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Monthly Updates

September 2020

PPP Update: Two New Rules for Owners of S and C Corporations

The PPP rules are still changing.

During the past month, the SBA issued a new set of frequently asked questions (FAQs) and a new interim final rule, which in combination create the following good news for the PPP:

- **More forgiveness.** The $20,833 cap on corporate owner-employee compensation applies to cash compensation only. It's not an overall compensation limit as the SBA had stated in its prior interim guidance. Under this new rule, the owner-employee can add retirement benefits on top of the cash compensation, creating a new higher cap.

- **Escape owner status.** You are not an owner-employee if you have less than a 5 percent ownership stake in a C or an S corporation. Therefore, the cap on forgiveness for this newly defined non-owner-employee is not $20,833 but rather $46,154.

The new rules override prior guidance and have significance for PPP loan forgiveness today—and perhaps for obtaining additional loan monies retroactively (if Congress reinstates the PPP along with a round for businesses that suffered a big drop in revenue).

Here's one example of how the new rules benefit John, an S corporation owner.

Example. John, the sole owner and worker, operates his business as an S corporation. His 2019 W-2 shows $140,000 in Box 1, of which $20,000 is for health insurance. In addition, the S corporation pays state unemployment taxes of $500 on John's income and contributes $20,000 to his pension plan.

Based on the facts in the example, the corporation is eligible for up to $25,000 of PPP loan forgiveness, as follows:

- $20,833 on John's salary (the cap), which the corporation pays to John at his regular rate in less than 10 weeks during the covered period;

- $4,167 on John's retirement ($20,000 x 20.83 percent); and

- zero on the unemployment taxes because they were paid out in January, before the covered period began.

Advantage. Prior guidance limited forgiveness to $20,833. John's S corporation gains $4,167 in additional forgiveness thanks to the new FAQs, assuming that the S corporation's loan amount is $25,000 or more (which is possible).

The good news in the new guidance is that the corporate retirement contributions on behalf of owner-employees now count for additional forgiveness when the owner-employee has cash compensation greater than $100,000. And with the C corporation, the new guidance allows health insurance for the owner-employee.

PPP Loan Forgiveness Applications

We want to keep you updated on PPP loan forgiveness and help you prepare for the application process with us. We continue to hold off preparing PPP loan forgiveness applications while we await potential changes from the SBA that may streamline the PPP loan forgiveness process. Rest assured, we will let you know when you should apply for PPP loan forgiveness. Also, many Banks have not opened their portals for forgiveness.

Remember, there is still plenty of time to apply.

Your business has up to 24 weeks to spend PPP loan funds (or you are still allowed to use the original 8-week covered period).

Also, the deferral period for payments of principal and interest on any part of PPP loans not forgiven has been extended to 10 months after the end of the 8- or 24-week covered period, so there is plenty of time to apply for PPP loan forgiveness.

The Importance of Keeping a Mileage Log

What is the unpardonable sin in an IRS audit?

Suppose you just received a letter from the IRS telling you that you are the subject of an IRS audit. What one record receives special attention? What one record can create a nightmare for you? What one record makes the IRS suspect that you are the keeper of lousy records?

Think of the record you most hate keeping. That's the one we are talking about. You have probably guessed what that record might be.

Red-Flag Record for the IRS Examiner

Once your audit examination begins, the examiner likes to see this record. If the record is missing or lacking, the IRS examiner knows that your other records probably are lacking, too. This record—the one you probably hate keeping—is the mileage log on your vehicle or vehicles.

The IRS notes that a taxpayer's failure to keep a mileage log on vehicles indicates that the activity under examination is not being conducted in a businesslike manner.

Do as the Tax Form Says

As a one-owner or husband-and-wife-owned business, regardless of whether it's a corporation, a partnership, or a proprietorship, you file a tax form that asks you for the following information about your vehicles:

1. Do you have evidence to support the business/investment use claimed? (If "yes," is the evidence written?)
2. List your total business/investment miles on each vehicle.
3. List your total commuting miles on each vehicle.
4. List your total personal miles on each vehicle.

IRS Form 4562 has columns for answers to the above questions for up to six vehicles used by either a sole proprietor or an owner of more than 5 percent of a corporation, a partnership, or another entity. The mileage log is the record of proof that you need to use for your answers to the tax form questions.

Do What the Audit Would Require

Above, we said to do as the IRS form says. For additional clarification, it is good to know what information the IRS, in a correspondence audit, requires you to provide related to that tax form:

1. Send copies of repair receipts, inspection slips, and other records showing total mileage for the year.
2. Send copies of logbooks and other records to support the business mileage claimed.
3. Provide a copy of your appointment book or calendar of business activities for the year.
4. If you are claiming actual expenses, provide copies of paid bills, invoices, and canceled checks for automobile expenses. These would include gas, oil, tires, repairs, insurance, interest, tags, taxes, parking fees, and tolls.
5. Send a copy of the bill of sale or other verification to establish your basis in the vehicle, including the trade-in of another vehicle.

Note that the IRS is looking for

- a match of the repair bill odometer reading with the mileage in your logbook;
- a match of the inspection slip odometer reading with the mileage in your logbook;
- the mileage between repair stops, to see whether that ties in with your claimed mileage; and
- a business purpose that ties in with your appointment book or other calendar of business activities.

Takeaways

If you want to avoid big trouble during an IRS audit, keep a good mileage log. This takes just minutes a day.

The mileage log is often one of the first records that an IRS examiner will look at. A good mileage log shows that you know the rules and you respect them. Many IRS audits end favorably and quickly upon presentation of a good mileage log.

Thinking of Moving to a Lower-Tax State? Tax Angles to Consider

If you're considering moving to a different state, taxes in the new state may be the deciding factor—especially if you expect them to be lower.

Consider All Applicable State and Local Taxes

If your objective is to move to a lower-tax state, it may seem like a no-brainer to move to one that has no personal income tax. But that's *not* a no-brainer!

You must consider all the taxes that can potentially apply to local residents—including property taxes and death taxes.

One Case Study

Texas is "famous" for having no personal state income tax, while Colorado has a flat 4.63 percent personal state income tax rate. So, you might reasonably think it would be much cheaper taxwise to live in Texas than Colorado if you have a healthy income. Not necessarily! Here's why.

The property tax rate on a home in some Colorado Springs locales is about 0.49 percent of the property's actual value, as determined by the county assessor. Say you move to one of these areas and buy a $500,000 home. Your annual property tax bill would be about $2,450.

Say your taxable income is $200,000. Your Colorado state income tax bill would be $9,260. Your combined property tax bill and state income tax bill would be about $11,710 ($2,450 + $9,260).

According to the Dallas Central Appraisal District's online property tax estimator, the annual property tax bill on a $500,000 home in some Dallas locales would be about $21,200, or about $17,800 if you're over 65 or a surviving spouse. You would have no state income tax bill.

In most areas within both Colorado Springs and Dallas, the combined state and local sales tax rate is 8.25 percent, so no difference there.

So the relevant comparison for property and income taxes is $11,710 in Colorado Springs and about $21,200 (or $17,800 if you're over 65 or a surviving spouse) in Dallas.

But if your income is really high, it could be the other way around—assuming you don't buy a really expensive home in Dallas.

Defang the State Tax Domicile Issue

If you decide to make a permanent move to a lower-tax state, it's important to establish legal domicile there in order to decouple yourself from taxes in the state you came from.

The exact definition of "legal domicile" varies from state to state. In general, your domicile is your fixed and permanent home location and the place where you plan to return, even after periods of residing elsewhere.

Because each state has its own rules regarding your domicile, you could wind up in the worst-case scenario—with two states claiming that you owe state taxes because you established domicile in the new state but did not successfully terminate domicile in the old state.

Finally, if you die without clearly establishing domicile in just one state, both the old and new states may claim that state death taxes are owed. Not good!

Section 179 Expense Deductions

Okay, so you took the big Section 179 expensing deduction on your vehicle.
How do you keep it? You might wonder: What do we mean by "keep it"?

In tax law, there's no free lunch. The Section 179 deduction comes with "recapture strings" attached.

When you claim your Section 179 deduction, you make a deal with the government to keep your business use above 50 percent during the "designated" depreciation periods (five years for vehicles).

One Sad Story

In 2018, Jerry Jackson claimed a $53,000 Section 179 deduction on a qualifying pickup truck. In 2020, Jerry's wife drives the truck and Jerry's business use drops to zero.

Jerry violated his 50 percent business-use agreement with the government. Now he has phantom income to report (called "recapture"), and he's going to pay the price for breaking his tax promise on the Section 179 deal.
The pickup truck is listed property. This means that Jerry must recompute his allowable deductions using the ADS straight-line depreciation tables, which will result in the following:

- $5,300 deduction (10 percent of $53,000) in 2018
- $10,600 deduction (20 percent of $53,000) in 2019

In 2018, Jerry deducted his 90 percent business cost ($53,000) using Section 179. But now, with recapture, his ADS straight-line depreciation for 2018 and 2019 totals only $15,900 ($5,300 + $10,600).

So in 2020, the year of violation, tax law recaptures $37,100 ($53,000 - $15,900). Jerry must report the 2020 recapture income on the same form or line on which he (or his corporation) claimed the original $53,000 deduction in 2018.

For example, say Jerry operates as a proprietor who claimed his 2018 Section 179 deduction on Schedule C. In 2020, he reports the recapture income as other income on Schedule C.

Holy smokes! On Schedule C, that means the Section 179 recapture is going to create self-employment taxes. Correct! The original Section 179 deduction reduced self-employment taxes.

On his recapture income, Jerry gets the double whammy: increased income and self-employment taxes.

Traps to Consider

Retirement. Are you going to retire? Will retirement bring your business use to zero?

Children. Do your children drive your business vehicle(s)? Will their driving bring your business use to 50 percent or less?

Spouse. Does your spouse drive your business vehicle for personal purposes? Will your spouse's mileage drop your business use to 50 percent or less?

Personal use. Are you converting Section 179 assets, such as a vehicle, to personal use? Does the conversion to personal use occur during the recapture period?

August 2020 Jobs Report

As usual, the monthly employment report dominated the headlines and the interest of most analysts and investors last week. Payroll employment increased by 1.4 million net new jobs in August. That was a decline from 1.7 million jobs in July.

Let's take a closer look at the details of the jobs report:

• Goods-producing jobs – increased by just 43,000. The manufacturing sector continues to be weak and is likely to remain so going forward.

• Service sector jobs - generally low wage with few benefits -showed an increase of 1,328,000. About 300,000 of those jobs were connected with the 2020 census, and they will be eliminated at the end of September.

• Average hourly earnings – jumped 0.4%, the biggest monthly gain since April.

• Unemployment rate – dipped to 8.4%, a strong number, especially since the labor force increased by 968,000 workers in August.

Overall, we're gaining back many of the jobs that we lost since the virus pandemic that really hit home in February and March of this year. We're really not adding many new jobs.

Finally, the nation's trade deficit jumped sharply to -$63.6 billion in July, up from -$50.5 billion in June. The increased trade deficit will take a bite out of GDP for the third quarter.

Changing Tax Laws

Federal taxes, including taxes that effect estate planning, may again be changed by Congress after the November 2020 election. Both Republicans and Democrats have spoken about reforming the federal tax laws after the election. Additionally, there have been proposals in California (which have not yet become law) to increase California's income tax rates on high earners, to modify the property tax laws, and to impose a new type of tax on a California resident's wealth.

1. Federal Gift and Estate Tax Laws May Change

After the 2016 election, under the *Tax Cuts and Jobs Act of 2017*, the unified federal gift and estate tax exclusion amount (known as the **"Gift and Estate Tax Exemption"**) increased so that in 2020 (after considering adjustments for inflation) it is now $11,580,000 per person (or a total of $23,160,000 for a married couple). This exemption can be utilized by clients for lifetime gifts or at the client's death to leave assets to their families and beneficiaries. Currently, the estate and gift tax for amounts over this exemption (given during lifetime or at death) are subject to a top marginal 40% federal tax rate. For assets that clients leave to their grandchildren or that are left in a manner that "skips a generation" there is an additional generation-skipping tax of 40% (plus a generation-skipping tax exemption that applies to such transfers which is the same amount as the current Gift and Estate Tax Exemption of $11,580,000 per person).

Under current tax laws, these exemptions for both the federal estate and gift taxes and for the generation-skipping tax, are scheduled to revert to their prior 2018 levels in January 2026.

This Gift and Estate Tax Exemption amount is currently the highest it has ever been in history. Clients need to be aware that after this upcoming November election, Congress may choose to enact tax legislation to have this Gift and Estate Tax Exemption amount revert to its prior levels (or an even lower amount) sooner than January 2026, and that estate and gift tax rates may be increased.

Furthermore, there have been discussions to eliminate the current step-up in income tax basis of assets at death under Section 1014. The step-up in tax basis rule has been a part of federal tax law since the inception of the U.S. income tax, although for a brief time period in the late 1970s there was a temporary carryover of an asset's income tax basis at death. A repeal of the step-up in income tax basis tax rule would effectively cause an income tax increase to those persons who inherit property at a family member's death.

Even if the current $11,580,000 Gift and Estate Tax Exemption is reduced by Congress in the future, gifts made prior to its reduction will still be recognized at death under current tax laws. In other words, the Treasury Regulations specifically state that there is no "clawback" of the previously used exemption when the donor dies, even if that donor has made gifts previously in excess of the Gift and Estate Tax Exemption amount in effect at that donor's death.

In addition to the Gift and Estate Tax Exemption, each individual in 2020 may gift $15,000 per calendar year to any number of donees without incurring a gift tax. Thus, under this annual gift tax exclusion, a married couple may gift up to $30,000 per year per donee, gift tax-free. Under current law this $15,000 amount increases for inflation. Additionally, amounts may be given gift tax-free for a donee's tuition and medical expenses.

Clients who want to take advantage of the current high Gift and Estate Tax Exemption amount and lower transfer tax rates should be proactive and take action now to transfer their wealth to lower family generations levels. Even though any federal tax legislation under a new Congress is likely not to be enacted until February or March 2021 at the earliest, Congress could make the effective date of such a tax change back to January 1, 2021. In addition, many estate planning transfers and planning techniques require valuation appraisals, and enough time may be needed to obtain such appraisals.

2. Estate Planning Techniques for Clients to Consider

Clients who make gifts of significant wealth to family members not only take advantage of the current high Gift and Estate Tax Exemption amount and the current low gift and estate tax rates, but also can shift future appreciation and taxable income to those family members. Sophisticated estate planning methods can take advantage of the current low interest rates. For example, the September 2020 long term AFR interest rate is 1%, and the Grantor Retained Annuity Trust (known as a "GRAT") has a favorable low interest rate of 0.4% for September 2020. Using these low interest rates allows clients to use irrevocable "grantor" trusts to transfer assets gift tax-free to younger generations. Under a grantor trust (sometimes known as a "defective income trust") all of the trust's taxable income and deductions flow through to the parents for income tax purposes, but the appreciation in those grantor trust assets goes gift and estate tax-free to the children and grandchildren. Grantor trusts are effective tax planning devices since the parents continue to pay the income taxes on the income, business earnings and dividends that, in fact, go to the client's children and grandchildren (resulting in the children and grandchildren receiving more assets).

Parents transferring assets today to lower level family members not only removes those assets from the parents' taxable estate for federal gift and estate tax purposes, but any of those assets' subsequent income or appreciation inures to the benefit of the clients' children and grandchildren. Gifting and selling assets to irrevocable trusts (grantor trusts and other types of trusts) for children and grandchildren can also have the added advantage of shielding those assets from the children's and grandchildren's creditors and protecting those assets in the event of divorce.

3. New California Legislative Proposal to Increase California's State Income Tax Rates

Currently, California taxpayers in the highest tax bracket of 13.3% pay the highest income tax rate of any state (California does not have a lower capital gains tax). Assembly Bill 1253 which is now pending in the California state legislature would increase California's income tax rates even higher. Assembly Bill 1253's proposal is to tax higher earning California taxpayers by imposing an additional income tax as follows: 1% for taxable incomes over $1,181,484; 3% for taxable incomes over $2,362,968; and 3.5% for taxable incomes over $5,907,420. Thus, the wealthiest California taxpayers would pay a California income tax of 14.3% on their taxable incomes over $1,181,484 and 16.8% on their taxable incomes over $5.907 million. As an example, a California resident earning more than $5.907 million would pay a combined 53.8% tax rate of federal and California income taxes at this highest tax bracket. Additionally, there is the current 3.8% federal net investment income tax under the Medicare rules. Under this proposed California tax legislation in its current form these increased California income tax rates would apply retroactively to January 1, 2020.

If these proposed high California state income tax rates are enacted into law then they will have an especially detrimental tax effect since current federal income tax rules makes state income taxes nondeductible above a $10,000 cap amount.

4. New California Legislative Proposal to Tax a Client's Wealth

There was introduced into the California's legislature a new proposal to impose a tax on the amount of a California resident's wealth. California currently has no state level estate or inheritance tax, which has been the case since June 1982 when the California state inheritance tax was repealed by a ballot measure. However, in recent years legislation has been introduced (which has never been passed) into the California legislature to attempt to reenact the California inheritance tax. Now, additionally, a new proposed wealth tax (to apply to California residents while alive) was introduced on August 13, 2020 into the California State Assembly (but has not been passed) to impose a 0.4% annual tax on a resident's worldwide net worth over $30 million (or $15 million for married taxpayers filing separately). This wealth tax is aimed at wealthy California residents and is intended to be an annual tax based upon a person's net worth. Under this proposed wealth tax once a person becomes a resident of California, if that person then later leaves the state that person will still have this wealth tax imposed on a fraction of their wealth in excess of $30 million for up to ten (10) years after leaving California (note that there are federal constitutional issues as to whether such a wealth tax would be enforceable if it were ever enacted into law by the State of California). If this wealth tax were enacted, it would discourage wealthy persons from remaining residents of California and would discourage wealthy persons and businesses from moving into the State of California.

5. Proposals on the November 2020 Ballot Which Will Increase California Property Taxes

Currently, under Proposition 13 real property assessed values for purposes of property taxes are limited to increases of no more than 2% each year, except where there is a “change of ownership” of that property. A “change of ownership” can trigger a reassessment of the real property unless there is a specific property tax exemption that applies.

One of the current California property tax exemptions preventing a change of ownership is where a principal residence is transferred between parents and their children. Additionally, currently there is an exemption for $1 million of assessed value of real property being transferred between a parent and their children. These parent-child property tax exemptions have proven invaluable as estate planning tools, enabling clients to transfer their California real estate (such as their principal residence) to their children without having that property reassessed for property tax purposes. However, other than the parent’s principal residence, California Proposition 19 on the November 2020 ballot proposes to eliminate the $1 million exemption for parents transferring other properties to their children. Additionally, Proposition 19, if passed, would place limitations on the parent-child exemption for transfers of a principal residence between parents and children, by limiting this exemption to the amount of $1 million plus the amount of that residence’s assessed value on the date of transfer (this $1 million limit amount would be adjusted annually by an index rate). Furthermore, Proposition 19, if passed by the voters, would also require that the transferee child continue to use that residence as their principal residence in order to be entitled to apply this exemption from a change of ownership.

Thus, if Proposition 19 passes it will have a negative effect on a parent’s ability to transfer their California real estate to their children and avoid reassessment of that property for property tax purposes. Clients could consider transferring now in 2020 their real estate to their children in order to avoid proposed Proposition 19’s restrictions.

Additionally, also on the November 2020 ballot is Proposition 15, which if passed, would produce a split-roll for California real property effective January 1, 2022. Proposition 15 would require that commercial and industrial property, and vacant land not zoned for residential use and not used for commercial agricultural production, to be reassessed every three years to that property’s full market value.

Our Network

If you would like a second opinion regarding your Estate Plan or Financial Investing please contact us. We have attorneys and financial advisors ready to help.