K C Dowell, CPA, LLC
3046 Breckenridge Lane, Suite 203
Louisville, Kentucky 40220
502.515.9292
www.kcdowellcpa.com

K C DOWELL, CPA, LLC
Tax-Saving Tips

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The Latest on Payroll Tax Deferral

If you have employees, you must withhold their 6.2 percent share of the Social Security tax from their wages up to an annual wage ceiling ($137,700 for 2020). You must pay the money to the IRS along with your matching 6.2 percent employer share of the tax.

But under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, as you likely know, employers are allowed to defer paying their 6.2 percent share of the Social Security tax on wages paid to employees through the end of 2020. Fifty percent of these deferred taxes will have to be paid during 2021 and the remainder in 2022.

Both the Trump administration and the IRS have issued orders permitting employers to defer withholding and paying the employee portion of the Social Security tax for a limited time. But the executive order on employee deferral is much more limited in scope than the CARES Act employer deferral, and it's beset with practical problems for employers.

Which Taxes Can Be Deferred?

The deferral applies only to the employee portion of the Social Security tax due on wages paid from September 1, 2020, through December 31, 2020. No other payroll taxes can be deferred.

Which Employees Qualify for the Deferral?

Only employees who earn less than $4,000 biweekly qualify for the deferral. Employees who are not paid on a biweekly basis qualify if their pay is equivalent to less than $4,000 biweekly. This would include employees who are paid less than

- $2,000 weekly,
- $4,333 semimonthly, or
- $8,666.67 monthly.

Each pay period is tested separately. An employee who earns too much during one pay period can still qualify for the deferral if he or she earns less than the ceiling amount in a later pay period.

Is the Deferral Mandatory?

IRS officials have stated that the deferral is not mandatory. Employers are not obligated to offer the deferral to their employees. This is so even if an employee requests it.

What Happens When the Deferral Period Ends?

The employee Social Security tax deferral ends on December 31, 2020. IRS guidance provides that the deferred taxes must then be paid “ratably” from wages paid from January 1, 2021, through April 30, 2021. Employers must withhold and pay the deferred taxes from employee wages paid during this period.

Thus, from January 1, 2021, through April 30, 2021, most employees will have to pay a 12.4 percent Social Security tax instead of the normal 6.2 percent. This amounts to a 6.2 percent pay cut for affected employees for four months.

What If Employees Quit or Get Fired?

If an employee quits or is fired during the four-month repayment period, there may not be enough wages paid to cover the deferred Social Security taxes. The IRS says that in this event employers can “make arrangements to otherwise collect” the deferred taxes. What form such “arrangements” could take is unclear.

Interest, penalties, and additions to taxes will begin to accrue on any unpaid deferred Social Security taxes starting May 1, 2021. Thus, if you (the employer) fail to remit the deferred monies because employees were not employed during the collection period, you are on the hook.

Due to the uncertainty involved, many employers have reportedly elected not to participate in the employee Social Security tax deferral.

Using Whole or Partial Rooms for Your Home Office

With the COVID-19 pandemic still going on, you may be spending more time working from your home office.

You may have taken some extra rooms for your business use. Is that okay?

Section 280A(c) states that you may claim a home office based on the portion of the dwelling that you use exclusively and regularly for business. Thus, the law dictates no specific number of rooms or particulars regarding the size of the office.

The courts make this rule clear, as you can see in the *Mills* (less than one room) and *Hefti* (lots of rooms) cases described below.

The *Mills* Case

Albert Victor Mills maintained an office in his apartment from which he conducted his rental property management business. The apartment was small, totaling only 422 square feet. In the office area of the apartment where Mr. Mills had his desk, he also kept tools, equipment, paint supplies, and a filing cabinet.

The court agreed with Mr. Mills’s allocations and awarded the home-office deduction based on his claimed 23 percent business use of the 422-square-foot apartment.

Planning note. Mr. Mills did not have a single room dedicated to a home office. He had only an area of the apartment where he grouped his office furnishings, equipment, and supplies. If you have a similar situation, make sure your business assets are located in a group.

The *Hefti* Case

Charles R. Hefti lived in a big house, totaling 9,142 square feet. He claimed that more than 90 percent of his home was used regularly and exclusively for business.

Based on its review of the rooms, the court concluded that 13 rooms, totaling 19 percent of the home, were used exclusively and regularly for business.

Insights

The deductible portion of your home for an office includes the area used exclusively and regularly for business.

Let’s say you have an office in one room and your files in a second room, and you never use these rooms for personal purposes. Further, let’s say you use the office area on a daily basis and the files area in connection with that daily work.

Both rooms would meet the exclusive and regular use requirements, just as Mr. Mills’s and Mr. Hefti’s offices met these rules.

But Not This

“Exclusive use” means that you must use a specific portion of the home only for business purposes. You must make no other use of the space.

Exception. One exception to the exclusive use rule is storage of inventory or product samples if the home is the sole fixed location of a trade or business selling products at retail or wholesale.

Example 1. Your home is the only fixed location of your business, which involves selling mechanics’ tools at retail. You regularly use half of your basement for storage of inventory and product samples. You sometimes use the area for personal purposes. The expenses for the storage space are deductible even though you do not use this part of your basement exclusively for business.

Example 2. In *Pearson*, Dr. Pearson practiced orthodontics in a downtown medical building but retained the dental records of more than 3,000 patients in 36 file drawers (each measuring 26 inches by 14 inches by 12 inches) and had 1,461 boxes containing orthodontic models (each box measuring 10 inches by 6 inches by 2 1/2 inches).

He stored the records in the attic and basement of his home. The areas used for such storage were not separate rooms, and the remaining portions of the attic and basement were used by Dr. Pearson and his family for personal purposes.

The court ruled that Dr. Pearson may not treat the storage areas as home-office expenses because the records were not inventory or samples and Dr. Pearson did not operate a wholesale or retail trade or business from his home.

Don’t Let the IRS Set Your S Corporation Salary

You likely formed an S corporation to save on self-employment taxes.

If so, is your S corporation salary

- nonexistent?
- too low?
- too high?
- just right?

Getting the S corporation salary right is important. First, if it’s too low and you get caught by the IRS, you will pay not only income taxes and self-employment taxes on the too-low amount, but also both payroll and income tax penalties that can cost plenty.

Second, in most cases, the IRS is going to expand the audit to cover three years and then add the income and penalties for those three years.

Third, after being found out, you likely are now stuck with this higher salary, defeating your original purpose of saving on self-employment taxes.

Getting to the Number

The IRS did you a big favor when it released its "Reasonable Compensation Job Aid for IRS Valuation Professionals."

The IRS states that the job aid is not an official IRS position and that it does not represent official authority. That said, the document is a huge help because it gives you some clearly defined valuation rules of the road to follow and takes away some of the gray areas.

Market Approach

The market approach to reasonable compensation compares the S corporation's business with others and then looks at the compensation being paid by those businesses to employees who look like you, the shareholder-employee who is likely the CEO.

The question to be answered is, how much compensation would be paid for this same position, held by a nonowner in an arm's-length employment relationship, at a similar company?

In its job aid, the IRS states that the courts favor the market approach, but because of challenges in matching employees at comparable companies, the IRS developed other approaches.

Cost Approach

The cost approach breaks your employee activities into their components, such as management, accounting, finance, marketing, advertising, engineering, purchasing, janitorial, bookkeeping, clerking, etc.

Here's an example of how the cost approach works to support a $71,019 salary as reasonable compensation for this S corporation owner whose corporation had $3.5 million in revenue and 19 employees:

Task	Hours	Wage	Amount
Taxi driver and chauffeur	104	$12.75	$1,326
General manager	624	$58.32	$36,392
Wholesale buyer	166	$27.59	$4,575
Collections clerk	146	$15.32	$2,237
Sales representative	624	$30.96	$19,149
Order clerk	416	$18.56	$7,340
Totals	2,080	N/A	$71,019

Health Insurance

The S corporation's payment or reimbursement of health insurance for the shareholder-employee and his or her family goes on the shareholder-employee's W-2 and counts as compensation, but it's not subject to payroll taxes, so it fits nicely into the payroll tax savings strategy for the S corporation owner.

Pension

The S corporation's employer contributions on behalf of the owner-employee to a defined benefit plan, simplified employee pension (SEP) plan, or 401(k) count as compensation but don't trigger payroll taxes. Such contributions further enable the savings on payroll taxes while adding to the dollar amount that's considered reasonable compensation.

Planning note. Your S corporation compensation determines the amount that your S corporation can contribute to your SEP or 401(k) retirement plan. The defined benefit plan likely allows the corporation to make a larger contribution on your behalf.

Section 199A Deduction

The S corporation's net income that is passed through to you, the shareholder, can qualify for the 20 percent Section 199A tax deduction on your Form 1040.

Getting Around the New Law That Impairs the Stretch IRA Strategy

Last December, the Setting Every Community Up for Retirement Enhancement (SECURE) Act became law.

The SECURE Act was intended mainly to expand opportunities for individuals to increase their retirement savings and to simplify the administration of retirement plans. That's the good part.

But the act also included a big unfavorable change that kneecapped the so-called stretch IRA estate planning strategy that was employed by well-off IRA owners.

The Stretch IRA Strategy

The stretch IRA strategy involves keeping as much money as possible in your traditional IRA or Roth IRA while you're still alive and then leaving the account to your spouse or a younger beneficiary, who keeps the inherited account rolling for as long as possible and keeps collecting the tax benefits. Thus, the term "stretch IRA."

The SECURE Act Imposes a New 10-Year Account Liquidation Rule That Seriously Injures the Stretch IRA Strategy

Unfortunately for the estate plans of well-off IRA owners and the tax situations of some of their IRA beneficiaries, the SECURE Act requires most non-spouse beneficiaries to drain inherited IRAs within 10 years after the account owner's death.

As we just explained, the pre–SECURE Act required minimum distribution (RMD) rules allowed a non-spouse IRA beneficiary to gradually drain the substantial traditional or Roth IRA inherited from good-ole Grandpa Frank over the beneficiary's IRS-defined life expectancy. That deal is off the table if Grandpa Frank dies in 2020 or later.

Who Is Affected by the SECURE Act Change?

The SECURE Act's anti-taxpayer 10-year account liquidation rule doesn't affect RMDs taken by original traditional IRA owners. They still operate under the same RMD rules as before.

As under pre–SECURE Act law, original owners of Roth IRAs need not take any RMDs for as long as they live. Roth IRA owners are unaffected.

Beneficiaries who want to quickly drain their inherited IRAs also are unaffected.

Bottom line. The 10-year account liquidation rule affects only certain non-spouse beneficiaries who would otherwise keep inherited accounts open for as long as possible to reap the tax advantages.

Exception for Eligible Designated Beneficiaries

The SECURE Act's 10-year account liquidation rule does not immediately affect accounts inherited by a so-called *eligible designated beneficiary*.

An eligible designated beneficiary is

- the surviving spouse of the deceased account owner,
- a minor child of the deceased account owner,
- a beneficiary who is no more than 10 years younger than the deceased account owner, or
- a disabled or chronically ill individual.

Under the exception for eligible designated beneficiaries, RMDs generally can be taken from the inherited account over the life expectancy of the eligible designated beneficiary, beginning with the year following the year of the account owner's death.

Other non-spouse beneficiaries, whom we will call *affected beneficiaries*, will be slammed by the 10-year account liquidation rule.

Following the death of an eligible designated beneficiary, the account balance must be distributed within 10 years.

The account balance also must be distributed within 10 years after a child of the account owner reaches the age of majority under local law.

10-Year Account Liquidation Rule Specifics

When applicable, the 10-year account liquidation rule generally applies regardless of whether you, as the original account owner, die before or after your RMD beginning date. Thanks to another SECURE Act change, the RMD rules do not kick in until age 72 if you attain age 70 1/2 after 2019. If you are in that age category, your required beginning date is April 1 of the year following the year during which you attain age 72.

And then, again thanks to the other SECURE Act change, an affected beneficiary must drain the account inherited from you by the end of the 10th calendar year following the year of your demise. Until that deadline is reached, your beneficiary can leave the account untouched.

Failure to comply with the 10-year account liquidation rule will expose the affected beneficiary to a penalty equal to 50 percent of the account balance that remains after the 10-year deadline has passed.

Reminder. As stated earlier, the SECURE Act's 10-year account liquidation rule applies only to affected beneficiaries who inherit IRAs from original account owners who die after 2019. An IRA inherited by a non-spousal beneficiary from an original account owner who died in 2019 or earlier is unaffected, so the inherited account can still work as a stretch IRA, the same as before the SECURE Act.