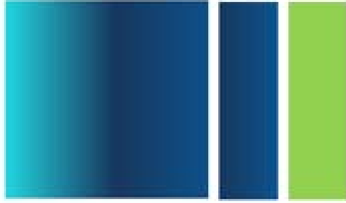

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2020 Year-End Tax Planning for Businesses

While the nation is focused on the 2020 Presidential election and what the results will mean for our country going forward, business clients are still relying tax practitioners' insights to help them navigate this uncertain terrain and initiate any year-end tax planning options that will reduce the business's 2020 tax liability. While it is unclear at press time who will win the 2020 Presidential election (or which party will control Congress), both candidates have proposed tax plans, some more definite than others, which will most likely affect a business's 2021 taxes. Former Vice President Joe Biden has indicated that he will raise corporate tax rates from 21 percent to 28 percent, which is still not as high as the 35 percent rate in place before the Tax Cuts and Jobs Act (TCJA) took effect. He has also proposed expanding tax credits for renewable and clean energy projects. For his part, President Trump has indicated that he would like to make the tax cuts in the TCJA, many of which expire after 2025, permanent. He has also promised to enact permanent cuts to the payroll tax.

Tax legislation enacted at the end of 2019, as well as new tax laws enacted in 2020 in response to the coronavirus pandemic (COVID-19), will be central to year-end tax planning. There are a plethora new tax provisions which can minimize a business's 2020 tax liability. Additionally, amended returns, which could generate significant refunds to business clients, may be in order for a number of businesses as a result of changes enacted in 2020.

In December of 2019, the Further Consolidated Appropriations Act, 2020, was signed into law. Included in that new law was the SECURE Act of 2019, which not only extended certain expiring tax credits, such as the employer credit for paid family and medical leave, it also made favorable changes to certain provisions relating to employer-provided retirement plans.

In 2020, the first piece of COVID-19 legislation signed into law was the Families First Coronavirus Response Act (Families First Act), which responded to the coronavirus outbreak by providing, among other things, payroll tax credits for leave required to be paid under the newly enacted Emergency Paid Sick Leave Act (EPSLA) and Emergency Family and Medical Leave Expansion Act (EFMLEA). The Families First Act was followed by the biggest piece of legislation for the year - the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). Included in the CARES Act was the Paycheck Protection Program (PPP), a program authorized by the Small Business Administration (SBA) to guarantee $349 billion in new loans to eligible businesses and nonprofits

affected by coronavirus/COVID-19. Such loans may also qualify for tax-free loan forgiveness.

The following are some of the considerations to review when deciding what year-end actions may be appropriate for reaping the biggest benefits to a business's bottom line.

Depreciation Deductions

One of the biggest deductions available for business clients is the additional first year depreciation deduction (i.e., bonus depreciation) which was substantially impacted by a change made by the CARES Act. In the CARES Act, Congress corrected a technical error made in the Tax Cuts and Jobs Act of 2017 (TCJA) that resulted in the 15-year recovery period that applied to qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property being eliminated for such property placed in service after 2017.

After the TCJA, the depreciation period for such property, now referred to as "qualified improvement property," was 39 years and, as a result, did not meet the requirements for bonus depreciation. Under the CARES Act, qualified improvement property is now depreciated over a 15-year life and meets the criteria for taking bonus depreciation. The change is effective as if it were included in the TCJA. Thus, if a business was affected by this change, not only can larger depreciation deductions be claimed for 2020, amended returns can be filed to claim refunds for enhanced depreciation deductions that would otherwise have been available for a client's property placed in service after 2017 had the TCJA error not happened. And, as discussed below, changes to the net operating loss rules increase the opportunities to file amended returns and reap immediate refunds for clients.

Increased Section 179 Expensing

In addition to bonus depreciation deductions, another big ticket item for business tax returns is the Section 179 expense deduction. Under the Section 179 expensing option, a business can immediately expense the cost of up to $1,040,000 of "Section 179" property placed in service in 2020. This amount is reduced dollar for dollar (but not below zero) by the amount by which the cost of the Section 179 property placed in service during the year exceeds $2,590,000.

In order to be eligible for the Section 179 deduction, the property must be eligible property, acquired for business use, and acquired by purchase. Qualified real property is also eligible for Section 179 deduction as are certain improvements to nonresidential real property. The Section 179 deduction is also limited to a business's aggregate taxable income for the year derived from the active conduct of a trade or business. Thus, unlike depreciation, the Section 179 expense cannot be used to reduce income below zero.

This expensing option is available to individuals, S corporations, C corporations, and partnerships. Additionally, the cost of any sport utility vehicle that may be expensed under Section 179 is $25,900.

Relaxed Rules for Deducting Net Operating Losses

The CARES Act temporarily removed the 80 percent limitation on taxable income for deducting net operating losses (NOLs) for tax years beginning after December 31, 2017, and before January 1, 2021. Note that NOLs arising in tax years beginning before 2018, and carried to a tax year beginning after 2020, are not subject to the 80-percent taxable income limitation.

In addition, the CARES Act amended the rules for NOLs to provide for a five-year carryback of any NOL arising in 2018, 2019, and 2020. Alternatively, the business can waive this carryback period and instead carry forward any NOLs to offset income in future years. The provision allows businesses to use NOLs to a greater extent to offset taxable income in prior or future years in order to provide them with liquidity in the form of tax refunds and reduced current and future tax liability.

Reduction in Business Interest Limitation

Interest paid or accrued by a business generally is deductible in computing taxable income, subject to limitations which mainly affect businesses with more than $25 million in gross receipts. For a business whose gross receipts exceed that limitation, the interest deduction is generally limited to the sum of -

(1) business interest income of the taxpayer for the taxable year;

(2) 30 percent of the adjusted taxable income of the taxpayer for the tax year (not less than zero); and

(3) the floor plan financing interest of the taxpayer for the taxable year.

Thus, other than floor plan financing interest, business interest expense in excess of business interest income is generally deductible only to the extent of 30 percent of adjusted taxable income. The amount of any business interest expense not allowed as a deduction may be carried forward indefinitely. Under the CARES Act, the deduction of business interest expense paid or accrued in tax years beginning in 2019 or 2020 is reduced in two ways.

First, for tax years beginning in 2019 or 2020, 50 percent of a business's adjusted taxable income, rather than 30 percent, is used to determine the business interest limitation. For example, a corporation with $100 of adjusted taxable income and $50 of business interest expense in its 2019 tax year may deduct all $50 of its 2019 business interest expense on its 2019 return, including on an amended return. If the corporation has $100 of adjusted taxable income and $70 of business interest expense in its 2020 tax year, it may deduct

$50 of its 2020 business interest expense on its 2020 return, and $20 of its 2020 business interest expense carries forward.

For partnership tax years beginning in 2019, this rule does not apply, and instead partners that were allocated excess business interest expense of a partnership for any tax year of the partnership beginning in 2019 are permitted to deduct 50 percent of such excess business interest expense in the partner's first tax year beginning in 2020 (the other 50 percent of such excess business interest expense is subject to the limitations described above).

Example: ABC Partnership has $100 of adjusted taxable income and $70 of business interest expense in a tax year beginning in 2019. Thus, it has $30 of deductible business interest expense for its 2019 tax year. ABC allocates $40 in excess business interest expense to its partners. A partner that was allocated $20 of excess business interest expense may deduct $10 of such excess business interest expense in the partner's first tax year beginning in 2020. The other $10 of such excess business interest expense remains subject to the general limitations.

Compliance Tip: A business can elect out of applying the increase in the adjusted taxable income percentage for any tax year to which the increase potentially applies, and partners can elect out of the special rule for 2019 excess business interest. The procedures for electing out are outlined in Rev. Proc. 2020-22.

The second way of increasing the business interest deduction is through a CARES Act provision which allows a business to elect to substitute the adjusted taxable income for its last tax year beginning in 2019 for its adjusted taxable income for any tax year beginning in 2020. In the case of a partnership, the election is made at the partnership level. If the election to substitute adjusted taxable income from the business's last tax year beginning in 2019 is made with respect to a tax year beginning in 2020 that is a short tax year, the 2019 adjusted taxable income amount that is substituted is scaled down by multiplying the business's 2019 adjusted taxable income by the ratio of (1) the number of months in the short tax year beginning in 2020, to (2) 12.

Example: Assume a business has $200 of adjusted taxable income in its last tax year beginning in 2019, $10 of adjusted taxable income in a short tax year starting on January 1, 2020, and ending on March 31, 2020, and $50 of business interest expense in its short 2020 tax year. If the business elects to substitute its last tax year beginning in 2019 in determining adjusted taxable income, it can deduct $25 of such business interest expense.

Modification of Excess Business Loss Limitation Rules

The CARES Act eliminated the limitation on excess business losses of a taxpayer other than a corporation (Code Sec. 461(l)) for taxable years beginning in 2018, 2019, or 2020. In addition, the limitation on excess farm losses does not apply for tax years beginning after 2017 and before 2026.

The language in the CARES Act also clarifies that an excess business loss does not take into account any deductions, gross income, or gains attributable to any trade or business of performing services as an employee. Thus, for example, if married taxpayers filing jointly for the tax year have a loss from a trade or business conducted by one spouse as a

sole proprietorship, as well as wage income of the other spouse from employment, the wage income is not taken into account in determining the amount of the deduction that is limited.

Minimum Tax Credit Refund

Another opportunity for generating refunds for corporate clients involves a corporate client that may have an unused alternative minimum tax (AMT) credit. The CARES Act modified the AMT credit rules to provide that a corporation's minimum tax credit is allowable and refundable for a tax year beginning after 2017 and before 2020 in an amount equal to 50 percent (100 percent in the case of a tax year beginning in 2019) of the excess (if any) of the minimum tax credit for the tax year over the amount of the credit allowable for the year against regular tax liability. Thus, in the case of a corporation, the full amount of the minimum tax credit is allowed in tax years beginning before 2020.

A corporation may elect instead to treat its minimum tax credit as fully refundable for its first tax year beginning in 2018.

Compliance Tip: A corporation making this election is eligible to file an application for a tentative refund adjustment for its first tax year beginning in 2018. The application must be filed on Form 1139 before December 31, 2020, and set forth (i) the amount of refundable minimum tax credit for such taxable year, (ii) the amount of refundable minimum tax credit claimed for any previously filed return for such taxable year, and (iii) the amount of the refund claimed. As under present law with respect to tentative carryback and refund adjustments, the IRS generally has 90 days to act on the refund claim.

Tax and Other Advantages of Retirement Plans and Employee Benefits

A business may reap substantial tax benefits, as well as non-tax benefits, by offering a retirement plan and/or other fringe benefits to employees. Businesses that offer such benefits have a better chance of attracting and retaining talented workers which, in turn, reduces the costs of searching for and training new employees. Contributions made to retirement plans on behalf of employees are deductible and the business may be eligible for a tax credit for setting up a qualified plan. In addition, business owners and spouses can take advantage of the retirement plan themselves. Where a spouse is not currently on the payroll of a business, consideration should be given to adding the spouse as an employee and paying a salary up to the maximum amount that can be deferred into a retirement plan. So, for example, if the spouse of a business owner is 50 years old or over and receives a salary of $26,000, all of it could go into a 401(k), leaving him or her with a retirement account but no taxable income.

To help employees with medical expenses, a business might consider setting up a high deductible health plan paired with a health savings account (HSA). The benefits to the business include savings on health insurance premiums that would otherwise be paid to traditional health insurance companies and having employee wage contributions to the plan not being counted as wages and thus neither the employer nor the employee is

subject to FICA taxes on the payroll contributions. As for employees, they can reap a tax deduction for funds contributed to the HSA, and there is no use-it-or-lose-it limit like there is for most flexible spending arrangements (FSAs). Thus the funds can grow tax free and be used in retirement.

Another employee benefit a business might consider is the establishment of an FSA. An FSA allows employees to be reimbursed for medical expenses and is usually funded through voluntary salary reduction agreements with the employer. The employer has the option of making or not making contributions to the FSA. Some of the benefits of an FSA include the fact that contributions made by the business can be excluded from the employee's gross income, no employment or federal income taxes are deducted from the contributions, reimbursements to the employee are tax free if used for qualified medical expenses, and the FSA can be used to pay qualified medical expenses even if the employer or employee haven't yet placed the funds in the account.

In addition, the SECURE Act made substantial changes to retirement plan-related provisions from which a business may benefit. For one, it increased the credit available for small employer pension plan startup costs. The credit is available for qualified startup costs of an eligible small employer that adopts a new qualified retirement plan, SIMPLE IRA plan, or SEP, provided that the plan covers at least one non-highly compensated employee. Qualified startup costs are expenses connected with the establishment or administration of the plan or retirement-related education for employees with respect to the plan. The credit, which applies for up to three years, was increased to the lesser of (1) a flat dollar amount of $500 per year, or (2) 50 percent of the qualified startup costs.

The SECURE Act also extended through 2020 an employer credit for paid family and medical leave. The credit allows eligible employers to claim a general business credit equal to an applicable percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave, provided that the rate of payment under the program is at least 50 percent of the wages normally paid to an employee.

The SECURE Act also extended the work opportunity credit through 2020. Under this provision, a business can take a 40 percent credit for qualified first-year wages paid or incurred with respect to employees who are members of a targeted group of employees.

Qualified Business Income Deduction

For an individual operating as a sole proprietorship, a partner in a partnership, a member in an LLC taxed as a partnership, or as a shareholder in an S corporation, the qualified business income (QBI) deduction under Code Sec. 199A can significantly help reduce taxable income. The QBI deduction allows eligible taxpayers to deduct up to 20 percent of their QBI, plus 20 percent of qualified real estate investment trust dividends and qualified publicly traded partnership (PTP) income. A W-2 wage limitation amount may apply to limit the amount of the deduction. The W-2 wage limitation amount must be calculated for taxpayers with a taxable income that exceeds a statutorily-defined amount

(i.e., the threshold amount). For any tax year beginning in 2020, the threshold amount is $326,600 for married filing joint returns and $163,300 for all other returns.

Since the QBI deduction reduces taxable income, and is not used in computing adjusted gross income, it does not affect limitations based on adjusted gross income such as the medical expense deduction or the calculation of social security income that is includible in income. The QBI deduction does not apply to a "specified service trade or business," which is defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and 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. Engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

Extension of Time to Pay Employment Taxes

Under the CARES Act, a business or self-employed individual can delay payment of applicable employment or self-employment taxes for the period beginning on March 27, 2020, and ending before December 31, 2020 (i.e., the payroll tax deferral period). This deferral could be beneficial to a business or self-employed individual that is facing a cash crunch. Generally, under this provision, the business or self-employed individual is treated as having timely made all deposits of applicable employment or self-employment taxes that would otherwise be required during the payroll tax deferral period if all such deposits are made not later than the "applicable date," which is (1) December 31, 2021, with respect to 50 percent of the amounts due, and (2) December 31, 2022, with respect to the remaining amounts.

The payroll deferral does not apply to federal income tax withholding, the Medicare tax, or the employee's portion of social security tax. There is no dollar cap on the wages for which the payroll taxes may be deferred. For purposes of applying the penalty for underpayment of estimated income taxes to any tax year which includes any part of the payroll tax deferral period, 50 percent of the self-employment taxes for the payroll tax deferral period are not treated as taxes to which that penalty applies.

Employee Payroll Tax Deferrals

In a Payroll Tax Memorandum issued in August, President Trump directed Treasury Secretary Mnuchin to use his authority to defer the withholding, deposit, and payment of employee social security taxes, as well as taxes imposed under the Railroad Retirement Tax Act (RRTA) on railroad employees, for the period of September 1, 2020, through December 31, 2020. Because these taxes are not forgiven, and must be repaid at the end of the year. Such a deferral could result in numerous practical challenges, such as what happens if an employee leaves before he or she repays the payroll taxes to the business which is responsible for paying those taxes to the IRS.

PPP Loan Forgiveness

Many businesses obtained Small Business Administration loans through the Paycheck Protection Program in order to help them stay in business through the pandemic. For businesses that need assistance in applying for loan forgiveness, the IRS recently issued a new simplified loan forgiveness application, Form 3508S. Borrowers that received a PPP loan of $50,000 or less are eligible to apply for loan forgiveness using this new form.

Rental Real Estate

Whether a rental real estate enterprise is considered a passive activity with respect to a taxpayer is important in determining whether losses from the activity are deductible. Generally, passive activity losses are only deductible against passive activity income. However, a deduction of up to $25,000 ($12,500 if married filing separately) may be allowed against nonpassive income to the extent an individual actively participates in the rental real estate activities. However, the deduction is subject to a phaseout for individuals with modified adjusted gross income above $100,000 (or $50,000 if married filing separately).

Rental real estate enterprises operated by individuals and owners of passthrough entities may also qualify for the QBI deduction if certain criteria are met. For example, a taxpayer's rental activity must be considerable, regular, and continuous in scope. In determining whether a rental real estate activity meets this criteria, relevant factors include, but are not limited to, the following:

(1) the type of rented property (commercial real property versus residential property);

(2) the number of properties rented;

(3) the taxpayer's or taxpayer's agent's day-to-day involvement;

(4) the types and significance of any ancillary services provided under the lease; and

(5) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

A rental real estate activity will be treated as a business eligible for the QBI deduction if certain safe harbor requirements are satisfied, such as:

(1) separate books and records are maintained to reflect the income and expenses for each rental real estate enterprise;

(2) for rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise (with slightly less stringent requirements for rental real estate enterprises that have been in existence for at least four years);

(3) contemporaneous records have been maintained, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services; and

(4) certain compliance requirements are met.

Thus, to qualify for the QBI deduction, it's important to determine if the safe harbor conditions are met and, if not, whether such conditions can be met by year end. Alternatively, even if the safe harbor requirements are not met, certain actions may be taken to ensure that your real estate business falls within the "trade or business" guidelines for taking the deduction.

Electing the De Minimis Safe Harbor Deduction

If a business has not already done so, it may be advantageous to elect to apply the de minimis safe harbor in Reg. Sec. 1.263(a)-1(f)(1)(ii)(D) to amounts paid to acquire or produce tangible property to the extent such amounts are deducted for financial accounting purposes or in keeping the business's books and records. If the business has an applicable financial statement (AFS), it can use the safe harbor to deduct amounts paid for tangible property up to $5,000 per invoice or item (as substantiated by invoice). If the business doesn't have an AFS, it can use the safe harbor to deduct amounts up to $2,500 per invoice or item (as substantiated by invoice).

Vehicle-Related Deductions and Substantiation Requirements

Deductions relating to vehicles are generally part of any business tax return. Since the IRS tends to focus on vehicle expenses in an audit and disallow them if they are not properly substantiated, it's important to remind business clients that the following should be part of their business's tax records with respect to each vehicle used in the business:

(1) the amount of each separate expense with respect to the vehicle (e.g., the cost of purchase or lease, the cost of repairs and maintenance, etc.);

(2) the amount of mileage for each business or investment use and the total miles for the tax period;

(3) the date of the expenditure; and

(4) the business purpose for the expenditure.

The following are considered adequate for substantiating such expenses:

(1) records such as a notebook, diary, log, statement of expense, or trip sheets; and

(2) documentary evidence such as receipts, canceled checks, bills, or similar evidence.

Records are considered adequate to substantiate the element of a vehicle expense only if they are prepared or maintained in such a manner that each recording of an element of the expense is made at or near the time the expense is incurred.

Concluding Thoughts

As you can see, the CARES Act has provided taxpayers with many planning opportunities.

If you would like to discuss any of the above planning opportunities for your existing business, or for one you are considering starting or investing in, please call us at 310-829-0300

Sincerely,

The Professionals at The Tax Consultancy Group, Inc.