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*A Professional Corporation*

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Dear Client:

Several significant tax law changes took effect in 2021 that may affect your business's federal tax filings. As the year draws to a close, we should review these changes, as well as your business's projected taxable income or loss to see what actions might be appropriate before year end to reduce taxes. It's also important to ascertain whether enough estimated taxes have been paid to avoid any underpayment of estimated tax penalties.

As COVID-19 has continued to impact businesses, Congress passed the Consolidated Appropriations Act, 2021 (CAA 2021) at the end of last December and the American Rescue Plan (ARP) Act in March. A major highlight in CAA 2021 is a provision allowing businesses to fully deduct expenses paid with the proceeds of a forgiven Paycheck Protection Program loan, effectively overriding earlier guidance. The ARP followed up by extending and modifying certain refundable payroll tax credits for both businesses and self-employed individuals, which are discussed in depth below. As a result of this latter change, the IRS has revised Form 941-X to allow businesses to correct COVID-19 related employment tax credits reported on Form 941 earlier in the year. Reviewing your payroll tax returns to ensure that your business took full advantage of these credits, and filing any amended returns that may be necessary, should be one of our top year-end tax planning priorities.

Presently, Congress is engaged in negotiations on a tax and spending bill that will likely result in significant tax changes affecting businesses, beginning next year. Should such a bill pass, we will want to factor such changes into our year-end planning. For now, we'll need to base our planning on existing law.

Please review the letter and consider any actions that are needed before the end of the year.

## **Section 179 Expensing and Depreciation Deductions**

Depending on what the income of your business looks like for 2021, there are two "go-to" deductions that generally take priority when trying to reduce income for tax purposes: the Section 179 deduction, where your business can elect to deduct the entire cost of certain property acquired and placed in service during the year, and the bonus depreciation deduction, where 100 percent of the cost of business property may be expensed. Under the Section 179 expensing option, your business can immediately expense the cost of up to \$1,050,000 of "Section 179" property placed in service in 2021. This amount is reduced dollar for dollar (but not below zero) by the amount by which the cost of the Section 179 property placed in service during the year exceeds \$2,620,000.

The bonus depreciation rules apply unless the business specifically elects out of those rules. An election out might be preferable where a business expects a tax loss for the year and the bonus depreciation would just increase that loss or where it might be advantageous to push depreciation deductions into future years. For example, where the owner of a pass-thru entity to whom these deductions would flow expects to be in a higher tax bracket in future years, such deductions might be of more use in those future years. If applying both the Section 179 deduction and the bonus depreciation deduction to an asset, the Section 179 deduction applies first.

If you are in the market for a vehicle, the purchase of a sport utility vehicle weighing more than 6,000 pounds, can trigger a bigger deduction than if a smaller vehicle is purchased. This is because vehicles that weigh 6,000 pounds or less are considered listed property and the related first-year deduction is limited to \$18,200 for cars, trucks and vans acquired and placed in service in 2021. For vehicles weighing more than 6,000 pounds, however, up to \$26,200 of the cost of the vehicle can be immediately expensed.

If you leased a passenger automobile in 2021 with a value of more than \$51,000, the deduction available for that lease expense is reduced. In such cases, the lessee must include in gross income an amount determined by a formula the IRS issues each year.

## **Energy Efficient Building Deduction**

Please let me know if your business made any energy-efficient improvements to a building during the year, such as installing property that is part of (1) an

interior lighting system, (2) heating, cooling, ventilation, and hot water systems, or (3) the building envelope. If so, an energy efficient building deduction, which was made permanent in the CAA 2021, may be available.

## **Payroll Tax Credits Available**

Refundable payroll tax credits are available for businesses with under 500 employees that offered paid sick or family leave through September 30, 2021 (i.e., qualified leave wages), to employees who took leave due to COVID-19. In addition, an employee retention credit is available for all four quarters of 2021 for businesses that were impacted by COVID-19 but kept employees on the payroll.

Generally, employers claim these payroll tax credits on either Form 941, Employer's Quarterly Federal Tax Return, or Form 7200, Advance Payment of Employer Credits Due to COVID-19. Because of the numerous changes to the dates these credits apply, the IRS recently made significant revisions to Form 941-X to allow for correcting COVID-19 related employment tax credits reported on Form 941. Thus, we need to review the Forms 941 or any Forms 7200, Advance Payment of Employer Credits Due to COVID-19, filed for your business to ensure that all payroll tax credits for which your business is eligible have been claimed.

For the first three quarters of 2021, employers are eligible for tax credits for wages paid for up to 80 hours of paid sick leave in an amount equal to either: (1) the employee's regular wage, capped at \$511/day, up to a total of \$5,110 if the employee was sick or quarantining, awaiting the results of a COVID test, obtaining or recovering from a vaccine; or (2) two-thirds of the employee's regular wage, capped at \$200/day, up to a total of \$2,000, if the employee was taking time to care for someone quarantining or to provide care due to COVID-19 school or child care provider closures. In addition, employers may receive tax credits for up to 12 weeks of paid family leave provided to employees who are unable to work for any of the reasons listed above. These credits are equal to two-thirds of an employee's regular wages, capped at \$200/day up to a total of \$12,000.

Additionally, the payroll tax credits are also available to self-employed individuals, who will recoup these credits by filing Form 1040 or Form 7202, Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals.

Your business may be eligible for an employee retention tax credit (ERTC) if your business either (1) had their operations fully or partially suspended under government orders in 2021, or (2) experienced a decline in gross receipts for a quarter in 2021 of 20 percent or more compared to the same quarter in 2019 (i.e., a "significant decline in gross receipts"). However, if the business did not exist as of the beginning of the same calendar quarter in calendar year 2019, then the same calendar quarter in 2020 is used. The ERTC generally equals 70 percent of the first \$10,000 in wages, including certain health plan expenses, per employee in each quarter of 2021. For the third and fourth quarters of 2021, the credit amount is increased to \$50,000 per quarter if the business is a "recovery startup business." A recovery startup business is any business which (1) began carrying on any trade or business after February 15, 2020, (2) for which the average annual gross receipts for the three-tax year period ending with the tax year which precedes such quarter does not exceed \$1,000,000, and (3) with respect to such quarter, the operation of the trade or business is not subject to a government-ordered suspension or a significant decline in gross receipts. Its worth noting that the infrastructure bill passed by the Senate would terminate the ERTC as of September 30, 2021. That provision does not affect a recovery start-up business and its unknown whether this provision will survive in a final bill.

The IRS has issued guidance which says that, because of the interaction of certain Internal Revenue Code provisions, wages paid to majority owners, their spouses, and children generally are not qualified wages for purposes of the ERTC. This interpretation appeared to run contrary to the intent of Congress when it enacted the ERTC legislation. If your business is in this situation, we should discuss the potential avenues available for claiming, or postponing the claiming of, this credit.

## **Expenses Paid with Paycheck Protection Program Loan Funds**

If your businesses received a loan through the Paycheck Protection Program (PPP), which ended on June 30, 2021, and has not yet received forgiveness of that loan, a simplified loan forgiveness application has been issued for PPP loans of \$150,000 or less. A forgiven PPP loan is not includible in income, and no deduction will be denied, no tax attribute will be reduced, and no basis increase will be denied by reason of the exclusion from gross income of a forgiven PPP loan. In addition, PPP loan recipients that did not deduct certain otherwise deductible expenses paid or incurred in 2020 based on guidance available at that time can elect to deduct these expenses on their 2021 tax

return rather than by filing an amended return or administrative adjustment request. Thus, if you received a PPP loan, we need to discuss its impact on your 2021 tax return.

## **Importance of Employee Benefits**

As you probably well know, the employment landscape has changed significantly since the beginning of the COVID pandemic. Many businesses are facing a worker shortages and are reevaluating what it will take to get employees in the door. If your business is not already doing so, it may reap substantial tax benefits, as well as non-tax benefits, by offering a retirement plan and/or other fringe benefits to employees. Businesses that offer such benefits have a better chance of attracting and retaining talented workers which, in turn, reduces the costs of searching for and training new employees. Contributions made to retirement plans on behalf of employees are deductible and your business may be eligible for a tax credit for setting up a qualified plan.

In addition, as a business owner you, and your spouse, can take advantage of a retirement plan yourselves. By adding your spouse as an employee and paying a salary up to the maximum amount that can be deferred into a retirement plan you could realize significant tax savings. For example, if your spouse is 50 or older, a salary of \$26,000 could all go into a 401(k), leaving him or her with a retirement account but no current year taxable income.

Because health insurance is a much sought-after employee benefit, you might consider setting up a high deductible health plan paired with a health savings account (HSA). The benefits to your business would include savings on health insurance premiums that would otherwise be paid to traditional health insurance companies and having employee wage contributions to the plan not being counted as wages. Thus, neither your business nor the employee would be subject to FICA taxes on the payroll contributions. As for the employee, he or she can reap a tax deduction for funds contributed to the HSA. Because there is no use-it-or-lose-it policy, the funds can grow tax free and be used in retirement.

Another employee benefit worth considering is the establishment of a flexible spending account (FSA) for health-care and dependent-care expenses. An FSA allows employees to be reimbursed for medical and dependent-care expenses and is usually funded through voluntary salary reduction agreements with the employer. The maximum amount that can be set aside in

a health-care FSA for 2021 is \$2,750. The maximum amount that may be set aside for a dependent care FSA is \$5,250 for a single filer and \$10,500 for joint filers. Your business would have the option of making or not making contributions to the FSAs. Some of the tax benefits of an FSA include the fact that contributions made by the business can be excluded from the employee's gross income and thus no employment or federal income taxes are deducted from the contributions. Also, payments by the FSA to the employee are tax free if used for qualified expenses, and the FSA can be used to pay qualified expenses even if the employer or employee haven't yet placed the funds in the account. Also, while FSAs previously had a modified use-it-or-lose-it policy, meaning employees could carryover over a limited amount of unspent funds if the FSA plan allowed it, CAA 2021 temporarily allows a "full" carryover of unspent funds.

## **Qualified Business Income Deduction**

If you are conducting your business as a sole proprietorship, a partner in a partnership, a member in an LLC taxed as a partnership, or as a shareholder in an S corporation, the qualified business income (QBI) deduction under Code Sec. 199A can significantly help reduce taxable income. The QBI deduction allows eligible taxpayers to deduct up to 20 percent of their QBI, plus 20 percent of qualified real estate investment trust dividends and qualified publicly traded partnership income. A W-2 wage limitation amount may apply to limit the amount of the deduction. The W-2 wage limitation amount must be calculated for taxpayers with a taxable income that exceeds a statutorily-defined amount (i.e., the threshold amount). For any tax year beginning in 2021, the threshold amount is \$329,800 for married filing joint returns, \$164,925 for married filing separately, and \$164,900 for all other returns.

Since the QBI deduction reduces your taxable income, and is not used in computing adjusted gross income, it does not affect limitations based on adjusted gross income such as the medical expense deduction or the calculation of social security income that is includible in income. The QBI deduction does not apply to a "specified service trade or business," which is defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its

employees. Engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

## **Rental Real Estate**

If you incurred losses in a real estate business, we need to determine whether the losses were incurred in a passive activity or not, as passive activity losses are only deductible against passive activity income. However, a deduction of up to \$25,000 (\$12,500 if married filing separately) may be allowed against nonpassive income to the extent you or your spouse actively participated in the rental real estate activities. However, the deduction is subject to a phaseout for individuals with modified adjusted gross income above \$100,000 (or \$50,000 if married filing separately).

Rental real estate enterprises operated by individuals and owners of passthrough entities may also qualify for the QBI deduction if certain criteria are met. For example, to qualify for the QBI deduction, your rental business activity must be considerable, regular, and continuous in scope. In determining whether this criteria is met, relevant factors include, but are not limited to, the following:

- (1) the type of rented property (commercial real property versus residential property);
- (2) the number of properties rented;
- (3) an agent's day-to-day involvement;
- (4) the types and significance of any ancillary services provided under a lease; and
- (5) the terms of a lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

A rental real estate activity will be treated as a business eligible for the QBI deduction if certain safe harbor requirements are satisfied, such as:

- (1) separate books and records are maintained to reflect the income and expenses for each rental real estate enterprise;
- (2) for rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed per year with

respect to the rental real estate enterprise (with slightly less stringent requirements for rental real estate enterprises that have been in existence for at least four years);

(3) contemporaneous records have been maintained, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services; and

(4) certain compliance requirements are met.

Thus, to qualify for the QBI deduction with respect to rental real estate, it's important to determine if the safe harbor conditions are met. Alternatively, even if the safe harbor conditions are not met, there may be certain actions we can take to ensure that your real estate business falls within the "trade or business" guidelines for taking the deduction.

## **Meal and Entertainment Expenses**

Generally, the business deduction allowable for food or beverage expenses is limited to 50 percent of the amount spent. However, CAA 2021 enacted a more lenient rule for expenses relating to food and beverages purchased from restaurants in 2021 and 2022. Under that rule, a 100 percent deduction is allowed, providing the expense is properly documented. As part of that documentation, the business purpose of the meal must be provided. The term "restaurant" in this case means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises. It does not include a business that primarily sells pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk.

## **Electing the De Minimis Safe Harbor Deduction**

If your business has not already done so, and is eligible, we should explore making an election to apply the IRS's de minimis safe harbor rules to any amounts paid to acquire or produce tangible property to the extent such amounts are deductible for financial accounting purposes. If your business has an applicable financial statement (AFS), it can use the safe harbor to deduct amounts paid for tangible property up to \$5,000 per invoice or item (as



substantiated by invoice). If your business doesn't have an AFS, it can use the safe harbor to deduct amounts up to \$2,500 per invoice or item (as substantiated by invoice).

## **Vehicle-Related Deductions and Substantiation Requirements**

If your business has incurred vehicle or transportation-related expenses, we need to ensure that any amount taken as a deduction is properly substantiated. When the IRS selects a business return for an audit, it tends to focus on vehicle expenses and disallow them if they are not properly substantiated. Thus, for such expenses, it's important that the records relating to any such expenses include the following for each vehicle used in the business:

- (1) the amount of each separate expense with respect to the vehicle (e.g., the cost of purchase or lease, the cost of repairs and maintenance, etc.);
- (2) the amount of mileage for each business or investment use and the total miles for the tax period;
- (3) the date of the expenditure; and
- (4) the business purpose for the expenditure.

The following are considered adequate for substantiating such expenses:

- (1) records such as a notebook, diary, log, statement of expense, or trip sheets; and
- (2) documentary evidence such as receipts, canceled checks, bills, or similar evidence.

Records are considered adequate to substantiate the element of a vehicle expense only if they are prepared or maintained in such a manner that each recording of an element of the expense is made at or near the time the expense is incurred.

## **Increasing Basis in Pass-thru Entities**

If you are a partner in a partnership or a shareholder in an S corporation, and you expect the entity to pass through a loss for the year, it's important to determine if you have enough basis to absorb the loss. If not, then we should review actions that can be taken before the end of the entity's tax year to increase your basis. Generally, increasing basis in an entity is done by contributing or loaning money to the entity.

## **S Corporation Shareholder Salaries**

If you are doing work for an S corporation, it's important to ensure that you are being paid an amount that is commensurate with your workload. The IRS scrutinizes S corporations which distribute profits instead of paying compensation subject to employment taxes. Failing to pay arm's length salaries can lead not only to the assessment of tax deficiencies, but also penalties and interest on those deficiencies as well. The key to establishing reasonable compensation is being able to show that the compensation paid for the type of you did during the year is similar to what other corporations would pay for similar work. In such cases, we need to document the factors that support the amount paid.

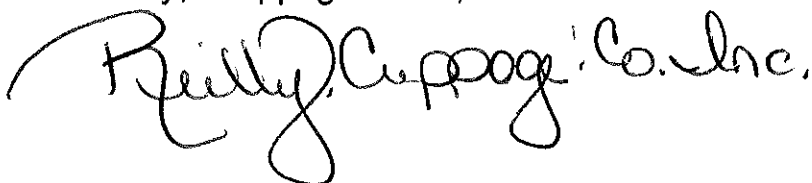
Also, because there are stringent requirements for who may be an S corporation shareholder, if the number of shareholders have changed or increased during the year, we should review the residency or citizenship status of the S corporation's shareholders and S corporation stock beneficiaries (including contingent and residuary beneficiaries).

As you can see, there is much to consider before we prepare your 2021 business tax return and calculate any estimated tax payments that might be due in 2022. Because it is unclear what, if any, tax legislation may ultimately be passed, we'll need to base our year-end planning on existing law.

If you need to discuss any of the issues, please do not hesitate to contact our office.

Sincerely,

Reilly, Creppage & Co., Inc.

A handwritten signature in cursive script that reads "Reilly, Creppage & Co., Inc." The signature is written in black ink and is positioned below the typed name of the firm.