Tax Newsletter

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JULY 2021

Now that 2021 is more than half-way in the books, it's time to kick your tax planning into high gear! Included in this month's newsletter are several ideas to help you reduce your tax bill.

There is also an article that provides some ideas on how to think about debt. Some of it is good, while other debt is bad. Plus, the IRS is turning up the heat on small business audits.

Please call if you would like to discuss how this information could impact your situation. If you know someone who could benefit from this newsletter, feel free to send it to them.

Ideas to Lower Your 2021 Tax Bill

Now is the time to begin tax planning for your 2021 return. Here are some ideas:

- **Contribute to retirement accounts.** Tally up all your 2021 contributions to retirement accounts so far and estimate how much more you can stash away between now and December 31. So, consider investing in an IRA or increase your contributions to your employer-provided retirement plans. Remember, you can reduce your 2021 taxable income by as much as $19,500 by contributing to a retirement account such as a 401(k). If you're age 50 or older, you can reduce your taxable income by up to $26,000!
- **Contribute directly to a charity.** If you don't have enough qualified expenses in order to itemize your deductions, you can still donate to your favorite charity and cut your tax bill. For 2021, you can reduce your taxable income by up to $300, if you're single and $600, if you're married, by donating to your favorite charity.
- **Consider a donor-advised fund.** With a 2021 standard deduction of $12,550, if you're single and $25,100, if you're married, you may not be able to claim your charitable donations as a tax deduction, if the total of your annual donations is below these dollar amounts. As an alternative, consider donating multiple years-worth of contributions to a donor-advised fund, if you have the available cash, so you can exceed the standard deduction this year. Then make your cash contributions from the donor-advised fund to your favorite charities over the next 3 years.
- **Increase daycare expenses.** If you and/or your spouse work and have children in daycare, or have an adult that you care for, consider using a daycare so you and a spouse can both work. This is because there is a larger tax break in 2021. If you have one qualifying dependent, you can spend up to $8,000 in daycare expenses while cutting your tax bill by $4,000. If you have more than one qualifying dependent, you can spend up to $16,000 in daycare expenses while cutting your tax bill by $8,000. To receive the full tax credit, your adjusted gross income must not exceed $125,000.
- **Contribute to an FSA or an HSA.** Interested in paying medical and dental expenses with pre-tax dollars? Then read on...If you have a flexible spending account (FSA), you can contribute up to $2,750 in 2021. This allows you to pay for medical expenses in pre-tax dollars! Even better, unspent funds in an FSA can now be rolled from 2021 to 2022. And if you have a health savings account (HSA), you can contribute up to $3,600 if you're single and $7,200 if you're married. So, add up all your contributions to your FSA or HSA so far in 2021 and see how much more you can contribute between now and December 31.

Good Debt Versus Bad Debt *- How to tell the difference*

Not all debt is created equal. Knowing the difference can change the way you look at your spending.

Good debt adds value

Good debt often leads to financial growth, because the product or service being purchased adds more value than the debt that comes with it. Student loans are usually an example of good debt because the related education allows you to earn more income.

Some purchases result in value more directly. Taking on a mortgage, for example, can be valuable simply by giving you access to a place to live all while building equity. Additionally, a mortgage is often considered good debt because your property can be used as collateral for other debt once you've made some payments on it, or your home has gained in market value. Even better, good debt often comes with a tax deduction on the interest you pay on things like your mortgage or student loans.

Bad debt adds expense

Credit card debt is almost always bad debt. Not only are interest rates on credit cards higher than most other types of debt, but most purchases made with credit cards are for things that do not contribute to personal financial growth. In fact, interest expense is so high that credit card companies are now legally required to display the cost of this debt directly on their billing statements. Auto loans are another example of bad debt, because cars usually lose value quickly, often leaving more money owed on the debt than the car is worth! But even good debt can turn bad if there is too much of it. Take out too large a mortgage and you may struggle to make payments!

Debt always means higher cost

Debt's big benefit is allowing you to pay for something over time. The cost of any purchase using debt MUST include the interest expense of taking on that debt. You can compare that with the option of saving up money and then making the purchase without interest. Is the extra interest worth the benefit? Comparing the cost of the purchase with interest, to the value you stand to gain by purchasing the asset, can help you determine whether using debt is a good or bad choice for you.

Final thoughts

Here are some ideas on how to manage good versus bad debt.

- Consider carefully what you can afford and make a plan for how you will pay off any debts before you take on the debt.
- Never carry a balance on a credit card unless it is an emergency. Pay the balance in full every month.
- Calculate the entire cost, including interest, of anything you purchase using debt. This is the REAL cost of an item.
- Use savings, whenever possible, to purchase goods and services that would otherwise be considered bad debt.
- Pay off high interest debt first.
- Financial growth is often the key measure for defining good versus bad debt, but not always. Other factors, like personal interest, growth, and well-being can also be measures for your debt decisions, as long as you can truly afford the payments.

Reach out for help if you aren't confident whether a potential debt will lead to more good or harm. Making the right choice could save you money.

Small Business IRS Audit Mistakes

In late 2020, the IRS announced that it will increase tax audits of small businesses by 50 percent in 2021. Here are several mistakes to avoid if you do get audited by Uncle Sam.

- ***Mistake:*** **Missing income.** A long history of investigating has led IRS auditors to focus on under-reported income. If you're a business that handles cash, expect greater scrutiny from the IRS. The same is true if you generate miscellaneous income that's reported to the IRS on 1099 forms. Be proactive by tracking

and documenting all income from whatever source. Invoices, sales receipts, profit and loss statements, bank records—all can be used to substantiate income amounts.

- ***Mistake:*** **Higher than normal business losses.** Some small businesses struggle in the early years before becoming profitable. If your company's bottom line never improves, the IRS may view your enterprise as a hobby and subsequently disallow certain deductions. As a general rule, you must earn a profit in three of the past five years to be considered a legitimate business.
- ***Mistake:*** **Deductions lacking substantiation.** Do you really use your home office exclusively for business? Does your company earn only $50,000 a year but claim charitable donations of $10,000? Do you write off auto expenses for your only car? The key to satisfying auditors is having clear and unequivocal documentation. They want source documents such as mileage logs that match the amount claimed on your tax return and clearly show a business purpose. If you can't locate a specific record, look for alternative ways to support your tax return filings. In some cases, a vendor or landlord might have copies of pertinent records.
- ***Mistake:*** **No expense reports.** If you use your credit card for business, create an expense report with account numbers and attach it to each statement. Then attach copies of the bills that support the charges. This is an easy place to blend in personal expenses with business expenses and auditors know it.
- ***Mistake:*** **No separate books, bank accounts or statements.** Never run personal expenses through business accounts and vise versa. Have separate bank accounts and credit cards. A sure sign of asking for trouble is not keeping the business separate from personal accounts and activities.
- ***Mistake:*** **Treat the auditor as an enemy.** Auditors have a job to do, and it's in your best interest to make their task as painless as possible. Try to maintain an attitude of professional courtesy. If you're called to their office, show up on time and dress professionally. If they come to your place of business, instruct staff to answer questions honestly and completely.

Please call if you either need help preparing for an upcoming IRS audit or would like to know how to audit-proof your financial records.

Common Tax Mistakes When Selling a Home

With home sales booming throughout much of the country, you may decide that now's the right time to put your abode on the market. If you do put your primary residence up for sale, try to steer clear of the following mistakes.

- **Not qualifying for the home sale exclusion.** If you've owned and used your home as your principal residence at least two out of the last five years, you can exclude from your taxable income the first $250,000 of gain if you're single and $500,000 if you're married.

- ***What you can do:*** *Consider a delay of selling your home until you meet the 2-out-of-5-year threshold. If you can't qualify for a full exclusion, you may qualify for a partial exclusion if your sale results from an employment change, a need for medical care or other IRS-approved circumstances.*

- **Forgetting to deduct points.** If you have points from your current mortgage that you haven't deducted on a previous tax return, include the balance of these points on your next tax return. Too many taxpayers forget to do this and lose thousands in deductions.

- ***What you can do:*** *Review your loan documents before selling your property. Identify all costs, including points, that are included in the loan. Save the document with your tax records to ensure the deduction is not forgotten.*

- **Not double checking your settlement statement.** Closely review the closing statement. It is easy to assume all the numbers are correct and the math is done right. Often this is not the case! And a mistake here could be costly.

- ***What you can do:*** *Review the closing document multiple times. Have your Realtor and closing agent explain items you don't understand. Pay special attention to property taxes. The property tax bill will be*

allocated between the seller and the buyer. Only pay the share of the bill that covers the time period when you're the owner.

Manage Your Business's Unemployment Taxes

As a business owner, you're required to pay three different types of payroll taxes.

1. FICA (Federal Insurance Contributions Act) is the tax used to fund Social Security and Medicare programs.

2. FUTA (Federal Unemployment Tax Act). Employers pay this federal tax to provide unemployment benefits to laid-off workers.

3. SUTA (State Unemployment Tax Act). State governments also collect taxes known as SUTA that finance each state's unemployment insurance fund.

While FICA may be easy to understand, unemployment tax calculations are easily misunderstood.

How FUTA and SUTA taxes are calculated

The FUTA calculation. The federal unemployment tax rate is 6% on the first $7,000 of each employee's income, regardless of where the company does business. In addition, employers who pay their state's SUTA taxes on time can receive a maximum credit of 5.4%, reducing the FUTA rate to 0.6%. Certain employee benefits—employer contributions to health plans, pensions, and group life insurance premiums, for example—are also excluded from the calculation.

SUTA taxes are more complicated. Tax rates and taxable thresholds (known as wage bases) vary from state to state, industry to industry, and business to business. In Oregon, for example, the first $43,800 of an employee's salary is taxed under SUTA. In Arkansas, that threshold is $10,000. In Oregon, a new employer is taxed at a rate of 2.6%, but more established businesses in that state have rates ranging from 1.2% to 5.4%. Other factors affecting SUTA tax liability include the firm's history of on-time payments to the state insurance fund and the number of former employees receiving unemployment benefits.

How to reduce your SUTA and FUTA tax bills

- **Hire cautiously.** If you employ someone who doesn't work out, you could end up with additional unemployment claims and a higher SUTA tax rate.
- **Train vigorously.** To increase productivity and reduce turnover, target your investment in continuing education. Keep employees happy and loyal. Again, high turnover leads to unemployment claims, which leads to bigger SUTA tax bills.
- **Terminate judiciously.** If you must reduce personnel, consider offering severance or outplacement benefits to terminated employees. The sooner they return to the job market, the fewer the unemployment claims that will be factored into your company's SUTA tax calculation.
- **Dispute carefully.** Take the time to verify the accuracy of unemployment claims, as bogus representations by former workers can drive up your SUTA taxes. If an employee was fired for gross misconduct and thus disqualifying himself or herself from collecting unemployment, have strong documentation to support the termination.
- **Pay regularly.** Under federal guidelines, employers who make their SUTA contributions on time can reduce the amount of FUTA taxes by up to 90%.

As always, should you have any questions or concerns regarding your tax situation please feel free to call.

This newsletter provides business, financial, and tax information to clients and friends of our firm. This general information should not be acted upon without first determining its application to your specific situation. For further details on any article, please contact us at 304-233-5030.