Tax Planning for 2023 and Beyond

Southern California Veterinary Medical Association
Webinar
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Tom A. McFerson, CPA, ABV

- Mr. McFerson is the primary shareholder at Gatto McFerson, CPAs, a veterinary-focused financial and consulting firm located in Los Angeles, California.
- He is accredited in business valuations by the American Institute of Certified Public Accountants, and is a former director and active member of Vet Partners.
- Grew up in Fresno, California.
- Graduated from Loyola Marymount University in Los Angeles, California.
- Outside of work, Tom plays a lot of tennis, is an active dad with his three kids, and loves to travel with his wife and family, which includes two lovable labs.

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Before we get into taxes…

California Disaster Relief

IRS Penalty Letters

Employee Retention Credits

Pass-Through Entity Credit

State of the Veterinary Economy

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California Disaster Relief

On the morning of the final tax due date - October 16, 2023 - the IRS granted a last-minute, one-month additional extension to most California taxpayers.

The *final…final* due date is now November 16, 2023, and it applies to taxpayers that reside in 55 of California's 58 counties – all except Lassen, Modoc, and Shasta.

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California Disaster Relief

As before, the eligible returns/payments are as follows:

- Individual income tax returns, originally due on April 18, 2023;
- Various business returns (S-Corporations, C Corporations, Partnerships, Limited Liability Companies, Trusts) normally due on March 15, 2023 and April 18, 2023;
- Tax-exempt organizations, normally due on May 15, 2023;
- For California business owners, passthrough entity elective tax payments due on March 15, 2023 and June 15, 2023;

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California Disaster Relief

As before, the eligible returns/payments are as follows:

- Estimated tax payments for the 4th quarter of 2022, originally due on January 17, 2023;
- 2023 estimated tax payments, normally due on April 18, June 15 and September 15;

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California Disaster Relief

Why this is important:

- If you didn't file your taxes, or filed your taxes for 2022, but still owe, you have until November 16, 2023 to file/pay and not get charged penalties or interest;
- If you are behind on your estimated tax payment for 2023, you have until November 16, 2023 to catch up and not pay penalties or interest;
- If you didn't pay your first installment of the Pass-Thru Entity Tax or changed your mind about taking advantage of this, you have until November 16, 2023 to make it happen.

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IRS Penalty Letters

Many taxpayers who took advantage of the Disaster Relief extensions are now receiving tax due and penalty notices from the IRS.

The IRS is letting taxpayers know that these letters were automatically generated and were unintentional. They issued the following statement:

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IRS Penalty Letters

"The IRS reassures California taxpayers that they continue to have an automatic extension until later this year to file and pay their taxes for those covered by disaster declarations in the state.

The current mailings being received by some taxpayers, the IRS Notice CP-14, are for taxpayers who have a balance due, and they are sent out as a legal requirement. While the notice received by taxpayers says they need to pay in 21 days, most California taxpayers have until later this year to pay under the disaster declaration.

The IRS apologizes to taxpayers and tax professionals for any confusion as we continue to review the situation. Taxpayers receiving these letters do not need to call the IRS or their tax professional."

Taxpayers have been assured that once the returns have been filed and the payments received, the penalty notices will be eliminated in their system.

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Employee Retention Credits

- Last month, IRS suspended the processing of new ERC claims until the end of 2023. The IRS warned that "some third parties are taking improper positions related to taxpayer eligibility for and computation of the credit." Fraud related to the program has the attention of IRS.
- ERC claims that had already been filed will still be processed.

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Employee Retention Credits

- Taxpayers are always responsible, the IRS notes, for the information reported on their tax returns. Improperly claiming the ERC could result in repayment of the credit, plus penalties and interest.
- IRS gearing up for ERC audits.
- Make sure you have a reputable group processing your ERC claim.

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Pass-Through Entity Credit

Several states, including California, have recently enacted legislation that allows S-Corporations and partnerships to pay state income taxes at the business level via their Pass-Through Entity (PTE) tax return - Form 1120S or Form 1065.

This treatment allows state taxes paid at the entity level to be deductible by the shareholder/partner for Federal income tax purposes. This “work-around” was designed to avoid the current $10,000 limitation on the deductibility of state and local taxes for Federal tax purposes.

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Pass-Through Entity Credit

To be eligible to take credit for 2023 tax year, you would need to have made or make a payment by November 16, 2023.

This payment would have been the greater of:

$1,000 or

50% of your 2022 PTE credit

Details to follow later in Webinar

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2023 General Economy in a Nutshell

- Unemployment is Down
- Interest Rates are Up
- Consumer Spending is Sideways
- Home Values are Flat
- Stock Market is Down
- Inflation is Up

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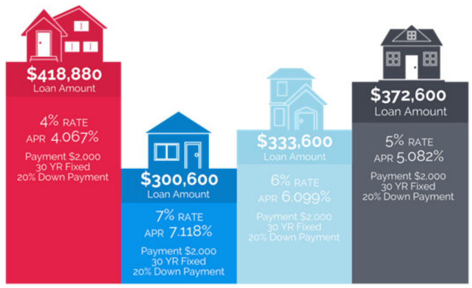
Impact of Rising Interest Rates

(A/P)



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Veterinary Economy in a Nutshell

- Pet Ownership is Up
- Demand for Service is Up
- Profitability is Sliding
- Practice Value is Sliding
- Financing is Tightening
- Availability of Labor is Down
- Stress Level is Up

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Veterinary Labor Market

- Incredibly High Demand
- Shortage of Candidates
- Salaries Rising
- Benefits Increasing
- Consolidators Tipping Scales
- Flexible Schedules
- Competitive

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Veterinary Consolidation Market

- Contraction
- Higher Interest Rates Impacting
- Big Players Backing Off/Slowing Down
- Multiples Shrinking
- Less Cash Up Front
- Last Minute Reversals
- Doctor Shortages Taking Toll

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Taxes!!

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Remember when…

About three years ago, panic in the streets about taxes.

- Biden elected.
- Congress Blue
- Corporate tax increase imminent
- Big wave of individual tax increases also coming
- $400,000 was magic number

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Remember when…

About three years ago, panic in the streets about taxes.

- Capital gains skyrocketing
- Higher ordinary tax rates
- Capped itemized deductions
- Etc., etc., etc.

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Now…

- No significant tax legislation in last year.
- No significant tax legislation expected next year (election year).
- Taxes on back-burner as other issues have emerged:
  - Russia/Israel
  - Inflation
  - Interest Rates

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Taxes

No Changes to Top Income Tax Rate

This has been dropped entirely. It appears ordinary income tax rates and their corresponding thresholds will remain the same.

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Taxes

Single taxpayers

Taxable income over	But not over	Is taxed at
$0	$11,000	10%
$11,000	$44,725	12%
$44,725	$95,375	22%
$95,375	$182,100	24%
$182,100	$231,250	32%
$231,250	$578,125	35%
$578,125		37%

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Taxes

Married filing jointly

Taxable income over	But not over	Is taxed at
$0	$22,000	10%
$22,000	$89,450	12%
$89,450	$190,750	22%
$190,750	$364,200	24%
$364,200	$462,500	32%
$462,500	$693,750	35%
$693,750		37%

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Taxes

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. Marginal.

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Underground Economy

In an attempt by the IRS to crack down on the underground economy, taxpayers should plan on possibly receiving more 1099s for the 2023 tax year.

Third-party payment processors (Venmo, PayPal, eBay, Crypto-related) are now required to provide 1099-Ks to individuals who have more than $600 worth of transactions with the processor for the year.

The processor will likely not know whether a transaction is personal or taxable, so the burden to clarify will fall on the taxpayer.

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Taxes

Year-End

Given that it now appears rates will remain the same next year, consider pushing income into 2024 and/or accelerating expenses into 2023.

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Taxes

No Changes to Long-Term Capital Gains/Qualified Dividends

- The plan was to tax capital gains and qualified dividends at ordinary income tax rates if the taxpayer's income was over $400,000, almost doubling the tax on this type of income.
- It appears long-term capital gain rates will remain the same.

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Taxes

No Changes to Long-Term Capital Gains/Qualified Dividends

- Even though the stock market has been mixed, consider pushing gains into 2024 and/or realizing losses in 2023.
- Also, the rush to close a business sale by the end of the year has been greatly diminished. In fact, if capital gain rates do remain unchanged, then pushing a sale off to early 2024 might be the better play.

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Taxes

E-Filing and Direct Deposits Highly Recommended

According to the IRS, tax returns that are paper filed, and/or refunds using paper checks will take much longer to process this year. Filing electronically and opting to receive refunds via direct deposit will significantly decrease the processing time.

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Student Loan Payment Exclusion

One piece of legislation that doesn't get much attention is Section 2206 of the CARES Act, which allows employers to make up to $5,250 in tax-free annual payments directly to their employees or their employees' federal student loans.

These payments represent the best of both worlds. Employees don't pay tax on this added "income," and employers can still deduct these payments while not paying additional payroll taxes on these funds.

The provision has been extended until December 31, 2025.

Nice recruiting tool for attracting and retaining employees.

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Taxes

Internal Revenue Service received additional funding for 2023 and beyond.

Gearing up for audits:
- ERC
- High income individuals
- Certain industries

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Taxes

- Classic audit virtually extinct;
  - IRS office/Boxes of receipts
- Shifting toward electronic verification
  - Covid;
  - Shortage of resources;
  - Document (W2s, 1099s) matching;
- Red Flag audits – something stands out
- Random audits – chances slim

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Taxes

Audit Chart

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
OVERALL CORP/PARTNERSHIP AUDIT RATE	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

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Section 179/Bonus Depreciation – New Equipment/Assets

- Still one of the best tax planning tools for small businesses.
- Veterinary practices can write-off the cost of qualifying new equipment (digital x-ray or computers, for example) placed in service, up to $1,160,000 in a given year.
- Bonus Depreciation allows practice owners to also write-off longer term assets such as improvements and furnishings.

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Section 179/Bonus Depreciation – New Equipment/Assets

- This provision provides financial assistance to veterinarian looking to improve or expand her/his practice.
- Can finance equipment, get full write-off with very little money spent up front.
- As long as the equipment is signed for and in service by the end of the year, this deduction can be taken.
- Equipment acquired through a capital lease also qualifies.

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Retirement Plans - 2023

Change in Required Minimum Distributions:

There has been an increase in the beginning age for mandatory Required Minimum Distributions, from age 72 to age 73 starting in 2023, and then to age 75 starting in 2033.

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Retirement Plans - 2023

The IRS has significantly increased the contribution limits for 2023 retirement plans, as follows:

IRA contributions have been increased to $6,500 (up from $6,000 for 2022). The $1,000 IRA catch-up contribution limit for those over 50 years old remains.

401(k) employee contribution limits have been increased to $22,500 (up from $20,500 for 2022) and the catch-up contribution limit for taxpayers above aged 50 has been increased to $7,500 (up from $6,500). The total 401(k) contribution for taxpayers age 50 and over will now be $30,000 for 2023 ($22,500 regular contribution + $7,500 catch-up contribution).

SIMPLE IRA contribution limit have been increased to $15,500 (up from $14,000)

SEP contribution limits have been increased to $66,000 (up from $61,000).

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ROTH Conversions

Is now the time to convert a traditional IRA to a Roth IRA? You pay tax on the converted amount, but future earnings are tax-free.

Factors to consider:

- Current income/tax rate in 2023. If a low-income year, may be the time to take advantage
- Value of your IRA has gone down
- Current age
- No RMDs for Roth
- Can convert in pieces

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Pass-Through Entity Credit

Several states, including California, have recently enacted legislation that allows S-Corporations and partnerships to pay state income taxes at the business level via their Pass-Through Entity (PTE) tax return - Form 1120S or Form 1065.

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Pass-Through Entity Credit

Here is how it works (for California and most states):

- The shareholder/partner will report their share of the corporate or partnership net income to the Internal Revenue Service, but this net will be reduced by the amount of the state tax paid at the entity level. For California, the state tax deducted on the federal return will be added back into net income on the California K-1, but the owners will receive a California tax credit for the tax paid.
- Boiling it down, this allows the K-1 recipient to reduce their federal AGI by the state tax paid, rather than having a state tax deduction on Schedule A. As you know, the state taxes deduction is subject to the $10,000 state and local tax (SALT) limit.

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Pass-Through Entity Credit

- What is the PTE elective tax calculation?

The elective tax is 9.3% of the entity's qualified net income, which is basically the total taxable income subject to California personal income tax. There is no adjusting this percentage.

- When do you get the federal deduction for PTE Tax?

The payments needs to be made on or before December 31, 2023. Because the payment is made in 2023, the federal deduction would be taken on your 2023 tax return.

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Pass-Through Entity Credit

- What is included in an entity's qualified net income?

In general, for an S Corporation, this will be the sum of lines 1-10 (all different types of income) minus the sum of lines 11 and 12 (Section 179 and donations) that are on the K-1 (100S). For a partnership, it will be the same, including guaranteed payments made to partners on the K-1 (565/568).

Incidentally, a gain from the sale of an entity level asset (goodwill, for instance) is also included.

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Pass-Through Entity Credit

Questions about the Pass-Through Entity Credit

- Can you walk us through a simple calculation?

McFerson Enterprises, Inc. is taxed as an S Corporation, has one shareholder, and has qualified net income of $200,000 for the year. Using the required 9.3% tax rate, the corporation makes a payment of $18,600 to the FTB. The corporation then reports $181,400 ($200,000 - $18,600) of net income on the Federal Form 1120s. The California returns filed will report $200,000 of net income, and a credit of $18,600 will be available for use against the sole shareholder's individual California income tax.

The shareholder then reports this credit on his/her personal California tax return

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Related Accounting Concepts – Tax Implications

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Should I keep my books on Cash or Accrual Basis of Accounting?

Cash Basis of Accounting: Recognize revenue when cash actually changes hands (deposited). Recognize expenses when expenses are actually paid.

Accrual Basis of Accounting: Recognize revenue when it is earned/billed. Recognize expenses when they are incurred.

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Should I keep my books on Cash or Accrual Basis of Accounting?

Cash Basis

Positives:
- Simpler
- Less time consuming
- Don't have to worry about inventory

Negatives:
- Can be misleading
- Breakeven harder to determine
- Year-to-year comparisons

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Should I keep my books on Cash or Accrual Basis of Accounting?

Accrual Basis

Positives:
- Accuracy
- Determining profitability
- Benchmark tracking
- Helps determine cash flow

Negatives:
- Time Consuming
- Inventory counts
- Tracking accounts payable

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Should I keep my books on Cash or Accrual Basis of Accounting?

Keys Factors to Consider:

- Required if gross revenues about $25 mil
- Need accounting software to properly use accrual basis
- Need bookkeeper/person to properly use accrual basis

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What exactly is EBITDA?

Earnings
Before
Interest
Taxes
Depreciation
Amortization

Figures shown as taxable income or net income may be dramatically different from real operating profit

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What exactly is EBITDA?

- Financial/Taxable Income
  - Trying to keep low as possible
  - Includes all expenses, including quasi-business
  - May include excessive depreciation/179
  - May include excessive owner compensation
  - May include excessive owner rent
- EBITDA
  - Good to know for financing purposes
  - Valuation purposes
  - Make adjustments for perks, other non-cash items
  - Good in comparing to rest of industry

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What exactly is EBITDA?

	Taxable Income	EBITDA
Revenue	2,000,000	2,000,000
Less:		
Cost of Prof. Services	410,000	410,000
Payroll	960,000	910,000
Occupancy	170,000	120,000
Administrative Expenses	140,000	140,000
Loan Interest Expense	15,000	-0-
Owner Perks	35,000	-0-
Depreciation Expense	16,000	-0-
Net	$ 254,000	$ 420,000

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Questions?

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