Tax Traps and How to Avoid Them

Forewarned is forearmed.

BY MARK E. BATTERSBY

The One Big Beautiful Bill Act (OBBBA) extended the statute of limitations for many tax deductions. Today, it is more important than ever to be aware of the many "traps" lurking in the tax rules, new and old. Failing, even accidently, to comply with the tax rules or tax codes can leave every podiatric practice—and its principals—open to possible penalties and fines.

A good example of one potentially expensive tax trap involves the entity under which the practice operates.

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Practical Practice Entities

While the structure used to conduct business is already in place, is it the entity that will produce the lowest tax bills and provide the most liability protection for its principals? Choosing the original practice structure, e.g., sole proprietorship, LLC, S, or a regular corporation, may have been done without considering all of the tax implications. Or, the ever-changing tax rules may make switching entities today worthwhile.

Ignoring the so-called LLC "loophole" where the podiatric practice is treated as a pass-through entity is another trap, one where it is not the IRS impacted but rather the LLC and its members. Both can be expensive—if not avoided.

Physician Incorporate Yourself

From medical school on, almost every physician is advised to incorporate for the tax benefits and liability protection. Unfortunately, this advice ignores several realities including the hidden cost of incorporating.

Incorporation isn't free. There are those high accounting fees, legal costs, and administrative burdens that all affect the potential tax savings. Switching might be called for. Would an LLC or even an S corporation provide similar liability protection with more tax-related benefits?

The OBBBA and the QBI

The One Big Beautiful Bill Act (QBBBA) made the deduction for Qualified Business Income (QBI) permanent. The QSI allows a 20% deduction from the income "passed on" by small businesses and practices, such as sole proprietorships, partnerships, and S corporations.

While making the 20% deduction for QBI permanent, the law also added new restrictions such as a $5 million gross receipts cap and a minimum deduction, beginning in 2026, for taxpayers with a minimum of $1,000 in total QBI, allowing them a QBI deduction of $400.

Most podiatric practices operating as pass-through entities potentially face a trap by being labeled as a so-called "Specified Service Trade Business" (SSTB). As an SSTB, the total taxable income—the amount of income subject to tax after deductions and exemptions—must be considered in order to determine whether it gets the full 20% deduction, a limited deduction, or no deduction at all.

Any taxpayer with income passed on from an SSTB below $197,300 (or $394,000 for married couples filing jointly), can generally claim the full 20% deduction. Of course, if income exceeds those caps, the limited QBI deduction is phased out above $247,000 for single taxpayers and $364,000 for married couples, with taxpayers no longer eligible for the QSI deduction.

Whether doing business as an SSTB or not, a QBI deduction can be carried forward when a practice or business has a negative QBI or qualified business losses which adversely impact the annual deduction. Those losses can be carried forward indefinitely until fully offset by positive QBI amounts down the road.

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Employee or Independent Contractor

A question often facing many DPMs is whether the income they receive as W-2 income is more favorable than income reported on Form 1099 as an independent contractor. Which type of income will mean more control over taxes and greater deduction potential—if established the right way.

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When a podiatric practice misclassifies its employees, it is a clear and potentially expensive trap. If the practice hires workers, it's essential to understand the difference between employees who are subject to payroll taxes and benefits and independent contractors who are not.

Worker classification impacts on the payments of Social Security, Medicare, employment taxes and, of course, whether the practice must withhold income tax. Misclassification not only makes the operation a prime target for audits, it can trigger back payroll tax liabilities, penalties, and interest.

Using the IRS's common-law independent contractor test and its updated "gig" economy factors can help avoid this trap. Keeping copies of contracts, scope-of-work documents, and evidence about financial and other controls along with detailed information about an independent contractor's other clients, patients or customers, his or her licenses, etc. may support the independent contractor label. When in doubt, treat the worker as an employee or seek legal consultation.

More Woes with Employees

The list of worker-related potential tax traps is far more extensive. No employer wants to deprive their staff overtime payments that might be tax-free—if the practice handles them correctly.

The OBBBA created a new tax deduction for overtime pay where workers making less than $150,000 annually can deduct as much as $12,500 for single filers and $25,000 for those filing jointly.

The podiatric practice, the employer, should remember that overtime is still considered as wages for FICA tax purposes, meaning the wages are still subject to Social Security and Medicare tax. And, unfortunately, workers can only deduct overtime that is specifically reported as overtime on their W-2s.

Don't overlook the withholding requirements for employment taxes.

Unpaid Payroll Taxes

Unpaid payroll taxes have long been an expensive trap. All employers are required to deposit all taxes withheld from an employee's wages as well as the operation's share of those taxes. As practices collect these taxes throughout the year, the law requires them to forward the amount to the IRS on a quarterly, monthly, or biweekly basis.

When a practice collects payroll taxes from its employees and fails to remit the funds to the IRS on time and in full, it becomes vulnerable to harsh penalties and even possible jail time.

What's worse, it is not only the practice that can be held responsible for unpaid payroll taxes. Anyone who has the authority to pay bills, hire, etc. can be held personally liable for a practice's unpaid employment taxes. There is no liability exemption, even if the practice is incorporated or an LLC; nor does the responsible person have to be an officer, principal, or shareholder in the podiatric practice.

Ignored Deductions

Quite a few podiatrists go overboard when searching for tax deductions. Unfortunately, this overboard search—whether finding too many tax deductions, making up tax deductions artificially, or enhancing existing write-offs in order to inflate deductions or expenses—appears to be on the increase just as the IRS's audit figures appear to be going down.

Naturally, not every expenditure can be claimed as a business expense. Non-deductible expenses—such as personal or private expenses unrelated to the podiatric practice, fines, or penalties including traffic or parking finesp—are to be avoided. Bottom line: all deductions must be "ordinary and necessary" and related to the practice. If the IRS catches the claiming of false deductions, penalties could be:

• 20% of the disallowed amount for filing false claims.

• $2,500 if the IRS determines a frivolous tax return was involved.

And, remember, there is no statute of limitations for fraudulent tax returns.

Tempted by Faster Deductions

Today, bonus depreciation is back. What's more, the FULL 100% deduction will apply through 2029 for property acquired after January 19, 2025. In addition to bonus depreciation, the OBBA doubled the current Section 179 first year expensing deduction from $1,250,000 to $2,500,000 and increased the asset acquisition limit from the current $3,130,000 to $4,000,000.

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However, while the result of these faster write-offers is tax savings in the short-term, the method used to pay for those purchases is what determines whether the deduction hurts or helps the practice or business. Many experts recommend that those faster write-offs be utilized only

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when the purchase has been made in cash.

If, for example, the full write-off is taken, but a purchase has been financed over several years, the current tax bill might be reduced, but the practice will be making loan payments long after the benefit is gone. In other words, the practice might save on taxes today, but future cash flow remains impacted by monthly loan payments. By carefully considering when and how to use the Section 179 deduction, you can avoid costly tax pitfalls and maintain strong cash flow for years to come.

Fatal and Expensive Tax Shelters

The sale of programs whose major purpose was to produce tax savings, so-called "tax shelters," continues to draw buyers. Obviously, not all shelters are solely to shelter income from the buyer or "investor" from taxes.

A loss resulting from fraud may or may not be tax-deductible. The scheme that leads to fraud, or the appearance of fraud, may be a tax trap. Despite numerous warnings, promoters continue to aggressively promote tax-saving strategies such as "captive" insurance companies.

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So-called "captive" insurance companies are a perfectly legitimate risk management tool for qualifying practices and their principals. However, many practice principals and owners of closely-held businesses continue to be persuaded by promoters, accountants, and wealth planners to participate in abusive "micro-captive" structures that lack many of the requirements of insurance providers.

Coverages offered by these questionable entities may "insure" implausible risks, meet genuine practice needs or, in many cases, duplicate the practice's existing commercial insurance coverages.

Being too creative with otherwise legitimate tax deductions is both a potential trap and a target for auditors.

Is It Personal or Business?

Mixing personal and practice finances is an all-too-common error.

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Using a single bank account or credit card for all expenses makes it difficult to distinguish legitimate practice-related costs from personal expenses. This can cause errors when claiming deductions and raise red flags.

Mixing personal and business expenses—or claiming deductions that aren't allowed—invites scrutiny and may make it more difficult to plan for the future. While it can be tempting to use a bank account or one credit card for all expenditures, doing so can make it difficult to tell legitimate practice-related expenses from personal ones. Using a separate practice bank account and a practice credit card can avoid scrutiny, potential audits, and help with an operation's financial planning.

Sooner Rather Than Later

With taxes, one of the biggest traps is failing to plan for succession. Without a clear strategy, heirs may face estate taxes, legal disputes, or more.

If the podiatrist dies and his or her assets pass via inheritance, there could be estate taxes, valuation issues, and disputes over what is "fair".

Also keep in mind that if the podiatric practice is "gifted" to a qualified recipient, the IRS may view it as a taxable transfer. If the practice is sold at a price the IRS feels is too low, they may get involved.

Don't Overlook State and Local Tax Traps

The federal State and Local Tax (SALT) deduction has been given a new life. Eligible taxpayers who itemize their deduction are allowed to subtract certain state and local taxes from their federal taxable income.

For tax years 2025 through 2029, the maximum SALT deduction has been increased to $40,000 ($20,000 for married individuals filing separately). Even better, the new rules allow pass-through entities like S corporations and LLCs to deduct state tax at the entity level, bypassing the SALT cap.

Those podiatrists working in multiple states may face conflicting and complex state tax obligations. Key to avoiding this potential tax trap involves understanding tax liabilities for different states, especially states that get priority taxation on income earned across state lines.

Moving to a state with lower taxes can admittedly reduce most people's tax burden and is one way of avoiding this potential trap. However, before taking any action, consider the overall picture and impact of all state taxes, not merely the income tax but also property and estate taxes before relocating.

While it can be tempting to use a bank account or one credit card for all expenditures, doing so can make it difficult to tell legitimate practice-related expenses from personal ones.

Avoiding Tax Traps—Legally

Avoiding potential tax traps involves a number of tried-and-true strategies such as:

• ***Getting Professional Help and/or Software.*** Using reliable accounting software or utilizing the services of a qualified tax professional can ensure accurate recordkeeping, proper tax planning, and timely filings.

• ***Documenting Everything.*** Keeping detailed documentations such as receipts, invoices, and contemporaneous logs for all transactions that will be claimed as deductions.

• ***Labeling All Income.*** Attempting to label a bank deposit or payments from third-parties months after they occur makes it difficult to battle the IRS's labeling them as taxable income—whether the sums were personal in nature or not,

• ***Being Aware of Common Mistakes.*** Awareness can help tame stress at tax time and ensure accurate reporting of the practice's income—and deductions.

• ***Going Paperless.*** Filing tax returns electronically can help avoid simple math errors and ensure timely submissions.

• ***Staying Informed.*** Keeping up-to-date with the ever-changing tax laws and regulations (federal, state and local) or working with a professional who does.

After the Fact

It is no secret that a podiatric practice's taxes can be complicated. However, many of the mistakes that lead to penalties, fines, or even audits are preventable. What's more, avoiding potential tax traps can derail the practice or reduce its profits—both of which are more important than ever in today's economy.

All medical professionals, including DPMs, face specific tax traps due to their high income, complex practice structures, etc. Consider the Alternative Minimum Tax (AMT). As income increases, podiatrists are more likely to be subject to the AMT, a parallel tax system that disallows many common tax deductions, potentially leading to a higher tax bill.

The IRS continues to target tax errors, errors likely to increase after the recent law changes. In fact, the IRS is increasing audits of professional practices, businesses, and high-income individuals. Inaccurate or inconsistent reporting, especially for those with income over $400,000, can act as a red flag for an audit.

Maintaining good records, using professional tax and/or accounting software, seeking professional guidance, and reconciling the podiatric practice's books on a regular basis will help avoid potential tax traps. **PM**

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