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2020 YEAR-END INCOME TAX PLANNING FOR BUSINESSES

INTRODUCTION

WOW – what a crazy year! We are sure that you're looking forward to 2021 as much as we are. Despite all of the difficulty that the Pandemic has caused all of us, one positive to come out of it was relatively few changes to our income tax laws. Those laws that were passed, were almost exclusively related to the Pandemic.

It's that time of year when businesses normally start developing year-end planning strategies. However, there has never been a year quite like 2020. We think it is safe to say that year-end tax planning for 2020 is proving to be the trickiest in recent memory. In response to the Coronavirus, Congress and the IRS have been exceedingly busy enacting and issuing never-seen-before tax relief for businesses and employers. Congress had little choice but to pass this complex legislation quickly, without time for adequate review. Consequently, as one would expect, there continues to be significant uncertainty on the application and implementation of many of the most important provisions in this legislation. In addition, Congress may not be through as it continues to struggle with attempts to enact even more Coronavirus relief legislation before the end of the year. Moreover, for well over a decade, we have been faced with the off-and-on expiration of a long list of popular business tax breaks. Historically, Congress has temporarily extended the majority of these tax breaks every few years. Unfortunately, several of these traditional tax breaks are currently scheduled to expire after the end of 2020.

We are sending this letter to help bring you up-to-date on the most significant tax provisions that could impact year-end planning for businesses. We start this letter with a listing of selected historic business tax breaks scheduled to expire at the end of 2020. We then discuss selected COVID-related tax provisions that are most likely to impact businesses. We conclude this letter by highlighting certain time-honored, year-end tax planning techniques many businesses should consider notwithstanding the uncertain times we are currently experiencing.

Caution! It is entirely possible that Congress could enact additional COVID-related tax legislation before the end of this year. In addition, the IRS continues releasing guidance on various important tax provisions (particularly on COVID-related tax provisions that have already been enacted). We closely monitor new tax legislation and IRS releases on an ongoing basis. Please call our firm if you want an update on the latest tax legislation IRS notifications, announcements, and guidance or **if you need additional information concerning any item discussed in this letter.**

Be careful! Although this letter contains planning ideas, you cannot properly evaluate a particular planning strategy without calculating the overall tax liability for the business and its owners (including the

alternative minimum tax) with and without the strategy. In addition, this letter contains ideas for Federal income tax planning only. **State income tax issues are not addressed.** However, you should consider the state income tax impact of a particular planning strategy. We recommend that **you call our Firm before implementing any tax planning technique** discussed in this letter, **or if you need more information concerning anything discussed.**

On a much brighter note, now that 2020 is almost toast, let's get to know the team and how we feel about our own toast! Catch all four tidbits about our crew and win a treat!!

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2020 MAY BE OUR LAST CHANCE TO TAKE ADVANTAGE OF THESE TRADITIONAL BUSINESS TAX BREAKS

For well over a decade, we have been faced with the off-and-on expiration of a long list of popular tax breaks for businesses. Historically, Congress has temporarily extended the majority of these tax breaks every few years. However, several of these tax breaks for businesses **are scheduled to expire at the end of 2020,** and Congress has yet to extend them. Some of the more popular business tax breaks scheduled to expire at the end of 2020 include: Deductions for qualified improvements to certain energy-efficient commercial buildings; Credit of up to $2,000 for construction of qualified energy-efficient new homes; 7-year depreciation period for certain motor sports racetrack property; Employer credit for payments for qualified family and medical leave; 3-year depreciation period for certain race horses; and the Work Opportunity Credit for hiring workers from certain disadvantaged groups. **Caution!** As we send this letter, it has been reported that some members of Congress are still pushing for these tax breaks to be extended beyond 2020. However, only time will tell whether they will be extended. **Planning Alert!** In addition to these traditional expiring tax breaks, the COVID-inspired CARES Act (discussed in more detail below) also contains certain tax breaks scheduled to expire after 2020. For example, the 50% Employee Retention Credit of up to $5,000 per employee is effective for qualified wages paid after March 12, 2020 and **before January 1, 2021.**

HIGHLIGHTS OF SELECTED COVID-RELATED TAX PROVISIONS IMPACTING BUSINESSES

Largely in response to government-mandated shutdowns caused by COVID-19 (COVID), Congress enacted a series of tax-relief measures for businesses, including: The **Families First Coronavirus Response Act (“Families First Act”)** and the **Coronavirus Aid, Relief and Economic Security Act (“CARES Act”).** It is well beyond the scope of this letter to provide you a detailed discussion of the many business tax relief provisions contained in this voluminous legislation. Instead, the following are *selected* highlights that could have an impact on your business tax planning. **Caution!** Congress passed most of this recent COVID-Related legislation in a hurried fashion, without time to address the many uncertainties that would inevitably arise. As a result, over the last several months we have experienced a stream of piecemeal guidance from the IRS and Small Business Administration (SBA) attempting to respond to some of these uncertainties. As we finish this letter, we are still waiting for guidance on many unanswered questions. Our firm continues to monitor the developments in this area, so please call our firm if you need additional information regarding any of the provisions listed below.

Paycheck Protection Program Loans (PPP Loans). This program was intended to provide struggling businesses with a quick infusion of cash to stay afloat and to retain employees in the midst of government-mandated shutdowns. The initial cash outlay was in the form of a PPP Loan, with a potential for all or a portion of the loan to be forgiven if the borrower could establish that the borrowed funds were used for certain qualifying business expenditures (i.e., generally payroll, rent, utilities, and mortgage payments) during a designated 8-week or 24-week “Covered Period.” As we send this letter, the PPP Loan program stopped accepting loan applications on August 8, 2020 (although there are legislative proposals to extend that deadline). The SBA reported that there have been more than 5.2 million PPP Loans made aggregating approximately $525 billion in total. **Planning Alert!** Most PPP Loan borrowers are now struggling with how and when they should apply to the lender for their PPP Loan forgiveness. There are continued uncertainties regarding the PPP Loan forgiveness process, and we are hoping for additional guidance in the near future. As we wait for that guidance, here are a few things you should know:

- **No Defined Deadline For Submitting PPP Loan Forgiveness Application.** There is currently no

deadline for submitting a PPP Loan Forgiveness Application. Generally, payments (if any) are not due on a PPP Loan until the SBA remits the PPP Loan's forgiveness amount (if any) to the initial lender of the PPP Loan. However, if the borrower fails to apply for loan forgiveness within 10 months of the end of the borrower's 8-week or 24-week covered period, payments of principal and interest on the PPP Loan must begin at the end of that 10-month period.

- **Deductibility Of Expenses Related To The PPP Loan Forgiveness Amount.** Even though the CARES Act provides that forgiveness of a PPP Loan is tax free, the IRS is currently taking the position that no tax deduction will be allowed for an expense, if the payment of that expense results in the forgiveness of a PPP Loan amount. As we complete this letter, there is significant pressure from business and professional groups urging the IRS to allow such deductions, or for Congress to pass legislation that would allow the deductions. Please contact our firm if you want a status report on this issue.

- **Potential For Expedited Forgiveness Procedures For Smaller PPP Loans.** The procedures for gathering documentation and applying for PPP Loan forgiveness could be tedious and time consuming. **Planning Alert!** In early October, the IRS and the SBA released a new "simplified" PPP Loan forgiveness Application Form that can be used only by borrowers that **received a PPP Loan of $50,000 or less.** This should significantly simplify the PPP Loan Forgiveness process for those qualifying borrowers who borrowed $50,000 or less. **Caution!** Certain members of Congress are currently promoting legislation that, if passed, could also substantially streamline the loan forgiveness process for PPP Loans under a certain dollar threshold that could turn out to be higher than $50,000. As we complete this letter, the chance of this type of legislation being enacted is uncertain.

Employment-Related Payroll Tax Credits, Deferrals, Etc. Last Spring, in addition to the PPP Loan provision, Congress passed a dizzying array of tax relief provisions designed to subsidize qualifying employers for keeping employees on their payroll, and to provide additional liquidity for their businesses. These tax relief provisions include: Refundable employer tax credits of up to 100% of the qualifying Sick Leave And Family Leave Payments made to qualifying employees; Refundable income tax credits for self-employed individuals with respect to their "Family Leave and Sick Leave Equivalent Amounts;" Refundable 50% Employee Retention Credit for qualifying wages paid by certain employers experiencing business closure or economic hardship due to COVID; and, Deferral of deposits for the 6.2% portion of employer payroll taxes (can also apply to the 6.2% portion of S/E Tax). **Planning Alert!** It is well beyond the scope of this letter to provide a detailed discussion of the various technical requirements a business must satisfy to qualify for and claim these benefits. However, if you think your business may qualify for any of these tax benefits, feel free to call our firm. We will be glad to review your particular situation and advise you whether your business qualifies.

Temporary Relief For Net Operating Losses (NOLs). Before the Tax Cuts And Jobs Act of 2017 (TCJA), net operating losses (NOLs) could generally be carried back two prior years, and carried forward for 20 years. TCJA generally repealed the 2-year carried back period for NOLs (except for NOLs attributable to certain farming businesses and certain property and casualty insurance companies), and allowed NOLs to be carried forward indefinitely. TCJA also limited the deduction for NOL carryforwards to 80% of the taxable income for the carryover year. The CARES Act generally provides the following temporary relief with respect to NOLs: **1)** Allows NOLs arising in tax years beginning after 2017 and before 2021 (e.g., NOLs arising in calendar years 2018, 2019, or 2020 for calendar-year taxpayers) to be carried back to 5 preceding years; and **2)** Removes the 80% of taxable income limit for the NOL deduction for any tax year beginning before 2021. **Planning Alert!** A taxpayer may elect to forego the carryback of an NOL. Generally, the election to forego the NOL carryback must be made by the due date (including extensions) for the year of

the NOL. The CARES Act provides that the election to forego the 5-year NOL carryback for tax years beginning in 2018 or 2019, may be made by the due date (including extensions) of the taxpayer's return for the first taxable year ending after March 27, 2020.

Temporary Suspension Of $500,000/$250,000 Loss Cap. For tax years beginning after 2017 and before 2026, TCJA placed a dollar cap of $250,000 ($500,000 for joint returns) on a noncorporate taxpayer's "Excess Business Loss." An Excess Business Loss for a year is generally the amount by which a taxpayer's aggregate business expenses exceed the aggregate business income for the year. The CARES Act retroactively suspends this cap on Excess Business Loss, and delays its effective date until tax years beginning after 2020.

Temporary Increase Of Limit On Business Interest Expense From 30% To 50% Of ATI. Effective for tax years beginning after 2017, TCJA generally limited the amount of business interest expense in excess of business interest income allowed as a deduction to 30% of Adjusted Taxable Income (ATI). Businesses with average gross receipts for the preceding three years of $25 million ($26 million for 2020) or less are generally exempt from this limit. The CARES Act makes the following changes: **1)** Increases the limit from 30% to 50% of ATI (unless the taxpayer elects otherwise) for tax years beginning in 2019 and 2020; **2)** Allows a taxpayer to use its "2019" ATI for purposes of determining the amount of the 50% of ATI limit for "2020"; **3)** For partnerships, the 30% of ATI limit remains in place for 2019 but is 50% for 2020; and **4)** Unless a partner elects otherwise, 50% of a partnership's "excess business interest" allocated to a partner in 2019 is fully deductible by the partner in 2020 and not subject to the 50% ATI limitation (the remaining 50% of excess business interest from 2019 allocated to the partner is subject to the regular ATI limitations for 2020 and subsequent years).

Retroactive Fix For Computing Depreciation For "Qualified Improvement Property." The CARES Act finally corrected the depreciation "glitch" contained in TCJA with respect to "Qualified Improvement Property." **Qualified Improvement Property (QIP)** is generally defined as ***"an improvement"*** to the ***interior portion*** of a ***commercial building*** (provided the improvement is not attributable to an enlargement of the building, elevators or escalators, or the internal structural framework of the building), if the improvement is placed in service ***"after"*** the building was first placed in service. Due to a drafting error in TCJA, QIP was assigned a depreciable life of 39 years, instead of the intended 15 year life. To compound the error, assigning QIP a depreciable life of 39 years (instead of 15 years) also disqualified QIP for the 100% 168(k) first-year bonus depreciation, because 168(k) property must have a depreciable life of 20 years or less. The CARES Act fixes this mistake retroactively by assigning a 15-year depreciable life for all QIP that was **placed in service after 2017.** Therefore, QIP placed in service in 2018 or 2019 retroactively qualifies for the 100% 168(k) bonus depreciation. **Tax Tip!** This is great news for taxpayers that have previously capitalized post-2017 remodeling costs for existing restaurants, retail stores, and office buildings. So long as the qualifying improvements to the remodeled property was placed in service after 2017, the capitalized remodeling should now qualify for a 100% write off under 168(k). **Planning Alert!** Recently-issued final 168(k) regulations confirm that a purchaser of an existing commercial building containing QIP made by a previous owner, will not be able to treat any portion of the building's purchase price as QIP.

- **Claiming The 100% 168(k) Depreciation For QIP Placed In Service In 2018 Or 2019.** The IRS says that we generally have two options to recoup the unclaimed 100% depreciation deduction for QIP placed in service in 2018 or 2019. **First,** we can amend the 2018 or 2019 return and claim the 100% depreciation deduction on the amended return. If we choose to amend the 2018 return, the IRS says that we must file the amended 2018 return **no later than October 15, 2021. Second,** we could recoup

the 100% 168(k) depreciation by claiming it through an automatic accounting method change in a subsequent year. For example, by filing an automatic accounting method change, you could claim the 100% deduction on your 2020 return (or even a later return). **Planning Alert!** If the QIP was placed in service in 2018 or 2019 by a partnership subject to the Centralized Partnership Audit Regime, our options for recouping the 100% depreciation deduction are more limited. We can either: **1)** File for an "Administrative Adjustment Request" (AAR) under the new Centralized Partnership Audit Regime for the current tax year, or **2)** File for an automatic accounting method change.

SELECTED TAX CHANGES INCLUDED IN OTHER RECENT LEGISLATION

Recent Legislation Extends The Due Date For Establishing A New Retirement Plan. Before the passage of the Consolidated Appropriations Act of 2020 (the "Appropriations Act"), calendar-year taxpayers wishing to establish a new qualified retirement plan for a tax year generally had to adopt the plan by December 31st of that year. However, a SEP could be established by the due date of the tax return (including extensions), but a **SIMPLE plan** was required to be established by October 1st of that year. **Effective for plans adopted for taxable years beginning after 2019,** the Appropriations Act generally allows the adoption of a stock bonus, pension, profit-sharing, or annuity plan for a taxable year after the close of the taxable year as long as the plan is adopted by the due date of the employer's tax return, including extensions. **Caution!** The IRS says that a SIMPLE plan must still be adopted for an existing business with an effective date no later than October 1st of the year. Moreover, the Committee Reports to the Act say this new extended adoption date does not override rules requiring certain plan provisions to be in effect during a plan year, such as the provision for elective deferrals under a qualified cash or deferral arrangement (also known as a 401(k) plan).

Increased Tax Credit For Small Employer Retirement Plan Startup Costs. Effective for tax years beginning after 2019, the Appropriations Act increases the credit for plan startup costs of employers with 100 or fewer employees. The credit is generally equal to 50% of the qualified startup costs paid or incurred during the taxable year. The credit is available for the first three years of the plan and cannot exceed the **greater of** **1) $500,** or **2) The lesser** of, **a) $250** for each employee eligible to participate in the plan who is not a highly compensated employee, or **b) $5,000.** Qualified startup costs are expenses connected with the establishment or administration of the plan or with retirement-related education for employees with respect to the plan. The credit is available for qualified start-up costs of an eligible employer plan, including: qualified pension, profit sharing, or stock bonus plans; qualified annuity plans; SEP plans; and SIMPLE plans.

New Three-Year Tax Credit For Small Employers Adopting Automatic Enrollment Provision For 401(k) Plan Or SIMPLE Plan. Effective for tax years beginning after 2019, the Appropriations Act provides a new $500 credit for employers with 100 or fewer employees. To obtain the credit, a qualified employer must adopt an automatic employee enrollment arrangement for the employer's qualified cash or deferred plan. An automatic enrollment arrangement generally provides that an eligible employee is automatically enrolled in the cash or deferred arrangement unless the employee elects not to defer compensation. The credit is only available for the year the employer sponsored plan first includes an enrollment feature and the two subsequent years. For example, an eligible employer is allowed a credit of $500 per year for up to three years for adopting an automatic employee enrollment provision for the employers 401(k) plan or SIMPLE IRA plan. The credit is available for newly-adopted plans containing an automatic enrollment provision as well as existing plans that adopt an automatic enrollment provision.

Retroactive Repeal UBIT Imposed On Tax-Exempt Organizations That Provide Employee Parking. Under

the Tax Cuts and Jobs Act (TCJA), a tax-exempt organization's unrelated business taxable income was increased by amounts paid or incurred by the organization to provide employee parking. This provision was effective for amounts paid or incurred after 2017. Recent legislation repealed this provision retroactively, effective for **amounts paid or incurred after 2017.** **Planning Alert!** Tax-exempt organizations that previously paid unrelated business income tax on expenses for qualified transportation fringe benefits, including employee parking, may now claim a refund. To do so, they should file an amended Form 990-T within the time allowed for refunds. More information on this process can be found at "*How To Claim a Refund or Credit of Unrelated Business Income Tax (UBIT) or adjust Form 990-T for Qualified Transportation Fringe Amounts* "at the IRS website.

Don't Overlook Simplified Accounting Methods For Certain Small Businesses. Although not part of the recent COVID-related tax legislation, its important to be aware that the Tax Cuts And Jobs Act (enacted in late 2017) provides for the following accounting method relief for businesses with **Average Gross Receipts (AGRs)** for the **Preceding Three Tax Years** of **$26 Million or Less for 2020: 1)** Generally allows businesses to use the cash method of accounting even if the business has inventories, **2)** Allows simplified methods for accounting for inventories, **3)** Exempts businesses from applying UNICAP, and **4)** Liberalizes the availability of the completed-contract method. **Planning Alert!** The IRS has released detailed procedures to follow for taxpayers who qualify and wish to change their accounting methods in light of these new relief provisions. Please call our firm if you want us to help you determine whether any of these simplified accounting methods might be available to your business.

TRADITIONAL YEAR-END TAX PLANNING TECHNIQUES

PAY SPECIAL ATTENTION TO "TIMING" ISSUES!

From a tax-planning standpoint, 2020 has been anything but a "normal" year for many businesses. The coronavirus has caused many businesses to incur an unprecedented loss of revenues during 2020, combined with unexpected additional costs. While at the same time, some business sectors have actually flourished during this difficult time. Consequently, for 2020, there is clearly no single year-end tax planning strategy that will necessarily apply to all (or even a majority) of businesses.

In normal times, a traditional year-end tax planning strategy for businesses would include reducing current year taxable income by deferring taxable income into later years and accelerating deductions into the current year. This strategy has been particularly beneficial where the income tax rate on the business's income in the following year is expected to be the same or lower than the current year. For businesses that have done well during the COVID crisis, this strategy would still generally be advisable. Consequently, in the following discussions we include "timing" suggestions as they relate to traditional year-end tax planning strategies that would cause you to accelerate deductions into 2020, while deferring income into 2021. However, for businesses that expect their taxable income to be much lower in 2020 than in 2021, the opposite strategy might be more advisable. That is, for struggling businesses, a better year-end planning strategy could possibly include accelerating revenues into 2020 (to be taxed at lower rates), while deferring deductions to 2021 (to be taken against income that is expected to be taxed at higher rates). **Caution!** As we discuss the planning methods that involve the "timing" of income or deductions, please keep in mind that you might want to consider taking the precise opposite steps recommended, if you decide it would be better to defer deductions into 2021, while accelerating income into 2020. **Planning Alert!** The relatively new 20% 199A deduction that was first available in 2018 adds another wrinkle to deciding whether to defer or accelerate revenues, and/or to defer or accelerate deductions. As discussed in much more detail below, your ability to take maximum advantage of the 20% 199A deduction for 2020

and/or 2021 may, in certain situations, be enhanced significantly if you are able to keep your taxable income below certain thresholds. Consequently, please keep that factor in mind as you read through the following timing strategies for income and deductions.

PLANNING WITH THE FIRST-YEAR 168(k) BONUS DEPRECIATION DEDUCTION

Traditionally, a popular way for businesses to maximize current-year deductions has been to take advantage of the **First-Year 168(k) Bonus Depreciation deduction.** Before the *"Tax Cuts And Jobs Act"* (TCJA) which was enacted in late 2017, the 168(k) Bonus Depreciation deduction was equal to 50% of the cost of qualifying **"new"** depreciable assets placed in service. TCJA temporarily increased the 168(k) Bonus Depreciation deduction **to 100%** for qualifying property acquired and placed in service **after September 27, 2017** and **before January 1, 2023.** TCJA further enhanced the 168(k) Bonus Depreciation deduction by making the following changes:

"Used" Property Temporarily Qualifies For 168(k) Bonus Depreciation. Before TCJA, only **"new"** qualifying property was eligible for the 168(k) Bonus Depreciation deduction. For qualifying property acquired and placed in service **after September 27, 2017 and before 2027,** the 168(k) Bonus Depreciation may be taken on **"new" or "used"** property. Therefore, property that generally qualifies for the 168(k) Bonus Depreciation includes **"new"** or **"used"** business property that has a depreciable life for tax purposes of **20 years or less** (e.g., machinery and equipment, furniture and fixtures, sidewalks, roads, landscaping, computers, computer software, farm buildings, and qualified motor fuels facilities). **Caution!** As discussed previously, a purchaser of an existing commercial building containing QIP made by a previous owner, will not be able to treat any portion of the building's purchase price as QIP.

- **Planning Alert!** The expansion of the 168(k) Bonus Depreciation to "used" property has expanded planning opportunities, including: **1)** A lessee that currently leases qualifying 168(k) property (e.g., leased equipment) from an unrelated lessor, could later purchase the property from the lessor and qualify for the 100% 168(k) Bonus Depreciation; **2)** Taxpayers that purchase the operating assets of another operating business will be able to deduct 100% of the purchase price that is properly allocated to 168(k) assets (other than QIP) of the target business; and **3)** The IRS says that a person who buys a partnership interest from an unrelated selling partner may be entitled to the 100% 168(k) Bonus Depreciation deduction with respect to a certain portion of the purchase price of the partnership interest, if the partnership owns existing qualifying 168(k) property. **(For Joan, jelly belongs on a PBJ sandwich, NOT on toast. She's a Benacol girl!)**

The 100% 168(k) Bonus Depreciation Deduction For "Used" Property Generally Makes Cost Segregation Studies More Valuable. Depreciable components of a building that are properly classified as depreciable personal property under a **cost segregation study** are generally depreciated over 5 to 7 years. **Before TCJA,** these depreciable building components for a purchaser of a "used" building generally qualified for the 179 Deduction (subject to the dollar caps), but did not qualify for a 168(k) Bonus Depreciation deduction because the 168(k) depreciation deduction only applied to "new" property. However, after TCJA, the depreciable components of a building that are properly classified as "personal property" (as opposed to "real property") will qualify for the 100% 168(k) Bonus Depreciation (whether new or used).

Example. Assume your S corporation acquired an existing shopping center during 2020 for $5,000,000. Pursuant to a cost segregation study, assume the taxpayer allocated the $5,000,000 purchase price to the various asset components as follows: **1)** $1,000,000 to land (non-depreciable), **2)** $750,000 to land improvements (15-year recovery period), **3)** $600,000 to equipment (five-year recovery period), and **4)**

$2,650,000 to the building (39-year recovery period). **For 2020,** the land improvements and the equipment identified in the cost segregation study would be eligible for a 100-percent 168(k) Bonus Depreciation deduction since **used property qualifies as long as the taxpayer did not** depreciate the property prior to its acquisition. Therefore, the **depreciation deduction for 2020 would be <u>$1,415,118</u>** ($750,000 for land improvements, $600,000 for equipment and $65,118 for the building).

<u>Annual Depreciation Caps For Passenger Vehicles Increased.</u> Vehicles used primarily in business generally qualify for the 168(k) Bonus Depreciation. However, there is a dollar cap imposed on business cars, and also on trucks, vans, and SUVs that have a **loaded vehicle weight of 6,000 lbs or less.** This dollar cap was increased significantly under TCJA. More specifically, for qualifying vehicles placed in service **in 2020** and used 100% for business, the annual depreciation caps are as follows: **1st year - $10,100; 2nd year - $16,100; 3rd year - $9,700; fourth and subsequent years - $5,760.** Moreover, if the vehicle (new or used) otherwise qualifies for the 168(k) Bonus Depreciation, the first year depreciation cap (assuming 100% business use) is increased by $8,000 (i.e., from $10,100 to $18,100 for 2020). Thus, a vehicle otherwise qualifying for the 168(k) Bonus Depreciation deduction with loaded **Gross Vehicle Weight (GVW) of 6,000 lbs or less** used **exclusively for business** and **placed in service in 2020** would be entitled to a **depreciation deduction for 2020 of up to $18,100,** whether purchased new or used. If the vehicle continues to be used exclusively for business during the **second year** (i.e., during 2021), it would be entitled to a second-year depreciation deduction of **up to $16,100.** **<u>Planning Alert!</u>** Even better, if the same new or used business vehicle (which is used 100% for business) has a loaded GVW **over 6,000 lbs, 100% of its cost** (without a dollar cap) could be deducted **in 2020** as a **168(k) Bonus Depreciation deduction.**

<u>168(k) Bonus Depreciation Taken In Tax Year Qualifying Property Is "Placed In Service."</u> The 168(k) Bonus Depreciation deduction is taken in the tax year the qualifying property is "placed in service." Consequently, if your business anticipates acquiring qualifying 168(k) property between now and the end of the year, the 168(k) Bonus Depreciation deduction is taken in 2020 if the property is placed in service no later than December 31, 2020. Alternatively, the 168(k) Bonus Depreciation deduction can be deferred until 2021 if the qualifying property is placed in service in 2021. Generally, if you are purchasing "personal property" (equipment, computer, vehicles, etc.), "placed in service" means the property is **ready and available** for use (this commonly means the date on which the property has been **set up and tested).** If you are dealing with building improvements (e.g., "Qualified Improvement Property"), the date on the **Certificate of Occupancy** is commonly considered the date the qualifying building improvements are placed in service. **<u>Practice Alert!</u>** Unlike the 179 Deduction (discussed in the immediately-following segment), the 168(k) Bonus Depreciation deduction is automatically allowed unless the business timely **elects out** of the deduction. However, the 179 deduction is not allowed unless the taxpayer makes an **affirmative election to take it.**

<u>PLANNING WITH THE SECTION 179 DEDUCTION</u>

Another popular and frequently-used way to accelerate deductions is by taking maximum advantage of the up-front Section 179 Deduction ("179 Deduction"). TCJA made several taxpayer-friendly enhancements to the 179 Deduction which include: **1)** Substantially increasing the 179 Deduction limitation (up to $1,040,000 for 2020), **2)** Increasing the phase-out threshold for total purchases of 179 property ($2,590,000 for 2020), and **3)** Expanding the types of business property that qualify for the 179 Deduction. **<u>Planning Alert!</u>** To maximize your 179 Deductions for 2020, it is important for your business to determine which depreciable property acquired during the year qualifies as 179 Property. The following is a list of the types of business property that qualify for the 179 Deduction (as expanded by TCJA):

General Definition Of 179 Property. Generally, "depreciable" property qualifies for the **179 Deduction** if: **1)** It is purchased **new or used, 2)** It is "tangible personal" property, **and 3)** It is used primarily for business purposes (e.g., machinery and equipment, furniture and fixtures, business computers, etc.). Off-the-shelf business software also qualifies. **Planning Alert! Before TCJA,** the 179 Deduction was not allowed for property used in **connection with lodging** (other than hotels, motels, etc.). TCJA removed this restriction, so the 179 Deduction **is now allowed** for otherwise qualifying property used in connection with lodging (e.g., the cost of furnishing a home that the owner is renting to others would now qualify).

Expanded Definition Of "Qualified Real Property." Before TCJA, property that qualified for the 179 Deduction also included **"Qualified Real Property"** (i.e., certain leasehold improvements to existing commercial buildings; certain costs of acquiring and/or improving restaurant buildings; and, certain costs of improving the interior of existing buildings used for retail sales). **Effective for property placed in service in tax years beginning after 2017,** TCJA changed the definition of **"Qualified Real Property"** (which qualifies for the 179 Deduction) to mean any of the following **"improvements" to an existing commercial** (i.e., nonresidential) building that are **placed in service after** the **commercial building was first placed in service: 1) "Qualified Improvement Property"** (previously discussed), **2) Roofs, 3) Heating, Ventilation, and Air-Conditioning Property, 4) Fire Protection and Alarm Systems,** and **5) Security Systems. Tax Tip!** Determining whether a major repair to a building's roof should be capitalized or deducted immediately as a repair under the voluminous capitalization regulations, is not always an easy task. Since new roofs with respect to an existing commercial building may now qualify for the 179 Deduction, in many situations, the "capitalization vs. repair" issue relating to the replacement of roofs should largely be eliminated where the 179 limitation caps for the year are not exceeded. **Planning Alert!** As we discussed above, "Qualified Improvement Property" (QIP) now qualifies for the 100% 168(k) first-year bonus depreciation. QIP also qualifies for the 179 Deduction, subject to the dollar limitation listed previously.

Business Vehicles. New or used business vehicles generally qualify for the 179 Deduction, provided the vehicle is **used more-than-50% in your business. Planning Alert!** As discussed previously in the 168(k) Bonus Depreciation segment, there is a dollar cap imposed on business cars and trucks that have a **loaded vehicle weight of 6,000 lbs or less.** If applicable, this dollar cap applies to both the 168(k) Bonus Depreciation and the 179 Deduction taken with respect to the vehicle.

- **So-Called "Heavy Vehicles" Exempt From Dollar Caps.** Trucks and SUVs that **weigh over 6,000 lbs** are exempt from the annual depreciation caps. In addition, new or used "heavy vehicles," if used more-than-50% in business, will also generally qualify for a **179 Deduction of up to $25,900** if placed in service in 2020 (if placed in service in 2021 the limit is projected to be $26,200). **Tax Tip!** Pickup trucks with loaded vehicle weights over 6,000 lbs are exempt from the $25,900 limit to the 179 Deduction if the truck bed is at least six feet long. **Planning Alert!** The $25,900 cap applies only for purposes of the 179 Deduction. This $25,900 cap **does not apply** with respect to the 100% 168(k) Bonus Depreciation deduction taken on vehicles weighing over 6,000 lbs.

- **Example.** Let's assume that before the end of 2020 you purchase and place in service a **new** or **used** *"over-6,000 lb"* SUV costing $60,000 **used entirely for business.** If you elected to take the 179 Deduction for the SUV, your 179 Deduction would be capped at $25,900. However, the remaining cost of $34,100 ($60,000 - $25,900) would be deducted as 168(k) depreciation unless you elected "out" of the 168(k) depreciation deduction. Alternatively, you could forego the 179 Deduction and simply deduct the entire $60,000 cost under 168(k) in 2020, provided you **placed the SUV in service no later than December 31, 2020.** Generally, you will be considered to have placed the SUV in service in 2020 if you have purchased

the vehicle and made it **ready and available** for use **no later than December 31, 2020. Caution!** Whether you take the 179 Deduction or 168(k) Bonus Depreciation on your business vehicle (and whether or not it weighs more than 6,000 lbs), if your business-use percentage **drops to 50% or below** in a later year, you will generally be required to bring into income a portion of the deductions taken in previous years.

- **Tax Tip.** Neither the **179 Deduction** nor the 168(k) Bonus Depreciation deduction requires any proration based on the length of time that an asset is in service during the tax year. Therefore, your business would get the benefit of the **entire 179 or 168(k) Deduction** for 2020 purchases, even if the qualifying property **was placed in service as late as December 31, 2020!** However, you would claim the 168(k) and 179 deductions in 2021 if the qualifying property was placed in service on January 1, 2021 or later in 2021.

The 100% 168(k) Depreciation Deduction (Through 2022) Has Temporarily Made The Section 179 Taxable Income Limitation Less Important. The 179 Deduction is limited to a taxpayer's "trade or business" taxable income (determined without the 179 Deduction) for the tax year. Any excess 179 Deduction over the "taxable income limitation" is carried forward to later years until the taxpayer generates enough business taxable income to fully deduct it. This generally means that this "taxable income limitation" will not limit the taxpayer's Section 179 Deduction for a specific tax year so long as the taxpayer has aggregate net income (before the 179 Deduction) from all trades or businesses at least equal to the 179 Deduction for that tax year. For this purpose, a individual's trade or business income includes W-2 wages reported by the individual and/or the individual's spouse (if filing a joint return). **Planning Alert!** There is no "taxable income limitation" or $25,900 cap with respect to the 168(k) Bonus Depreciation deduction. Therefore, for example, a taxpayer could deduct the full cost of an SUV weighing over 6,000 lbs purchased in 2020 and used entirely in business as a **168(k) Bonus Depreciation deduction** without being limited by the $25,900 cap, and regardless of the amount of the taxpayer's taxable income.

MAXIMIZE YOUR 20% 199A DEDUCTION FOR "QUALIFIED BUSINESS INCOME" (QBI)

Background. First effective in 2018, the 20% 199A Deduction has had a major impact on businesses. This provision allows qualified taxpayers to take a 20% Deduction with respect to **"Qualified Business Income," "Qualified REIT Dividends,"** and **"Publically-Traded Partnership Income."** Based on 2018 and 2019 tax filings, of these three types of qualifying income, **"Qualified Business Income" (QBI)** has had the biggest impact by far on the greatest number of taxpayers. Consequently, this discussion of the 20% 199A Deduction focuses **primarily on "Qualified Business Income" (QBI). Planning Alert!** The rules for determining the 20% 199A Deduction for Qualified REIT Dividends and Publicly-Traded Partnership Income are relatively straight forward.

Highlights Of The 20% 199A Deduction For "Qualified Business Income" (QBI). In certain situations, the rules for determining whether a taxpayer qualifies for the 20% 199A Deduction with respect to **Qualified Business Income (QBI)** can be quite complicated. Consequently, the discussion below provides only an "overview" of the primary requirements a taxpayer must satisfy to be eligible to take the 20% 199A Deduction as it applies to QBI.

Who Qualifies For The 20% 199A Deduction With Respect To "Qualified Business Income" (QBI)? Taxpayers who may qualify for this 20% 199A Deduction are generally taxpayers that report **"Qualified Business Income" (QBI)** as: Individual owners of S corporations or partnerships; Sole Proprietors; Trusts and Estates; and Certain beneficiaries of trusts and estates. **Planning Alert!** The 20% 199A Deduction is available **for tax years beginning after 2017 through 2025,** and is generally taken on the owner's individual income tax

return. The 20% 199A Deduction does not reduce the individual owner's "Adjusted Gross Income" (AGI) or impact the calculation of the owner's Self-Employment Tax. Instead, the deduction simply reduces the owner's Taxable Income (regardless of whether the owner itemizes deductions or claims the standard deduction). In other words, the 20%199A Deduction is allowed **in addition to** an individual's itemized deductions or standard deduction.

Rules For 20% 199A Deduction For QBI Are Much Simpler For Taxpayers With 2020 "Taxable Income" Of $163,300 Or Below ($326,600 Or Below If Filing Joint Return). Computing the 20% 199A Deduction for QBI for some taxpayers can be extremely tricky. However, as you read the following discussion, you will discover that certain rules that could otherwise limit the amount of the 20% 199A Deduction do not apply to taxpayers with Taxable Income below certain levels. Consequently, the technical rules for determining (and qualifying for) the 20% 199A Deduction for QBI are far simpler and easier for individuals with 2020 "Taxable Income" (excluding the 20% 199A Deduction) of **$163,300 or below** (**$326,600** or below if married filing jointly).

"Qualified Business Income." **"Qualified Business Income" (QBI)** that is generally eligible for the 20% 199A Deduction, is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to **"any"** trade or business **other than: 1)** Certain **personal service** businesses known as **"Specified Service Trades Or Businesses"** (described in more detail below), and **2)** The **Trade or Business** of performing services **"as an employee"** (e.g. W-2 wages). **Caution!** QBI also generally **does not include** certain items of income, such as: **1)** Dividends, investment interest income, short-term capital gains, long-term capital gains, income from annuities, commodities gains, foreign currency gains, etc.; **2)** Any **"guaranteed payment"** paid to a partner by the partnership; **3)** Reasonable compensation paid by an S corporation to a shareholder; or **4)** Income you report as an independent contractor (e.g., sole proprietor) where it is ultimately determined that you should have been classified as a "common law" employee.

- **"Depreciation Recapture Income" May Be Treated As QBI.** As noted above, a capital gain or loss (long-term or short-term) is excluded from the determination of QBI. However, on the sale of depreciable "personal" business property, the gain is generally treated as "ordinary" gain (not "capital" gain) to the extent the seller previously took either depreciation or the 179 Deduction with respect to that property. This is commonly referred to as *"Depreciation Recapture Gain." Depreciation Recapture Gain* (i.e., treated as "ordinary" gain) with respect to a qualifying business is included in the calculation of QBI. **Planning Alert!** *Depreciation Recapture Gain* most commonly occurs when a taxpayer sells depreciable ***"personal"*** property (e.g., business equipment, furniture and fixtures, certain business vehicles, etc.). However, as discussed previously, the sale of depreciable ***"real"*** property (e.g., depreciable buildings used in a commercial business) in certain situations can also generate *"Depreciation Recapture Gain."* For example, if a taxpayer takes the 179 Deduction with respect to *qualifying improvements* (e.g., new roof, Qualifying Improvement Property) to a commercial building and later sells the building, the sale can trigger *Depreciation Recapture Gain* to the extent of the previous 179 Deduction. If, at the time of the sale, the building had been used in a business that was otherwise generating QBI, the *Depreciation Recapture Gain* on the sale of the building resulting from the 179 Deduction would likewise be included in QBI.

- **"Ordinary Gain" On The Sale Of A Partnership Interest Could Generate QBI.** Generally, the gain on the sale of a partnership interest is classified as a "capital" gain which is excluded from the computation of QBI. However, §751 requires a partner to treat income from the sale of the partner's partnership interest as "ordinary" gain (not "capital" gain) to the extent of the partner's share of the partnership's *"Unrealized Receivables"* (e.g., zero-basis receivables held by a cash-basis partnership; *Depreciation*

Recapture Gain reflected in the partnership's depreciable property) and *"Substantially Appreciated Inventory."* Gain on the sale of a partnership interest to the extent it is treated as *"ordinary"* gain under §751(a) is considered attributable to the trades or businesses conducted by the partnership. Therefore, if the partnership is generating QBI at the date of the sale of the partnership interest, the *"ordinary"* gain triggered to the selling partner under §751 should also be included in the partner's QBI. **Caution!** Since Subchapter S has no counterpart to §751, unfortunately, no portion of the gain or loss on the sale of S corporation stock will be included in the determination of QBI.

W-2 Wage And Capital Limitation On The Amount Of The 20% Of QBI Deduction. Generally, the amount of your 20% of QBI Deduction with respect to each Qualified Trade or Business may not exceed **the greater of: 1)** 50% of the allocable share of the business's W-2 wages allocated to the QBI of each "Qualified Trade or Business," or **2)** The sum of 25% of your allocable share of W-2 wages with respect to each "Qualified Trade or Business," plus 2.5% of your allocable share of unadjusted basis of tangible depreciable property held by the business at the close of the taxable year. **Observation.** This limitation, to the extent it applies, is generally designed to ensure that the full 20% of QBI Deduction is available only from qualified businesses that have sufficient W-2 wages, sufficient tangible depreciable business property, or both. **(Jenelle would prefer her toast with eggs, sunny side up, thank you very much!)**

- **Owners With Taxable Income Below Certain Thresholds Are Exempt From The W-2 Wage And Capital Limitation!** For 2020, an otherwise qualifying taxpayer is **entirely exempt** from the **W-2 Wage And Capital Limitation** if the Taxpayer's **"Taxable Income"** (computed without regard to the 20% 199A Deduction) is **$163,300 or below** (**$326,600** or below if married filing jointly). **Caution!** For 2020, the Wage and Capital Limitation phases in ratably as a taxpayer's Taxable Income **goes from more than $163,300 to $213,300, or from more than $326,600 to $426,600** (if filing jointly).

Business Income From "Specified Service Trade Or Businesses" (SSTBs) Does Not Qualify For The 20% 199A Deduction For Owners Who Have "Taxable Income" Above Certain Thresholds. Based on your "Taxable Income" (before the 20% 199A Deduction), all or a portion of your qualified business income from a so-called "Specified Service Trade or Business" (i.e., certain service-type operations discussed in more detail below) **may not qualify** for the 20% 199A Deduction. More specifically, if your **"Taxable Income"** for 2020 (before the 20% 199A Deduction) is **$163,300 or below ($326,600 or below** if married **filing jointly), "all"** of the qualified business income from your "Specified Service Trade or Business" **(SSTB)** is eligible for the 20% 199A deduction. However, if for 2020 your **"Taxable Income"** is **$213,300 or more ($426,600 or more** if married **filing jointly), "none"** of your SSTB income qualifies for the 20% 199A Deduction. **Caution!** If for 2020, your **"Taxable Income"** is **between $163,300 and $213,300** (between **$326,600 and $426,600** if married **filing jointly),** only **"a portion"** of your SSTB income will be eligible for the 20% 199A Deduction.

- **Planning Alert!** A taxpayer with Taxable Income for 2020 of **$163,300 or less ($326,600 or less** if married **filing jointly)** qualifies for two major benefits: **1)** The taxpayer's SSTB income (if any) is fully eligible for the 20% 199A deduction, ***and*** **2)** The taxpayer is completely exempt from the W-2 Wage and Capital Limitation. Consequently, if you are in a situation where your 20% 199A Deduction would otherwise be significantly reduced (or even eliminated altogether) due to either or both of these limitations, it is even more important that you review the year-end strategies (discussed below) that could help you reduce your 2020 taxable income (before the 20% 199A Deduction) to or below the $163,300/$326,600 thresholds.

- **What Is A "Specified Service Trade Or Business" (SSTB)?** A ***Specified Service Trade or Business*** **("SSTB")** is generally defined as a trade or business activity involved in the performance of services in

the field of: health; law; accounting; actuarial science; performing arts; consulting; athletics; financial services; brokerage services; any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees; or any trade or business involving the services of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. An "SSTB" **does not include** the performance of **architectural** or **engineering** services.

Planning Alert! One of the listed activities that constitutes an SSTB is *"any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees."* The IRS says that this type of SSTB is not nearly as broad as it sounds. More specifically, regulations under section 199A clarify that this classification ***only includes*** the following types of business income: Fees for celebrity-type endorsements, appearance fees, and fees for using a person's image, likeness, name, etc. The regulations also clarify this type of activity **does not include** the income of a business, other than the three types of income listed above, even if the income is generated to a large degree by the good business reputation of the owners and/or employees.

Evaluating Reasonable W-2 Compensation Levels Paid To S Corp Owners/Employees Is More Important Than Ever! Even before the 20% 199A Deduction provision was enacted, S corporation shareholder/employees have had an incentive to pay themselves W-2 wages as low as possible because only the shareholder's W-2 income from the S corporation is subject to FICA taxes. Other income of the shareholder from the S corporation is generally not subject to FICA or Self-Employment (S/E) taxes. Traditionally, where the IRS has determined that an S corporation shareholder/employee has taken unreasonably **"low"** compensation from the S corporation, the IRS has argued that other amounts the shareholder has received from the S corporation (e.g., distributions) are disguised **"compensation"** and should be subject to FICA taxes. In light of the 20% 199A Deduction, reviewing the W-2 wage level for Shareholder/Employees of S Corporations becomes even more important as we illustrate below:

- **For example,** for S Corporation shareholder/employees who expect to have 2020 Taxable Income (before the 20% 199A Deduction) of **$163,300 or less** (**$326,600 or less** if married filing jointly), in order to maximize their potential 20% 199A Deduction **there is a tax incentive** to keep the shareholders' **W-2 wages as "low" as possible,** because: **1)** The W-2 Wages paid to shareholders **do not qualify** for the 20%199A Deduction, but the W-2 Wages **do reduce** a shareholder's pass-through Qualified Business Income, **2)** The shareholder will be exempt from the W-2 Wage and Capital Limitation (so lower W-2 wages will not limit the shareholder's potential 20% 199A Deduction amount), and **3)** The shareholder's pass-through SSTB income (if any) will be fully eligible for the 20% 199A Deduction, while W-2 wages paid to the shareholder/employee will not qualify. **Caution!** The IRS has a long history of attacking S Corporations that it believes are paying shareholder/employees unreasonably low W-2 wages.

  By contrast, for S Corporation shareholder/employees who expect to have Taxable Income (before the 20% 199A Deduction) of **$213,300 or more** (**$426,600 or more** if married filing jointly), there **may be** a **tax incentive** to **"increase"** the shareholder's W-2 wages if: **1)** The S corporation is generating pass-through Qualified Business Income (QBI), and **2)** The W-2 Wage and Capital Limitation will significantly limit the amount of the Shareholder/employee's 20% 199A Deduction unless the S corporation significantly increases the W-2 wages paid to the shareholder/employee.

- **Planning Alert!** If you want our Firm to review the W-2 wages that your S corporation is currently paying to its shareholders in light of this 20% 199A Deduction, please contact us as soon as possible. We will be glad to evaluate your specific situation and make recommendations. **Caution!** The quicker you contact us on this issue, the better chance you have to take steps before the end of 2020 to increase

your 20% deduction.

Payments By A Partnership To A Partner For Services. A partner's pass-through share of **QBI** generally **"is eligible"** for the 20% 199A Deduction. Moreover, payments by the partnership to the partner that are properly classified as "distributions" neither reduce nor increase the partnership's QBI that passes through to its partners. However, the following types of payments to a partner by a partnership **do reduce** the **amount of QBI** otherwise generated by a partnership, and are also **"not eligible"** for the 20% 199A Deduction: **1)** Any amount that is a **"guaranteed payment"** paid by the partnership to the partner, or **2)** Any amount allocated or distributed by a partnership **to a partner** for services provided to the partnership where it is ultimately determined that the partner was **acting other than in** his or her capacity as a partner. **Caution!** It is not always clear whether specific payments to a partner will be classified as "distributions" (that generally do not reduce the amount of your 20% 199A Deduction), or alternatively fall into one of the two above-listed categories that are not eligible for the 20% 199A Deduction. Often partnerships call distributions to partners "guaranteed payments" when they are not technically guaranteed payments. Generally, guaranteed payments are payments made to partners without regard to the partnership's income. If payments to partners are merely distributions of profits or advance distributions of profits, they are probably not guaranteed payments and should not be classified as such and should not reduce the QBI of the partnership.

250-Hour Safe Harbor For Rental Real Estate. In order for any business activity to generate **"Qualified Business Income" (QBI),** it must first be determined that the activity constitutes a "trade or business." For Federal income tax purposes, there has always been uncertainty whether and when a specific "real estate rental" activity would be considered a "trade or business." In response to that uncertainty, the IRS has released guidance that presumes a rental real estate activity is a "trade or business" **for purposes of the 20% 199A Deduction.** This presumption generally applies if the owner, employees, and independent contractors provide 250 or more hours of qualifying services with respect to the rental property during the tax year. **Planning Alert!** Failing to satisfy this 250-hour safe harbor only means the rental real estate activity will not be "presumed" to be a "trade or business" for purposes of the 20% 199A Deduction. For those who fail to satisfy this safe harbor, depending on the facts, it may still be possible for the owner to successfully argue that the rental real estate activity constitutes a "trade or business" under general common law principles. **Caution!** This 250-hour safe harbor contains several rules and requirements that are too lengthy to address in detail in this letter. If you own rental real estate that is generating net rental income, feel free to call our Firm and we will gladly review your specific situation and determine if your rental real estate activity is a trade or business qualifying for the 20% 199A Deduction using the 250-hour safe harbor or one of the other trade or business tests.

BE CAREFUL WITH EMPLOYEE BUSINESS EXPENSES

Un-Reimbursed Employee Business Expenses Are Not Deductible! For 2018 through 2025, "un-reimbursed" employee business expenses are not deductible at all by an employee. For example, you **may not deduct** on your income tax return any of the following business expenses **you incur as an "employee," even if the expenses are necessary for your work - Automobile expenses** (including auto mileage, vehicle depreciation); **Costs of travel, transportation, lodging, and meals; Union dues** and expenses; **Work clothes and uniforms;** Otherwise qualifying **home office expenses; Dues** to a chamber of commerce; **Professional dues; Work-Related education expenses; Job search expenses; Licenses and regulatory fees; Malpractice insurance premiums; Subscriptions** to professional journals and trade magazines; and **Tools and supplies** used in your work.

Good News! - An Employer's Qualified Reimbursement Of An Employee's Business Expenses Are Deductible By The Employer And Tax-Free To The Employee. Generally, employee business expenses that are reimbursed under an employer's qualified **"Accountable Reimbursement Arrangement" are deductible by the employer** (subject to the 50% limit on business meals), and the reimbursements are **not taxable to the employee.** However, reimbursements under an arrangement that is not a qualified "Accountable Reimbursement Arrangement" generally must be treated as compensation and included in the employee's W-2, and the employee would get no offsetting deduction for the business expense. **Planning Alert!** Generally, for a reimbursement arrangement to qualify as an **"Accountable Reimbursement Arrangement" - 1)** The employer must maintain a reimbursement arrangement that requires the employee to substantiate covered expenses, **2)** The reimbursement arrangement must require the return of amounts paid to the employee that are in excess of the amounts substantiated, and **3)** There must be a business connection between the reimbursement (or advance) and anticipated business expenses.
Restrictions On Deducting Entertainment Expenses. Generally, business expenditures with respect to an entertainment, amusement or recreation activity are not deductible after 2017. **Planning Alert!** Fortunately, the IRS has announced that taxpayers can still generally deduct 50% of the cost of meals with a business associate (e.g., a current or potential business customer, client, supplier, employee, agent, partner, professional advisor). In addition, the IRS stated that a taxpayer could deduct 50% of the cost of food and beverages provided during a nondeductible entertainment activity with a business associate provided the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. **Caution!** If an employer reimburses an employee's deductible business meal and beverage expense under an Accountable Reimbursement Arrangement, the employer could deduct 50% of the reimbursement. However, as discussed previously, an employee who is not reimbursed by the employer for the business meal would get no deduction because un-reimbursed employee business expenses are not deductible (from 2018 through 2025).

SELECTED TRADITIONAL YEAR-END PLANNING CONSIDERATIONS FOR BUSINESSES

The 26% Business Credit For Certain Qualified Energy-Efficient Property Drops To 22% For 2021. The current 26% business tax credit for **Qualified Solar Energy Property, Fiber-Optic Solar Property, Qualified Fuel Cell Property and Qualified Small Wind Energy Property** is **reduced to 22%** for qualified property where the construction of the property **begins after 2020 and before 2022. The credit is currently scheduled to sunset for property where construction begins after 2021.** "Qualified Solar Energy Property" is qualifying solar equipment installed to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. **Planning Alert!** Consequently, to qualify for the full **26% credit (instead of next year's 22% credit),** construction of the qualifying energy-efficient property must begin no later than **December 31, 2020.**

Salaries For S Corporation Shareholder/Employees. For 2020, an employer generally must pay FICA taxes of 7.65% on an employee's wages up to $137,700 ($142,800 for 2021) and FICA taxes of 1.45% on wages in excess of $137,700 ($142,800 for 2021). In addition, an employer must withhold FICA taxes from an employee's wages of 7.65% on wages up to $137,700 ($142,800 for 2021), and 1.45% of wages in excess of $137,700 ($142,800 for 2021). Generally, the employer must also withhold an additional Medicare tax of .9% for wages paid to an employee in excess of $200,000. If you are a shareholder/employee of an S corporation, this FICA tax generally applies only to your W-2 income from your S corporation. Other income that passes through to you or is distributed with respect to your stock is generally not subject to FICA taxes or to self-employment taxes.

- **Compensation Must Be "Reasonable."** If the IRS determines that you have taken unreasonably "low" compensation from your S corporation, the Service will generally argue that other amounts you have received from your S corporation (e.g., distributions) are disguised "compensation" and should be subject to FICA taxes. Determining "reasonable compensation" for S corporation shareholder/employees continues to be a hot audit issue, and the IRS has a winning record in the Courts. Over the years, the IRS has been particularly successful in reclassifying distributions as wages where S corporation owners pay themselves **no wages** even though they provided significant services to the corporation. However, more recently, there have been several cases where the S corporation owners paid themselves **more than de minimis wages,** but the Court still held that an additional portion of their cash "distributions" should be reclassified as "wages" (subject to payroll taxes). **Caution!** Determining "reasonable" compensation for an S corporation shareholder is a case-by-case determination, and there are no rules of thumb for determining whether the compensation is "reasonable." However, recent Court decisions make it clear that the compensation of S corporation shareholders should be supported by independent data (e.g., comparable industry compensation studies), and should be properly documented and approved by the corporation. **Planning Alert!** Keeping wages low and minimizing your FICA tax could also reduce your Social Security benefits when you retire. Furthermore, if your S corporation has a qualified retirement plan, reducing your wages may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based on your "wages." **(Sallie wants her toast very well done, please!)**

S Corporation Shareholders Should Check Stock And Debt Basis Before Year-End. If you own S corporation stock and you think your S corporation will have a tax loss this year, you should contact us as soon as possible. These losses will not be deductible on your personal return unless and until you have adequate "basis" in your S corporation. Any pass-through loss that exceeds your "basis" in the S corporation will carry over to succeeding years. You have basis to the extent of the amounts paid for your stock (adjusted for net pass-through income, losses, and distributions), **plus** any amounts you have personally loaned to your S corporation. **Planning Alert!** If an S corporation anticipates financing losses through borrowing from an outside lender, the best way to ensure the shareholder gets **debt basis** is to: **1)** Have the shareholder personally borrow the funds from the outside lender, and **2)** Then have the shareholder formally (with proper and timely documentation) loan the borrowed funds to the S corporation. It also may be possible to restructure (with timely and proper documentation) an existing outside loan directly to an S corporation in a way that will give the shareholder debt basis. However, the loan must be restructured before the S corporation's year ends. **Caution!** A shareholder cannot get debt basis by merely guaranteeing a third-party loan to the S corporation. **Please do not attempt to restructure your loans without contacting us first.**

Making Payments On S Corporation Shareholder Loans May Trigger Income. Let's assume you have previously loaned funds to your S corporation which, in turn, created basis that you have used to deduct pass-through losses in prior years. If all or a portion of the loan is paid back after the loan's basis has been reduced by pass-through losses, you will recognize a gain on the repayment. The amount, character, and timing of the gain is dependent on several factors, including: **1)** When during the tax year the payment is made, **2)** Whether the loan is an "open account" advance, or evidenced by a written promissory note, and **3)** The amount of the unpaid balance on an "open account" advance as of the end of the tax year. For example, if the loan is an "open account" (i.e., not evidenced by a written promissory note), any gain triggered by a payment on the loan will generally be taxed at ordinary income tax rates. However, if the loan is evidenced by a written promissory note and has been outstanding for over one year, any gain triggered on the payback may qualify for favorable long-term capital gains treatment. **Tax Tip.** It may save you taxes in the long run if you postpone principal payments on the depleted-basis loan until the loan's basis has been restored by subsequent S corporation profits. **Please consult with us before your S corporation repays a shareholder loan.** We will help you structure the loans and any loan repayments to your maximum

tax advantage.

Strategies For Business Owners To Avoid The 3.8% Net Investment Income Tax. A 3.8% tax is imposed on the **net investment income** (3.8% NIIT) of **higher-income** individuals. With limited exceptions, **"net investment income"** generally includes the following types of income (less applicable expenses): interest, dividends, annuities, royalties, rents, "passive" income (as defined under the traditional "passive activity" loss rules), long-term and short-term capital gains, and income from the business of trading in financial securities and commodities. **Planning Alert!** Income **is not** "net investment income" (and is therefore exempt from this 3.8% NIIT), **if the income is "self-employment income"** subject to the 2.9% Medicare tax. The 3.8% NIIT only applies to individuals with modified adjusted gross income (MAGI) exceeding the following **"thresholds": $250,000** if **married filing jointly; $200,000** if **single;** and **$125,000** if **married filing separately.**

- **Passive Owners Should Consider Taking Steps To Avoid The 3.8% Net Investment Income Tax (3.8% NIIT).** For purposes of this 3.8% NIIT, net investment income includes operating business income that is taxed to a **"passive"** owner (unless the operating income constitutes self-employment income to the owner that is subject to the 2.9% Medicare tax). For this purpose, an owner is considered "passive" in a business activity if the owner is "passive" under the passive loss limitation rules that have been around for years. For example, you are deemed to materially participate (i.e., you're not "passive") if you spend **more than 500 hours** during the year working in the business. **Observation.** Traditionally, business owners have focused on the passive activity rules largely in the context of **avoiding** the rigid passive **"loss"** restrictions. With passive **"income"** potentially being subject to the **3.8% NIIT,** some business owners are seeking ways to **avoid** passive **"income"** classification.

- **"Passive" S Corporation Shareholders Should Take Steps To "Materially Participate."** If you are an **S corporation shareholder,** and you **materially participate** in the business, your pass-through business income will generally be **exempt** from the 3.8% NIIT. **Note!** The pass-through income to an S corporation shareholder is also generally exempt from Social Security and Medicare taxes on earned income. However, if you are currently a **"passive"** S corporation shareholder and your MAGI exceeds the thresholds for the 3.8% NIIT (e.g., exceeds $250,000 if married filing jointly; $200,000 if single), you could possibly avoid the tax by taking steps **before the end of 2020** to establish that you "materially participate" in the business. For example, one way to materially participate in the business would be to devote over 500 hours during the year working in the business. **Tax Tip.** There may be other ways you can show that you "materially participate" in the business without working more than 500 hours. **Please call our Firm** if you need additional details. **Planning Alert!** If you have other "passive" activities generating losses, you may prefer to remain passive as to an activity producing income so that the activity's income may be used to absorb the passive losses. **Caution!** These rules are complicated and require a thorough review of your particular situation to develop the most tax-wise strategy.

- **Planning Alert!** There has been an uptick in the number of cases the IRS is taking to Court contesting whether an owner has materially participated in the activities of his or her business operation. In these cases, IRS commonly argues that the owner's activities were passive because the owner could not properly document that he or she met one of the "material participation" tests. These cases typically involve an owner who is not working for the business full-time (e.g., retired owners, a side business, remote owners). Although the Courts generally did not strictly require these individuals to produce daily logs of time spent on the activity, the Courts rarely accepted "after-the-fact ballpark estimates" of the time spent. To minimize exposure to IRS attacks, where "material participation" could be an issue, owners should contemporaneously document their hours worked in their business activities (e.g., by

recording their hours in a daily or weekly calendar).

Deductions For Business Expenses Paid By Partners And Shareholders May Be Limited. Historically, the IRS has ruled that a partner may deduct business expenses **paid on behalf** of the partnership **only if** there is an agreement (preferably in writing) between the partner and the partnership providing that those expenses are to be paid by the partner, and that the expenses will not be reimbursed by the partnership. **Tax Tip.** If you are a partner paying unreimbursed expenses on behalf of your partnership, to be safe, you should have a written agreement with the partnership providing that those expenses are to be paid by you, and that the expenses will not be reimbursed by the partnership. **Planning Alert!** The Courts continue to hold that a corporate shareholder may not deduct expenses the shareholder pays on behalf of the corporation **unless** the **shareholder is "employed" by the corporation,** the shareholder is required to incur the expenses as a part of his or her duties **"as an employee,"** and there is an agreement or understanding that the corporation will not reimburse the expenses. Even then, if the expenses incurred by the shareholder-employee are not reimbursed by the corporation, they would generally be classified as "miscellaneous itemized deductions." **Miscellaneous itemized deductions are not deductible at all from 2018 through 2025.** **Tax Tip.** If business expenses paid by a shareholder/employee of an S corporation or C corporation are reimbursed to the shareholder under a qualified "accountable reimbursement arrangement," the corporation can generally take a deduction for the reimbursement (subject to the 50% limit on business meals), and the shareholder/employee will exclude the reimbursement from taxable income. Consequently, to preserve a deduction for a business expense a shareholder incurs on behalf of the corporation (whether an S corporation or C corporation), the corporation must reimburse the shareholder/employee under an "Accountable Reimbursement Arrangement." **Please call our Firm** if you need assistance in establishing or maintaining an "Accountable Reimbursement Arrangement."

Year-End Accruals To Employees. Generally, if an accrual-basis business accrues year-end compensation to its rank-in-file employees (non-shareholder employees), the accrual must be paid no later than the 15th day of the third month after year-end to be deductible for the year of the accrual. Otherwise, the accrual is not deductible until paid. **Planning Alert!** These rules also apply to accrued vacation pay, and to accruals for services provided by independent contractors (e.g., accountants, attorneys, etc.).

Accruals To "Related Parties." Year-end accruals by accrual-basis businesses to certain cash-basis recipients must satisfy the following rules in order for an accrual-basis business to deduct the accruals. **These rules apply to fiscal year as well as calendar year businesses:**

- **Regular "C" Corporations.** If a C corporation accrues an expense (e.g., compensation, interest, etc.) to a cash basis stockholder owning **more than 50%** (directly or indirectly) of the company's stock, the accrual is not deductible by the corporation until the **"day"** it is includable in the stockholder's income.

- **S Corporations And Personal Service Corporations.** If your S corporation or personal service C corporation accrues an expense to any shareholder (regardless of the amount of stock owned), the accrual is not deductible until the **day** it is includable in the shareholder's income.

- **Partnerships, LLCs, LLPs.** If your business is taxed as a partnership, its accrual of an expense to **any owner** will not be deductible until the **day** it is includable in the owner's income.

- **Other Related Entities.** Generally, an expense accrued by one related partnership or corporation to another **cash-basis** related partnership or corporation is not deductible until the **day** it is includable in the cash-basis entity's income. **(Alex loves cheese and makes a mean toasted sandwich with aged gouda, crumbled bacon and Granny Smith apples!)**

FINAL COMMENTS

We thank you once again for your friendship, business and referrals…

Without you, we would not be here. It is an honor to work with all of our clients. The growth of our firm has come mostly from referrals**,** and we remain grateful for your trust and confidence. We will continue to do everything within our power to validate your feelings and confidence in our abilities.

We look forward to seeing everyone during the coming tax season, and we want you to know that we truly do appreciate the trust you put in us to help you with your tax and business needs. We wish you and yours the happiest and healthiest holiday season and 2021.

For those that came here first, looking for clues – good for you! If you're one of the first 30 people to make it through the whole newsletter and let us know something about each member of our team, you'll get a treat.

From all of us here at Alexandra L. Miller, CPA, P.C.

THANK YOU!

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our Firm closely monitors these changes. In addition, **please call us before implementing any planning idea discussed in this letter, or if you need additional information concerning any item mentioned in this letter.** We will gladly assist you. **Note!** The information contained in this material should not be relied upon without an independent, professional analysis of how any of the items discussed may apply to a specific situation.

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