Freddi Eberhart & Associates Inc.
CERTIFIED PUBLIC ACCOUNTANTS

Newsletter

MAY 2021

Freddi Eberhart & Associates Inc. would like to thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time. Also, thank you for recommending us to your family, friends, and associates. We truly appreciate your referrals.

This Month:

Upcoming dates:

May 9

- Mother's Day

May 17

- Individual income tax returns for 2020 are due

May 31

- Memorial Day

Tax day is finally here!

California continues to cause delays in 2020 tax filing for PPP loan recipients.

Also in this addition how to create fortress balance sheets and few basics about different types of taxes.

California Finalizes Rules on Tax Treatment of Forgiven PPP Loans

Back in February, we advised you that the State of California had not conformed to the deductibility of PPP expenses (essentially making PPP and EIDL loans taxable) but that legislation had been introduced to make it conform to the Federal Act. On Friday, April 16, 2021, that proposed legislation (AB 80) was amended to allow deductions for expenses paid with forgiven PPP funds, but with limitations which require reductions of gross revenue in 2020 compared to 2019 (which was not a limitation in the Federal Act). Newsom signed this amended legislation on April 29, 2021.

AB 80 is now officially law in California, providing partial conformity to federal law allowing taxpayers to deduct, in certain circumstances, expenses paid with PPP forgiven loan amounts as well as EIDL targeted and advance grants. Key points of measure AB 80 include:

- The conforming to federal rules apply retroactively to taxable years beginning on or after January 1, 2019.

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California Finalizes Rules on Tax Treatment of Forgiven PPP Loans (Cont'd)

- The 25% gross receipts reduction does not apply to the EIDL advance grants which means taxpayers may exclude the EIDL grants and can fully deduct these expenses even if they do not meet the gross receipts reduction level.
- AB 80 conformity is only applicable to the exclusion from income for PPP loan forgiveness and EIDL advance grants. AB 80 does not apply to SBA subsidies paid on SBA loans, Shuttered Venue Operator Grants or Restaurant Revitalization Grants. These subsidies/grants are considered income for California purposes, but expenses are fully deductible on the California return.
- The California Assembly did away with the $150,000 limitation for PPP loans that has been debated for several months now and installed two exceptions to deductibility. In general, the bill conforms California's tax treatment for expenses paid with forgiven loans under the CARES Act or the CAA for tax years beginning after January 1, 2019. The exceptions are for publicly traded companies and "ineligible entities."
- An entity is ineligible to deduct expenses from PPP and PPP2 funds if it does not have a 25% or greater reduction in gross receipts in any calendar quarter in 2020, compared to the same calendar quarter in 2019. If the taxpayer does not meet this gross receipts reduction level, the expenses cannot be deducted on the California return even though the federal rules allow expenses to be deducted regardless of whether there was a reduction in gross receipts.

AB 80 also provides that Economic Injury Disaster Loan (EIDL) advance grants received under the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the Consolidated Appropriations Act (CAA) of 2021 are not included in gross income and are not subject to the 25% reduction test.

State officials said the "tax breaks" (deductibility) will apply to up to 85% of the more than 1 million California businesses that received a combined $97 billion in federal loans, or an average of about $96,700 each. The bill is estimated to cost in the range of $4.4 billion to $6.8 billion with the final cost dependent on the percentage of PPP loans that are forgiven.

Now that the law has been signed, practitioners have many questions as to how the law will be applied. We are waiting for additional guidance.

Building a Fortress Balance Sheet

The best way to weather a storm is often by being prepared before the storm hits. In the case of small businesses, this means building a fortress balance sheet.

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Building a Fortress Balance Sheet (Cont'd)

What is a fortress balance sheet?

This long-standing idea means taking steps to make your balance sheet shockproof by building liquidity. Like a frontier outpost or an ancient walled city, businesses that prepare for a siege - in the form of a recession, natural disaster, pandemic, or adverse regulatory change - can often hold out until the crisis passes or the cavalry arrives. Building a fortress balance sheet isn't just a good idea for mitigating risk. Healthy cash reserves can also enable your firm to capitalize on opportunities, expand locations, or introduce new products.

Consider these suggestions for building your own fortress balance sheet.

- **Control inventory and receivables.** These two asset accounts often directly impact cash reserves. For example, carrying excess inventories can deplete cash because the company must continue to insure, store, and manage items that aren't generating a profit. Also take a hard look at customer payment trends. Clients who are behind on payments can squeeze a firm's cash flow quickly, especially if they purchase significant levels of goods and services - and then fail to pay.

- **Keep a tight rein on debt.** In general, a company should use debt financing for capital items such as plant and equipment, computers, and fixtures that will be used for several years. By incurring debt for such items, especially when interest rates are low, a firm can direct more cash towards day-to-day operations and new opportunities. Two rules of thumb for taking on debt are don't borrow more than 75 percent of what an asset is worth, and aim for loan terms that don't exceed the useful life of the underlying asset. A fortress balance sheet also means that debt as a percent of equity should be as low as possible. So total up your debt, equity and retained earnings. If debt is less than 50% of the total, you are on your way to building a stronger foundation for your balance sheet.

- **Monitor credit.** A strong relationship with your banker can help keep the business afloat if the economy takes a nosedive. Monitor your business credit rating regularly and investigate all questionable transactions that appear on your credit report. As with personal credit, your business credit score will climb as the firm makes good on its obligations.

- **Reconcile balance sheet accounts quarterly.** It's crucial to reconcile asset and liability accounts at least every quarter. A well-supported balance sheet can guide decisions about cash reserves, debt financing, inventory management, receivables, payables, and property. Regular monitoring can highlight vulnerabilities in your fortress, providing time for corrective action.

- **Get rid of non-performing assets.** Maybe you own a store across town that's losing money or have a warehouse with a lot of obsolete inventory. Consider getting rid of these and other useless assets in exchange for cash.

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Building a Fortress Balance Sheet (Cont'd)

- **Calculate ratios.** Know how your bank calculates the lending strength of businesses. Then calculate them for your own business. For example, banks want to know your debt service coverage. Do you have enough cash to adequately handle principal and interest payments? Now work your cash flow to provide plenty of room to service this debt AND any future debt! But don't forget other ratios like liquidity and working capital ratios. The key? Improve these ratios over time.

Remember, the best time to get money from a bank is when it looks like you don't need it. You do this by creating a fortress balance sheet!

Taxes: These Basics are for Everyone

Understanding how our tax system works can be tricky for anyone. Whether you're an adult who never paid much attention to the taxes being withheld from your paycheck or a kid who just got his or her first job, understanding the basics can help refine and define questions you may have.

Many schools don't teach these tax lessons. This results in many people entering life with a pretty incomplete picture of how taxes work, unless someone else takes the time to explain these tax concepts. Here are some pointers to help you or someone you know navigate our tax maze.

Taxes are mandatory!

While we can have a debate about how much each person should pay, there's no debating that local, state and federal governments need tax revenue to run the country. These funds are used to build roads, support education, help those who need financial assistance, pay interest on our national debt and defend the country.

There are many types of taxes

When you think of taxes, most think of the income tax, which is a tax on business and personal income you earn from performing a job. But there are also other types of taxes. Here are some of the most common.

- **Payroll taxes.** While income taxes can be used to pay for pretty much anything the government needs money for, payroll taxes are earmarked to pay for Social Security and Medicare benefits.

- **Property taxes.** These are taxes levied on property you own. The most common example of this is the property tax on a home or vacation property.

- **Sales tax.** These are taxes placed on goods and services you purchase. While most of this tax is applied at the state and local levels, there are also federal sales taxes on items like gasoline.

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Taxes: These Basics are for Everyone (Cont'd)

- **Capital gains taxes.** If you sell an investment or an asset for a profit, you may owe capital gains taxes. The most common example of this is when you sell stock for a gain. Capital gains taxes could also come into play with other assets, such as a rental property you sell for a profit.
- **Estate taxes.** This tax is applied to assets in your estate after you pass away.

Not all income is subject to tax

Most, but not all, of your income is subject to tax.

- While your paycheck is subject to tax, interest earned from certain municipal bonds is not. And the government often excludes things like benefits from the tax man.
- Capital gains taxes have exclusions for gains on the sale of your home and donated stock.
- Estate taxes have an exclusion, so only estates in excess of the exclusion are taxed.

This is why having someone in the know can be really helpful in navigating these rules.

The progressive nature of income tax

When it comes to income taxes, the government gets to take the first bite. The question is how BIG of a bite the government gets to take.

For example, there is a fairly complex deduction for families with children, and the earned income tax credit is an added tax cut for those in the lower end of the progressive income tax base. There are also credits and deductions for businesses, homeowners, education and many more types of taxpayers.

As you can imagine, the U.S. tax system is very complex with many nuances. Please seek help if you have further questions or are facing a complicated taxable transaction.

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.

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