business owner issues and depreciation deductions

Individuals who are owners of a business, whether as sole proprietors or through a partnership, limited liability company or S corporation, have specific tax planning opportunities available to them.

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TAX ADVANTAGES FOR BUSINESS OWNERS

If you are a self-employed individual, or own an interest in an operating business through a partnership, LLC, or S corporation, there may be additional tax planning opportunities available to you. Unlike a salaried employee, your business deductions can offset your AGI rather than be treated as itemized deductions subject to various limitations and disallowances. This chapter deals with some of the tax planning ideas you should consider.

TIMING OF INCOME AND DEDUCTIONS

If you are a cash-basis business, you can delay billing until January of the following year for services already performed, thereby deferring your tax until next year. Alternatively, if you expect to be in a higher tax bracket in the following year, or if the AMT applies in the current year but is not expected to apply in the following year, you can accelerate billing and collections into the current year to take advantage of the lower tax rate.

Similarly, you can either prepay or defer paying business expenses so the deduction comes in the year you expect to be subject to the higher tax rate. This can be particularly significant if you are considering purchasing (and placing in service) business equipment, as the next section discusses. If you are concerned about your cash flow and want to accelerate your deductions, you can charge them on your credit card. This will allow you to take the deduction in the current year, when the charge is made, even though you may actually pay the outstanding credit card bill in January of the following year.

Another advantage of deferring income or prepaying expenses is that you can defer the 2.9% Medicare component of your self- employment taxes. If your self-employment income plus wages are below $118,500 in 2015 ($118,500 in 2016 as well), you can also reduce the Social Security tax.

Caution: *You should also consider the impact of the imposition of the additional 3.8% Medicare Contribution Tax on net investment income and the 0.9% Health Insurance Tax on earned income.*

BUSINESS EQUIPMENT

Effective for tax years beginning after December 31, 2014, PATH permanently extends the small business expensing limitations to $500,000 of the cost of qualifying property placed in services for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property during the taxable year exceeded $2,000,000. These amounts will be indexed for inflation for taxable years beginning after 2015.

Qualified property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. PATH treats air conditioning and heating units placed in service in tax years beginning after 2015 as eligible for expensing.

Special rules that allowed expensing for computer software and qualified real property (e.g., qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property) prior to 2015 are permanently extended.

Observation: *The basis of property for which a section 179 election is made is reduced by the amount of the section 179 deduction. The remaining basis is depreciable under the normal rules.*

BONUS DEPRECIATION

PATH extends bonus depreciation for property acquired and placed in service from 2015 through 2019 (with an additional year for certain property with a longer production period). The bonus depreciation percentage is 50% for property placed in service during 2015, 2016 and 2017 and phases down, with 40% in 2018 and 30% in 2019. Taxpayers can continue to elect to accelerate the use of AMT credits in lieu of bonus depreciation under special rules for property placed in service in 2015. The provision modifies the AMT rules beginning in 2016 by increasing the amount of unused AMT credits that may be claimed in lieu of bonus depreciation.

BUSINESS INTEREST

If you have debt traced to your business expenditures — including debt used to finance the capital requirements of a partnership, S corporation or LLC involved in a trade or business in which you materially participate — you can deduct the interest as business interest rather than as an itemized deduction. The interest is a direct reduction of the income from the business. This lets you deduct all of your business interest. You will need to check your particular state, as it may vary as to which states allow this deduction.

Business interest also includes finance charges on items that you purchase for your business (as an owner) using your credit card. These purchases are treated as additional loans to the business, subject to tracing rules that allow you to deduct the portion of the finance charges that relate to the business items purchased.

HOME OFFICE DEDUCTIONS

When you use part of your home for business, you may be able to deduct the business portion of the costs of running your home, such as real estate taxes, mortgage interest, rent, utilities, insurance, painting, repairs and depreciation. The home office deduction is available to both renters and homeowners, but is subject to an overall limitation that will prevent you from deducting a net loss from your business resulting from your home office deductions.

Generally, you must meet the following two requirements to qualify for the home office deduction:

- You must regularly use part of your home exclusively for a trade or business. Incidental or occasional business use is not regular use. "Exclusive use" means a specific area of your home is used only for trade or business activities.

- The home office must be your principal place of business. This requirement can be satisfied if the home office is used for the administrative or management activities of your business and there is no other fixed location where you can conduct these activities.

If you deduct depreciation for a home office in your principal residence, your ability to fully use the taxable gain exclusion on the sale of a principal residence will be limited since the portion of the gain attributable to your home office is not eligible for this exclusion. See the discussion in the chapter on principal residence sale and rental.

Expenses that are deductible only because the home is used for business (such as the business portion of home insurance and utilities) are limited to the gross income derived from the use of the home. Unused deductions are carried over to the subsequent year but are subject to the limitations calculated in that year. Expenses that would have been otherwise deductible, such as real estate taxes and qualified home mortgage interest, are not subject to these limitations.

For taxable years beginning on or after January 1, 2013 taxpayers can use a simplified option when calculating the home office deduction. The requirements to qualify for the deduction remain the same but the recordkeeping and calculation is simplified. Under the simplified option, the standard deduction is $5 per square foot used for business with a maximum of 300 square feet allowed; home-related itemized deductions are claimed in full on Schedule A; no home depreciation deduction or later depreciation recapture for the years the simplified option is used. The taxpayer may choose to use either the simplified method or the regular method for any taxable year on a timely filed original federal income tax return for the year. The method may not be changed for a particular year once selected but a different method may be used in a subsequent year.

START-UP EXPENSES

The amount of capitalized business start-up expenses eligible for deduction in the year the active business commences (instead of amortization over 180 months) is $5,000, reduced (but not below zero) by the amount the start-up expenses exceed $50,000. Expensing is automatic, and no longer requires an election to be formally made. However, taxpayers wishing to elect out must "affirmatively elect to capitalize" the costs on a timely filed federal income tax return (including extensions). The election to either deduct or capitalize start-up costs is irrevocable and applies to all start-up costs of the taxpayer. Capitalized start-up costs must be amortized over 180 months.

ORGANIZATION COSTS

The amount allowed as a current expense for organization costs is $5,000 (reduced by the amount of costs that exceed $50,000). The excess amount must be amortized over 180 months. Expensing is automatic and no formal election need be made. Affirmatively electing to amortize the organization costs on a timely filed return (including extensions) will be considered as "opting out" of the expense election.

SELF-EMPLOYED HEALTH INSURANCE DEDUCTION

As a self-employed individual, you can deduct 100% of the health insurance premiums you pay for yourself, your spouse, your dependents, and any child of the self-employed under the age of 27 as of the end of the tax year. This deduction applies if you are a general partner in a partnership, a limited partner receiving guaranteed payments, or a more-than-2% shareholder who receives wages from an S corporation. You can also include the premiums paid for eligible long-term care insurance policies as deductible self-employed health insurance subject to certain limitations. Medicare premiums are also includible.

Note: *These rules only apply for any calendar month in which you are not otherwise eligible to participate in any subsidized health plan maintained by any employer of yours or of your spouse, or any plan maintained by any employer of your dependent or your under-age-27 child.*

UTILIZE BUSINESS LOSSES OR TAKE TAX-FREE DISTRIBUTIONS

If you have an interest in a partnership, LLC or S corporation, you can deduct losses from the entity only to the extent you have tax basis and are "at-risk" for the losses. If you have a loss from any of these entities that will be limited, you may want to make a capital contribution (or a loan) before year-end to allow you to deduct the loss. However, losses may still be limited by the passive activity loss rules.

You can take tax-free distributions from a partnership, LLC or S corporation if you have tax basis in the entity and have already been taxed on the income. Since you are taxed on your share of the income of these entities, regardless of whether or not distributions were made, you may have paid tax in a prior year, or will pay tax in the current year, on income that you have not received. Therefore, you can now take a distribution without paying additional tax, if funds are available and the entity permits such distributions, to the extent of your tax basis and at-risk amount in the entity. However, there are special considerations for distributions from S corporations.

SELF-EMPLOYMENT TAX

Your net earnings from self-employment are subject to Social Security and Medicare taxes. As a self-employed individual, your share of these taxes almost doubles since you pay both the employer's and employee's portions of these taxes. However, if you are also a salaried employee, your wages will offset the portion of your self-employment earnings subject to the Social Security tax.

The self-employment tax rate is 15.3%, which consists of 12.4% Social Security tax and 2.9% Medicare tax. The maximum amount of combined 2015 wages and self-employment earnings subject to the 12.4% Social Security tax is $118,500 (also $118,500 in 2016). There is no limitation on self-employment income subject to the 2.9% Medicare tax. An additional 0.9% Hospital Insurance tax (which, combined with the 2.9% Medicare tax, will total 3.8%) will be imposed on self-employment income in excess of $250,000 for joint returns; $125,000 for married taxpayers filing separate returns; and $200,000 in all other cases. See the chapter on tax rate overview.

Because of these taxes, your federal effective tax rate on self-employment income can be as high as 56%, compared to about 48% for income from wages (after including your employee share of Social Security and Medicare taxes). The reason the spread is not greater is primarily because you receive a deduction against AGI for 50% of the self-employment tax you pay. See the chapter on tax rate overview.

PENSION AND PROFIT SHARING PLANS

Rules governing contributions to, and distributions from, retirement plans are very complex, so an entire chapter is dedicated to this discussion. You should refer to that chapter for more specific information, including various plan restrictions.

NET OPERATING LOSS CARRYBACKS

Net operating losses generated can be carried back 2 years and carried forward 20 years.

Note: *A taxpayer can elect to relinquish the carryback period if a timely election is filed. Taxpayers whose losses are de minimis or who expect to be in a higher tax bracket in future years may benefit from this election.*

REPORTING REQUIREMENTS FOR EMPLOYEE STOCK PURCHASE PLANS AND ISOS

Corporations are subject to certain reporting requirements related to employee stock purchase plans and incentive stock options. See the chapter on stock options, restricted stock, and deferred compensation plans.

FINAL REPAIR/CAPITALIZATION REGULATIONS

The IRS released the final "repair" regulations in September 2013. These regulations explained when business owners must capitalize costs and when they can deduct expenses for acquiring, maintaining, repairing, and replacing tangible property. These regulations apply to tax years beginning on or after January 1, 2014. Taxpayers had the option to apply either the final or temporary regulations to tax years beginning in 2012 or before 2014. Taxpayers may consider whether to file amended tax returns for 2012 to take advantage of these elections.

Elections are made year-to-year, are not permanent and require either a simple attachment to the tax return or a change in accounting method by filing Form 3115.

The final regulations included a *de minimis* expensing rule that allows taxpayers to deduct certain amounts paid to acquire or produce tangible property. If there is an Applicable Financial Statement ("AFS") and a written accounting policy for expensing amounts paid or incurred for such property, then up to $5,000 per invoice can be deducted. Therefore, taxpayers should have had this written policy in place by the end of 2013 in order to qualify for 2014 and beyond.

Note: *The AFS should be an audited financial statement.*

There are certain relief provisions applicable for smaller businesses. A $500 expense threshold per item or invoice is allowed if the taxpayer does not have an AFS and has a written expensing policy in place at the beginning of the year. The $500 *de minimis* expense is increased to $2,500 starting for tax year 2016.

AFFORDABLE CARE ACT

The Patient Protection and Affordable Care Act of 2010 ("ACA"), along with the Health Care and Education Reconciliation Act, represents the most significant regulatory overhaul of the U.S. health care system since the passage of Medicare and Medicaid in 1965.

ACA was enacted to increase the quality and affordability of health insurance through the use of mandates, subsidies and insurance exchanges. The following are the major considerations of the ACA:

- Large Employer Mandate

The ACA requires that an applicable large employer pay an excise tax if:

1. The employer fails to offer its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan and any full-time employee is certified to the employer as having a premium assistance tax credit or cost-sharing reduction; or

2. The employer offers its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan, but the plan is either underfunded or too expensive. Also, at least one or more full-time employee is certified as having a premium assistance tax credit or cost-sharing reduction.

The Premium Assistance Tax Credit was designed to help offset the cost of health insurance coverage obtained through the marketplace.

Subject to certain transition relief for 2015, an applicable large employer is defined as one that employs within one calendar year an average of at least 100 (50 for 2016) full-time employees (including full-time equivalent employees). A full-time employee for every calendar month is an employee who has an average of at least 30 hours of service per week or at least 130 hours of service during the calendar month. For example, 40 full-time employees employed 30 or more hours per week on average plus 20 employees employed 15 hours per week on average are equivalent to 50 full-time employees. Seasonal workers are taken into account under special rules in determining the number of full-time employees. Seasonal workers are workers who perform services on a seasonal basis, including retail workers employed exclusively during the holiday season.

- Employer and Insurer Reporting

The ACA generally requires applicable large employers to file an information return that reports the terms and conditions of the employer-provided health care coverage for its full-time employees. Other parties, such as health insurance plans, have similar reporting requirements.

Effective for calendar 2015, the reporting begins in the first quarter of 2016. Separate from this rule, the ACA requires employers with 250 or more employees to provide the cost of the applicable employer-sponsored coverage on the employee's Form W-2, "Wage and Tax Statement."

- Small Employer Health Insurance Premium Credit

The ACA provides a tax credit to encourage eligible small employers to provide health insurance coverage to their employees. An eligible taxpayer can claim the Code Section 45B credit for 2 consecutive years beginning with the first tax year on or after 2014. A taxpayer may claim the credit for tax years beginning in 2010 through 2013 without those years counting towards the 2-consecutive-year period.

An eligible small employer is one with no more than 25 full-time equivalent employees for the tax years whose employees have an average annual wage that does not exceed $51,600 per employee in tax years beginning in 2015 and $51,800 in tax years beginning in 2016 (this number is indexed for inflation). Also, the employer has a qualifying arrangement in which the employer pays a uniform percentage of not less than 50% of the premium cost of a qualified health plan offered by the employer to its employees through a small business health options program ("SHOP") marketplace.

The maximum credit for 2014 and thereafter is 50% of the premium paid for small business employers and 25% for small tax-exempt employers.

- Individual Mandate

Beginning January 1, 2014, individuals must carry minimum essential coverage for each month or make a "shared responsibility payment" (penalty) with his or her tax return. Minimum essential coverage is that from an employer-sponsored plan, coverage obtained through a state or federal marketplace, Medicare, Medicaid, most student health plans or other similar plans.

For 2015, the penalty is the greater of $325 per person or 2% of taxable income and for 2016, it is the greater of $695 or 2.5% of taxable income. Certain family limits apply.

Planning Opportunity: *Employers facing increased costs in their health insurance coverage to meet the minimum essential coverage requirements, or incur a penalty, must decide if they should "pay or play." Business owners may wish to consider reviewing their company's entire employee compensation package, including the cost-effectiveness of their retirement plans, and perhaps revamping their entire compensation strategy to obtain and retain human capital.*

NEW LEGISLATION

The Surface Transportation & Veterans Health Care Choice Improvement Act of 2015 was signed into law on July 31, 2015. There are changes to tax return due dates and extensions for tax years beginning after December 31, 2015, thus impacting the 2017 filing season. For C corporations, the new due date is the 15th day of the 4th month following the end of the tax year. So for calendar year C corporations, the new due date will be April 15. Generally, a 6-month extension will be granted. C corporations with a June 30 year-end keep the September 15 due date until 2026. For partnerships, the new due date is the 15th day of the 3rd month following the end of the year, or March 15. Partnerships will be granted a 6-month extension, so the extended due date will be September 15. S corporations' due date of March 15th is unchanged.

The Bipartisan Budget Act of 2015 was signed into law on November 2, 2015. The law removed the automatic ACA registration to new employees (if over 200 in number). It also repealed the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and the electing large partnership ("ELP") rules for audit and legal procedures for partnerships. The law reduces the audit process for partnerships from 3 audit systems to one streamlined system, moves IRS audit adjustments from partner level to the partnership level, and provides for an option to elect out if there are 100 or fewer partners. Partnership agreements may need to be amended to reflect the impact of this legislation.

PATH permanently extends the rules reducing to 5 years (rather than 10 years) the period for which an S corporation must hold its assets following conversion from a C corporation to avoid the tax on built-in gains. In general, a corporate-level built-in gains tax, at the higher marginal rate applicable to corporations (currently 35%), is imposed on an S corporation's net realized built-in gain that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period.