## Other PPP Changes

- The Covered Period is the time period allowed for borrowers to spend their PPP loan proceeds on qualified expenses. The new law allows borrowers to choose a “Covered Period” of 8 or 24 months, depending on which is more appropriate.
- Also expands what expenses can be included in the forgiveness calculation. Before, only payroll costs and certain mortgage, rent, and utility expenses were allowed. Now, also:
  - Coronavirus supply costs (like cleaning supplies)
  - Related facility modifications
  - Personal protective equipment required for safety can now be included.

# PPP Update

## PPP Loans and the Sale of a Business

- On October 2, the SBA issued guidelines regarding PPP loans and the sale of a business. These guidelines address both the sale of business stock (20% or more) and the sale of business assets (50% or more).
- If, prior to closing on a business sale, the PPP loan has been repaid or forgiven, then there isn't an issue. However, if a sale is pending and the PPP loan hasn't been forgiven, then the PPP lender must be notified in writing ahead of time and provided copies of the sales documents.

# PPP Update

## PPP Loans and the Sale of a Business

- Under this scenario, the lender may then approve the sale without the SBA's consent, if:
  - The borrower has used all of its PPP loan funds appropriately;
  - The borrower has submitted to the lender a complete loan forgiveness application, and;
  - The borrower has established an interest-bearing escrow account controlled by the PPP lender with an amount of funds equal to the amount of the PPP loan outstanding. This escrow account must state that these funds go to repay any remaining PPP loan balance, *plus* interest, if any amounts under the PPP loan are not forgiven.

# PPP Update

The Treasury Department has identified the borrowers who received loans of \$150,000 or more.

The link for this borrower data is below:

<https://home.treasury.gov/policy-issues/cares-act/assistance-for-small-businesses/sba-paycheck-protection-program-loan-level-data>

# PPP Second Draw

The new law also provides loan funds for smaller and harder-hit businesses that had previously received PPP funding.

Doubtful most veterinary practices will qualify for loan this time around.

Sole proprietors, independent contractors, and some self-employed individuals eligible.

Requirements are much stricter.

# PPP Second Draw

## Details:

- Businesses must employ less than 300 employees
- Demonstrate a drop in revenues of at least 25% during the first, second, or third quarter of 2020, compared to the same quarter of 2019.
- Second-time PPP borrowers can borrow an amount equal to 2.5 times their average monthly payroll costs.
- SBA to establish regulations on small-business support no later than 10 days after the legislation is signed into law. The program will officially reopen and run through March 31, 2021.

# Other Stimulus Components

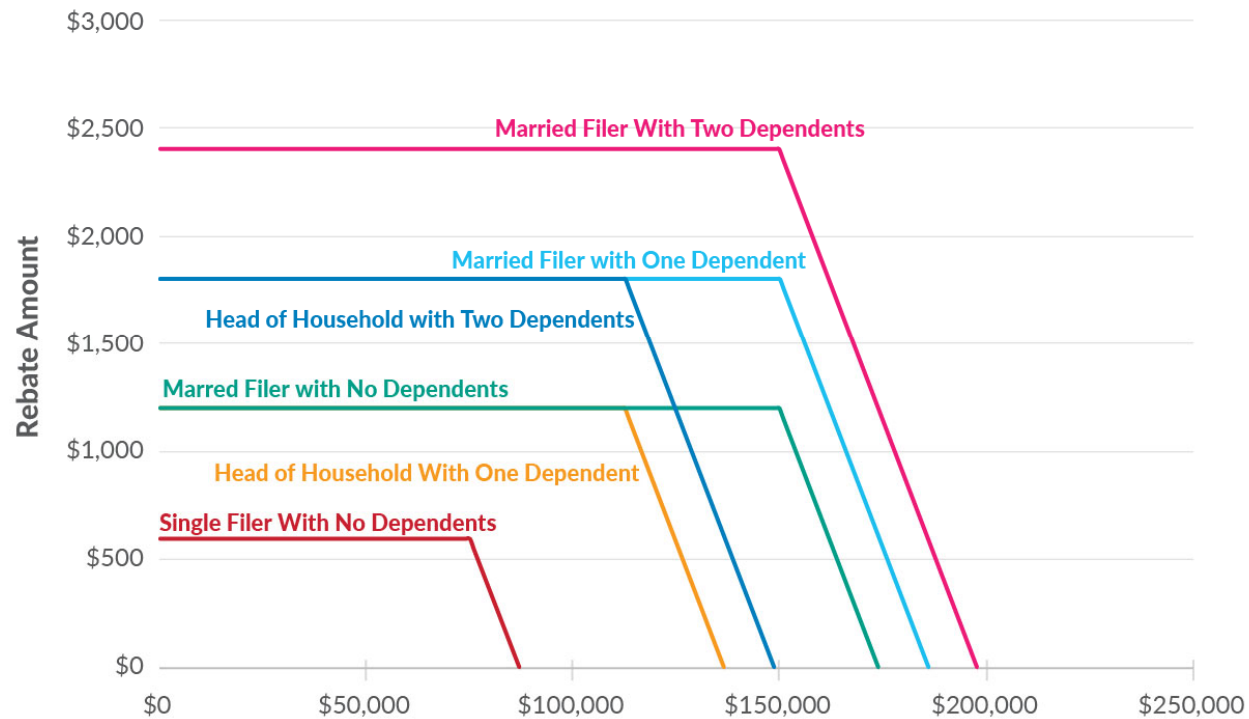
Contains a second round of direct payments to individuals.

- The direct payments would be up to \$600 (maybe \$2,000?) per individual and qualified child, with no cap on household size.
- Adult dependents are not eligible.
- Designed similarly to the previous rebates: advanced tax credits based on 2019 income
- Phase outs begin at \$75,000 for single filers, \$112,500 for heads of household, and \$150,000 for those married filing jointly.
- Phased out entirely at \$87,000 for single filers with no qualifying dependents and \$174,000 for those married filing jointly with no qualifying dependents.

# Other Stimulus Components

## Relief Rebates in the New Coronavirus Relief Package, Dec. 2020

Individual Economic Relief Rebate by Filing Status



Source: Consolidated Appropriations Act, 2021.

TAX FOUNDATION

@TaxFoundation



# Other Stimulus Components

Above-the-line charitable contribution is extended through 2021 at \$600 for those married filing jointly and \$300 for other filers.

Taxpayers will be able to take the standard deduction and deduct up to \$600 in charitable giving. For the 2020 tax year, taxpayers could deduct up to \$300 above-the-line for charitable contributions.

# Other Stimulus Components

Adjustments to how the Child Tax Credit and the Earned Income Tax Credit are calculated for the 2020 tax year.

Many individuals eligible for those credits have earned lower incomes due to job loss or underemployment. This may reduce the credits they are eligible for when filing taxes next spring.

This provision would use 2019 income to determine an individual's credit eligibility for the 2020 tax year.

# Potential Biden Tax Changes

Likelihood of major changes depends on:

- Which party controls Senate - Georgia run-offs – happening now
- Economic Health of Country – Higher Taxes Smart?
- COVID – Other Priorities
- If passed, effective 2021 v 2022?
- If passed mid-year, retroactive?
- Easy targets first?

# Potential Biden Tax Changes

## What's in Biden Plan?

- \$400,000 seems to be the central number inside the proposed Joe Biden tax plan.
- Has stated repeatedly that those with taxable incomes of under \$400,000 will not see a tax increase
- Those with incomes above that threshold could see higher taxes of varying degrees.

# Potential Biden Tax Changes

So, what does this mean? For those with taxable incomes above \$400,000, expect:

- Higher ordinary income tax rates,
- Additional payroll taxes
- Capped itemized deductions
- Phase out of Qualified Business Income deduction.

# Potential Biden Tax Changes

## Top Income Tax Rate

Plan to increase the top income tax rate from 37% to 39.6% for those with taxable incomes above \$400,000.

It is unclear on whether this \$400,000 threshold is across the board, or whether it will vary depending on your filing status. (Single, Married-Filing-Joint, Head-of-Household).

# Potential Biden Tax Changes

Keep in Mind...

These taxable income thresholds aren't all or nothing. You only pay tax at the higher rate on the income that exceeds the corresponding threshold.

# Potential Biden Tax Changes

## Social Security Tax

Currently, a 12.4% social security tax is imposed on employees earning \$137,700 or less. This “payroll” tax is split evenly between the employee and employer. For those who are self-employed, the entire 12.4% is paid by the sole-proprietor.

Under the Biden Proposal, the 12.4% tax would kick back in for those earning above \$400,000. The changes would look something like this:

- Wages/Self-Employed Earnings: \$0 - \$137,700 – SS Tax of 12.4%
- Wages/Self-Employed Earnings: \$137,701- \$399,999 – No SS Tax
- Wages/Self-Employed Earnings: \$400,000 and above – Resumption of SS Tax of 12.4%



# Potential Biden Tax Changes

## Social Security Tax

For shareholders in S Corporations, attempt to keep W2 wages under that \$400,000 threshold.

Unclear whether the Obamacare Medicare surtax of 0.9% on wages or self-employment income would continue to apply.

# Potential Biden Tax Changes

## Long-Term Capital Gains/Qualified Dividends

Currently, Long-Term Capital Gains and Qualified Dividends are taxed at 15% or 20%.

Under the Biden Proposal, for those with income of over \$1 million, these items would be taxed at the increased ordinary income tax rate of 39.6%.

Unclear whether Long-Term Capital Gains generated from the sale of a business would be included in this. It is possible that gains from the sale of a business, because it is typically a once-in-a-lifetime event for the taxpayer, would be excluded.

Also unclear whether the Obamacare Net Investment Income surtax of 3.8% would continue to apply.

# Potential Biden Tax Changes

## Deductions on State and Local Taxes/Property Taxes

Currently, a total deduction of \$10,000 is the maximum permitted for personal state income and home property taxes.

This is a very low number for most taxpayers, but especially those who live in states with high tax rates and/or high property values (like California).

# Potential Biden Tax Changes

## Deductions on State and Local Taxes/Property Taxes

### Example:

State Income Taxes	\$ 28,000
Real Estate Taxes	<u>\$ 12,000</u>
Total	\$ 40,000

Amount Deductible \$ 10,000

**Amount Lost \$ 30,000**

# Potential Biden Tax Changes

## Deductions on State and Local Taxes/Property Taxes

Under the Biden Proposal, these deductions could be restored.

The current limitation on property taxes only relates to your personal residence(s). It does not apply to any rental property you might own.

# Potential Biden Tax Changes

## Caps on Itemized Deductions

For those with taxable incomes above \$400,000, the taxable benefit of your itemized deductions will be limited to 28 percent (even if you're in a higher tax bracket), with additional phase-outs also possible.

# Potential Biden Tax Changes

## Qualified Business Income Deduction

Currently, individuals are allowed to deduct 20% of “qualified business income” (Section 199A) from a partnership, S corporation, or sole proprietorship.

The deduction is disallowed for specified service trades or businesses with income above a certain threshold.

Under the Biden Proposal, those with taxable incomes over \$400,000 would see a phase out of this qualified business income deduction.

Remember, a pass-through entity is considered to be a sole proprietorship, an S-Corporation, or a partnership (LLC/LLP). Employees are not eligible.

# Potential Biden Tax Changes

## Other Potential Changes

- Eliminate 1031 Exchanges (Real Estate) for those with higher taxable incomes;
- Reestablish First-Time Homebuyers' Tax Credit of up to \$15,000;
- Expand Dependent Care Tax Credit and Child Tax Credit;
- Restore estate and gift tax rates and exemption to 2009 levels;
- Restore full Electric Vehicle Tax Credit;



# Potential Biden Tax Changes

Keep in Mind...

Smaller estates may have tax implications. Currently \$11.2 million. Before, it was \$5.5 million;

Prior estate planning (children's trusts, planned gift giving) now being reconsidered?

# Taxes on Sale of a Practice

## Seller Tax Impact

- Drugs and Supplies – Ordinary Income Rates
- Accounts Receivable – Ordinary Income Rates
- Equipment/Furnishings/Fixtures – Ordinary Income Rates
- Covenant not to Compete – Ordinary Income Rates
- Goodwill – Capital Gain Rates
- Patient Records – Capital Gain Rates

# Taxes on Sale of a Practice

## Buyer Tax Impact

- Drugs and Supplies – Ordinary Expense
- Accounts Receivable – Non-taxable as you collect
- Equipment/Furnishings/Fixtures – 179 Expense, or depreciate over 5 or 7 years
- Covenant not to Compete – Amortize over 15 years
- **Goodwill – Amortize over 15 years**
- **Patient Records – Amortize over 15 years**

# Taxes on Sale of a Practice

## Seller Tax Impact - Example

- Drugs and Supplies – 45% (Fed and Cal)
- Accounts Receivable – 45% (Fed and Cal)
- Equipment/Furnishings/Fixtures – 45% (Fed and Cal)
- Covenant not to Compete – 45% (Fed and Cal)
- Goodwill – 30% (Fed and Cal)
- Patient Records – 30% (Fed and Cal)

# Taxes on Sale of a Practice

## Seller Example 1

	<u>Price</u>	<u>Tax</u>
Drugs and Supplies	\$ 25,000	\$ 11,250
Equipment/F&F	\$ 50,000	\$ 22,500
CNTC	\$ 100,000	\$ 45,000
Goodwill	\$ 700,000	\$ 210,000
Patient Records	\$ 125,000	\$ 37,500
Total	\$1,000,000	\$ 326,250

Tax Percentage 32.6%

# Taxes on Sale of a Practice

## Seller Example 2

	<u>Price</u>	<u>Tax</u>
Drugs and Supplies	\$ 75,000	\$ 33,750
Equipment/F&F	\$ 150,000	\$ 67,500
CNTC	\$ 250,000	\$ 112,500
Goodwill	\$ 325,000	\$ 97,500
Patient Records	\$ 200,000	\$ 60,000
Total	\$1,000,000	\$ 371,250

Tax Percentage 37.1%

# Taxes on Sale of a Practice

Taxes Paid – Example 1                      \$ 326,250

Taxes Paid – Example 2                      \$ 371,250

Difference in Tax                              \$ 45,000

# Taxes on Sale of a Practice

## Buyer First Year

	<u>Ex # 1</u>	<u>Ex # 2</u>
Expense - Drugs and Supplies	\$ 25,000	\$ 75,000
Depreciation - Equipment/F&F	\$ 30,000	\$ 50,000
Amortization - CNTC	\$ 6,667	\$ 16,667
Amortization - Goodwill	\$ 46,667	\$ 21,667
Amortization - Records	\$ 8,333	\$ 13,333
Total	\$ 116,667	\$ 176,667

Difference Deductions/Tax

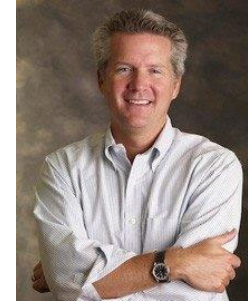
\$60,000/\$24,000



# Audits

Business/specialty taxpayer types, in descending likelihood of audit	Returns audited
Large corporations (Form 1120, assets greater than \$5 billion)	1 in 3
Estate tax returns	1 in 12
Large corporations (Form 1120, assets between \$10 million and \$5 billion)	1 in 23
Excise tax returns	1 in 72
Gift tax returns	1 in 130
Small corporations (Forms 1120, not 1120-S)	1 in 146
<b>OVERALL CORP/PARTNERSHIP AUDIT RATE</b>	1 in 224
Partnership returns (Form 1065)	1 in 260
Estate and trust income tax returns (Forms 1041)	1 in 971
Employment tax returns (Forms 940 and 941)	1 in 568
S corporation returns (Forms 1120-S)	1 in 358

## Tom A. McFerson, CPA, ABV



- Mr. McFerson is the managing partner at Gatto McFerson, CPAs, a veterinary-focused financial and consulting firm located in Santa Monica, California.
- He is accredited in business valuations by the American Institute of Certified Public Accountants, and is a former director and active member of VetPartners.
- Mr. McFerson is a speaker at local and national conferences, a frequent author for Veterinary Economics and other trade publications, and oversees the publication of the monthly California Veterinary Economic Report.

# Questions?



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