

New Practice Owners Can Avoid Tax Underpayment Ulcers

By: Owen E. McCafferty, CPA, CVPM

April 15 is a time when the Muse inspires thoughts of yearly tax-planning. The intensity of the inspiration increases when the tax bills hit. Why wait 3½ months into the New Year before taking charge of your tax life? Start now. The transition from associate doctor to new practice owner requires much more forethought. Anticipate, not procrastinate.

Before the end of the year, to mitigate tax costs, some of the more creative and visionary practitioners take advantage of an opportunity for early tax liability calculation. The more individualistic “do-it-yourselfers” choose to wait until the income tax returns are in need of preparation. By the time income tax returns are completed, the opportunity for planning is de minimis. To be effective, planning must be initiated before March, the last month of the first quarter of the New Year.

Practitioners may have owed money for the prior year’s taxes and still owe taxes owed for the coming year. Because of increases in income taxes resulting from greater financial prosperity, the tax liability sneaks up on unsuspecting new owners. Even more dastardly is this surprise since the Social Security and Medicare tax impact on earnings might not have been withheld. Not only is the income tax in arrears but also the FICA tax component is owing at double that of the prior employee status. The prior employer paid one half of the FICA tax and the associate paid the other half. As owner, both portions are paid.

The Medicare/Social Security tax has always hit associates hardest because a greater percentage of the associate’s adjusted gross income is used to pay the Medicare and Social Security taxes. Associates rarely generate material non-earned income. As new owners, the young practitioner still does not have much of an increase in adjusted gross income, but now must pay both sides of the FICA tax as employer and employee.

The reason for the double hit is that practitioners who are unincorporated must report not only the income tax impact on their income tax return but also the Social Security and Medicare tax costs. This Social Security and Medicare tax paid by a self-employed individual will usually be greater than the income taxes to be withheld.

Practitioners with adjusted gross incomes below \$90,000 are hit hardest. Most veterinary associates fall under this amount. The aggregation of the Social Security/Medicare tax, coupled with the income tax causes many unsuspecting veterinary practitioners to stagger by the aggregated cost of the amount of additional taxes owing.

Even in the years after the associate buys his/her first practice, the terror does not end. Most at risk is the 4- to 8-year practice owner. Depreciation benefits are dwindling, interest expense is diminishing with principal portion escalating on indebtedness owed. The reminder system is becoming more operative with three full years of client activity now available for recall. The new practice owner finds, much to his/her chagrin, that their income is escalating and with it is their tax obligation not only for federal, state, and local income tax purposes but also Social Security and Medicare costs.

Associates evolving into practice owners must be careful. Newer practice owners frequently fall prey to the depreciation reliance. They spend their tax money establishing a lifestyle far in excess of their competency to replicate it in subsequent years. Like a rubber band snapping, a new practice owner spends the tax money because of the long-repressed desire for a little luxury. Now in control of the money, the new practitioner throws caution to the wind. Before, the employer withheld funds from the paycheck.

The temptation becomes too great and the new practice owner snaps. The government tax money that should have been forwarded is now used to make up for years of deferred gratification. Soon the new practice owner has dug into a very deep hole. Multiple years of spending the government's money soon catches up. The terror of paying for prior tax liabilities, as well as paying the tax on the tax, and the tax on that tax, and the tax on that tax all aggregate to devastate the younger practice owner.

If the young practitioner is lucky, a strong-willed CPA will intervene. This CPA will be very unpopular with the practitioner because the CPA will spoil the fun of the spendthrift doctor. The CPA could even be fired for voicing the truth. Hopefully, the new owner practitioner will listen before it is too late!

This problem is further compounded because of lifestyle and demographic differences between the current generation of new doctors and those doctors precedent. In the old days (the late 70s to early 80s), veterinary practitioners were the sole support of their family unit. Their income was the only income subject to taxation.

That "Leave it to Beaver" type configuration no longer exists in the family unit. Both spouses are actively earning an income. Unfortunately, their employers are not withholding under this changed demographic reality. Employers withhold as if the income producer is the only income producer, unless specifically notified to withhold at a higher rate. The resulting impact is a higher than expected tax liability, many times calculated on the 11th hour on or near April 15 after a procrastinating practitioner finally surrenders the documents to the overworked accountant. (Editorial comment.)

The conclusion is not pleasant. Substantial dollars are required for payment to the various federal, state, and local entities with little cash reserves on hand. Because the procrastinating practitioner did not negotiate with the bank for a line of credit with a pre-authorized draft available, the new practitioner is forced to make an embarrassing trip to

the bank, hat in hand, requesting a bridge loan to cover the tax liability until the more lucrative summer months kick in and the practitioner has available capital to retire the tax-imposed debt. The pathos is quite simply that the tax-imposed debt is not retired, merely compounded year by year until hemorrhaged financially.

A Better Way to Do Things

As an alternative to this somewhat terrifying scenario, the young practitioner could have chosen to incorporate his/her practice. By incorporating the practice, W-2 earnings are withheld from the employee's payroll as cash is received. Not only is the federal income tax withheld, but that hated Social Security/Medicare tax is equally paid. The new practice owner, if approaching the problem with enough forethought, authorizes the payroll tax processing service to withhold at a higher rate than the statutory required minimum limit. The result is pleasant rather than onerous. Itemized deductions and exemptions often cushion the tax liability or can even result in a refund.

Dispelling That Old Myth

In years gone by, practitioners have long reveled in the theory that the most ideal situation is to either owe the government a bit or break even. The rationale is, "Why should you have the government use your money?" The answer is simple. Following a variation of theme on the Golden Rule, "It is far better to receive than to give."

Physically experience the terror of not having income tax money available to truly appreciate the beauty of the incorporated format. The fright causes many to incorporate. Although incorporation has many more tax benefits, this one very simple benefit that has improved the economic lot of decades of practitioners is available to practitioners today. LLCs and LLPs don't help, unless the LLC or LLP elects to be taxed as a corporation.

A practitioner can incorporate and be taxed under one of two separate code chapters, Subchapter C or Subchapter S. Under the Subchapter S format, the practitioner will not receive as many of the traditional tax fringe benefits of incorporation. The Subchapter S shareholder/employee will have flexibility and availability to maintain status as employee for withholdings, yet still be given wider breadth and latitude in conducting the affairs of the practice so that payments made can be classified as dividend distributions, not subject to the normal Subchapter C double taxation.

Our incorporated clients rarely have any difficulty with tax liability. The refunds they receive can be saved to either retire school or practice indebtedness or to secure additional assets. Unincorporated clients often receive surprises in the eleventh hour. Unincorporated practices cannot predict profit as easily as in years gone by.

The swings of income resulting from generation of profit of dietary products, flea control products, increased impact on boarding, and fee structure increases make the prediction of income generated in small animal veterinary medicine increasingly impossible. On the other hand, in large animal medicine, the opposite is occurring. The income decreases

each year because of the practitioner's inability to raise rates commensurate with their competencies.

Conclusion

Understand that incorporation will provide a cushion against the insidious ulcers resulting from underpayment of taxation. Money received and withheld upon receipt provides artificial discipline to the practitioner to help keep the practitioner out of harm's way. Incorporation will not solve all your problems. You can still under-withhold and cause yourself great difficulties. Other passive sources of income that are not subject to withholdings could cause your income tax liability to still be in the terror territory. We do suggest, though, that you consider incorporation and fully utilize the magic of payroll withholdings to help mitigate the pain that occurs on or near the month following the Ides of March.

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