Tax Planning with a Difference

A tax expert reminds you about some important new deductions.

By Mark E. Battersby

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Every practicing podiatrist should recognize the need for -- and the benefits that can be derived from -- tax planning. The objective of tax planning is to defer or reduce the podiatry practice's tax bill whenever possible. Unfortunately, tax planning is often complicated when state and local business taxes are brought into the equation.

One of the most difficult -- and often overlooked -- aspects of tax planning involves the podiatry practice's liability for state and local taxes. All too often, planning to take advantage of a legitimate "loophole" in the federal tax laws will reduce or even eliminate the benefits that the same transaction generates on the state tax return.

At its most basic, tax planning is an ongoing event. Every podiatrist should be on the lookout for ways to reduce the podiatry practice's federal and state tax liability. Many businesses -- and even some practices -- have a lot of ups and downs from one year to the next. Sizeable profits in one year reduced by a big tax bill often leave the podiatry practice without the reserves necessary to tide it over when business might not be so good.

Business Tax Planning

Effective tax planning for any podiatry practice involves a number of steps including the following:

-- The principal, shareholder or partner's personal tax situation should be assessed;

-- Tax-reducing strategies should be developed and implemented on an ongoing basis;

-- The form of doing business, such as sole practitioner, partnership, limited liability company, S corporation, regular 'C' corporation or even multiple entities should be reviewed;

-- Also reviewed should be the podiatry practice's accounting period and accounting method;

-- The practice's tax strategy should be coordinated with that of the principals;

-- State and local taxes should be minimized; and

-- Tax law changes should be factored into the ongoing tax planning process.

It goes without saying that recent tax law changes have significantly increased both the complexity and the rewards for tax planning. Remember, however, law changes impact not only on the federal tax bill.

Recent Federal Tax Law Changes

The Job Creation and Worker Assistance Act of 2002 (JCWA), signed into law by President Bush on March 9, 2002, for example, made a number of significant changes to our basic tax law. Designed to stimulate the economy, many podiatrists and their practices have already benefited from those changes, several of which were retroactive to the 2001 tax year. Unfortunately, the tax authorities in many states have been "cool" to the federal stimulus efforts.

Since most states use the Internal Revenue Code, the federal tax law, as the base for their state income taxes, the federal cuts threatened to reduce state revenues. Many state legislatures have forestalled that possibility -- and reduced the amount of savings that many podiatry practices might otherwise enjoy as a result of the economic stimulus package -- and other tax legislation passed in 2002.

With states limiting -- or taking away completely -- the benefits of JCWA, how can any podiatrist hope to fully stimulate the economy of their practice? The answer lies in the systems -- both federal and state.

Federal Tax Breaks

Businesses, from large multinational companies to self-employed professionals, received the lion's share of the tax breaks under the JCWA. That stimulus bill included a provision that provides podiatry practices and businesses with a "bonus" 30 percent depreciation deduction on capital equipment purchased between September 11, 2001 and September 11, 2004 -- and a second one that extended the time period for using net operating losses to offset taxes - In essence, creating refunds of previously-paid taxes for many troubled podiatry practices.

As passed, the federal stimulus package was much smaller than the one originally proposed by the Bush administration. However, its implications for state budgets were reportedly still too large for many state legislatures to go along with. Through legislative action or inaction, a majority of states have declined to fully adopt both the depreciation "bonus" and the NOL provisions.

The result will be more tax dollars flowing into straight state treasuries while many podiatry practices will face increased complexity as they account for their income and assets differently for state and federal purposes.

Bonus Depreciation Means More Bookkeeping

The depreciation "bonus" of the JCWA allows podiatry practices an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property such as equipment, software and even improvements made to leased business property. On the podiatry practice's federal tax returns, the 30 percent "bonus" depreciation is allowed for both regular and alternative minimum tax (AMT) purposes for the tax year in which the property is placed in service.

Naturally, the basis of the property and the depreciation allowance in the year of purchase as well as in later years must be adjusted to reflect the additional first-year depreciation deduction. In other words, any "bonus" deprecation claimed on the tax return will reduce the book value of the underlying asset and the amount of depreciation deductions that can be claimed in later years.

Only thirteen states have laws that conform to the new federal provisions on "bonus" depreciation. Twenty-four states plus the District of Columbia have not conformed. Of the remaining nine states with personal income taxes, corporate income taxes or other business taxes that are substantially similar to corporate income taxes, most require taxpayers to add back a portion of the federal depreciation "bonus" when figuring their state tax but then allow for the remainder of the "bonus" to be taken in later years.

Obviously, podiatry practices operating in states that choose not to conform fully with the deprecation "bonus" will find themselves compelled to keep multiple sets of books on the current book value (basis) for each asset that qualifies for the federal provision.

Few States Like NOL’s

Under our federal tax rules, net operating losses (NOLs) can be carried back two years. The new law temporarily extends that general carryback period from two to five years. In addition, certain NOL’s that are usually carried back for three years, such as casualty losses, can also be carried back five years under the JCWA.

This enhanced federal carryback applies only to losses that arise in tax years ending in 2001 and 2002. Every podiatry practice is given one opportunity to "elect out of" or reject this treatment and the choice is final. The new law also allows a taxpayer's NOL deduction to reduce its alternative minimum taxable income (AMTI) up to 100 percent.

Unfortunately, only seven states have adopted the NOL provision and only four of those -- Alaska, North Dakota, Oklahoma and Vermont -- have adopted the provision as written in the federal law. Delaware, New York and Wisconsin have adopted the basic NOL provision but limited the amounts that can be carried back.

Of the remaining jurisdictions, 40 states and the District of Columbia have not adopted the NOL provisions thus far, while Nevada, Washington and Wyoming don't impose corporate or personal income taxes.

Factoring it into Planning

Faced with budget shortfalls, many states are balking at adopting tax breaks included in the federal economic stimulus package and other federal tax-related legislation. The quandary for the states is this: Should they go along with the tax breaks and suffer another revenue hit, or refuse, thereby denying business taxpayers some benefit and complicating an already complex tax code?

Regardless of whether the states decide to accept or reject tax benefits created on the federal level, every podiatry practice can claim a legitimate federal tax deduction for all state, local and foreign taxes paid or accrued within the tax year -- at least to the extent that they are directly attributable to the practice (or to the production of income). In fact, even advance payments of estimated state income taxes made by a cash-basis podiatry practice under state law are tax deductible in the year paid.

The fact that a state is out of conformity with the JCWA and other federal tax breaks now doesn't mean that it will necessarily remain so. A number of states normally synchronize their law to the federal provisions as of January 1 of each year.

Remember, however, tax law changes whether on the federal or state levels are not the only reasons for tax planning. The changing economic climate, competition, the personal circumstances of the principal or principals and, of course, the goal of both the practice and the podiatrist are constantly changing. Tax planning should reflect those changes.

Tax planning is -- or should be -- a year 'round endeavor. A podiatrist should understand what deductions are available to the podiatry practice and keep the records necessary to support and document every business transaction. In this manner, the resulting tax savings can be used to successfully operate and grow the podiatry practice. Naturally, that tax planning should incorporate the tax rules of the state or states where the practice operates.

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