

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.

EISNERAMPER

TAX ADVANTAGES FOR BUSINESS OWNERS

A self-employed individual, or owner of an operating business through a partnership, LLC, or S corporation, may have additional tax planning opportunities available. Unlike a salaried employee, a self-employed person's business deductions can offset AGI, rather than be characterized as miscellaneous itemized deductions subject to the 2% floor, which the TCJA suspended for tax years beginning after December 31, 2017 and before January 1, 2026.

TIMING OF INCOME AND DEDUCTIONS

If you are in a cash-basis business, you can delay billing until January of the following year for services already performed, thereby deferring the 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 prepay or defer paying business expenses so the deduction occurs in the year you expect to be subject to the higher tax rate. This choice can be particularly significant if you are considering purchasing (and placing in service) business equipment, as the next section addresses. If cash flow is a concern, you can accelerate the business's deductions by charging them on a credit card. This method allows you to take a deduction in the current year when the charge is made, even though you may actually pay the bill containing those credit card charges in January of the following year. (The credit card rule only applies where the seller of the goods/services is different from the credit card company.)

Another advantage of deferring income or prepaying expenses is the opportunity to defer the 2.9% Medicare component of self-employment taxes. If the total of self-employment income plus wages is below \$128,400 in 2018 (\$132,900 in 2019), you can also reduce the Social Security tax that you pay.

Caution: *It is important to 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.*

FIRST-YEAR EXPENSING FOR BUSINESS EQUIPMENT

For years beginning after December 31, 2017, the IRC Sec. 179 small business expensing limitation is \$1,000,000 of the cost of qualifying property placed in service for the taxable year. The \$1,000,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property during the taxable year exceeded \$2.5 million. After reaching the \$2.5 million threshold, the deduction is phased out, dollar for dollar, up to \$3.5 million. For years beginning

after 2018, these amounts are indexed for inflation and rounded to the next \$10,000.

For 2018, qualified property is defined as depreciable tangible personal property which is purchased for use in the active conduct of a trade or business. Qualified property also includes computer software and qualified real property (combining the classifications of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property). The TCJA also expanded IRC Sec. 179 eligibility to certain improvements made to non-residential real property such as roofs, heating, ventilation and air-conditioning property, fire protection systems, alarm systems and security systems.

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

BONUS DEPRECIATION

The bonus depreciation percentage was 50% for property placed in service through September 26, 2017. Under the TCJA, the bonus depreciation percentage was increased to 100% for property placed in service after September 27, 2017 through December 31, 2022. For property placed in service after September 27, 2017 and before December 31, 2017, taxpayers had the option to take 100% bonus depreciation or to elect to apply the original 50% bonus rate. The allowable bonus percentage decreases by 20% each year, beginning in 2023 with 2026 being the last year at 20% bonus. An important change from the TCJA is the expansion of the definition of qualified property to include used property, consistent with IRC Sec. 179, as long as the taxpayer did not use the property before purchase or acquire it from a related party.

Prior to the TCJA, bonus depreciation was available for eligible property with a recovery period of less than 20 years. This included equipment, furniture and fixtures, computer software and qualified improvement property. Under the pre-TCJA rules, qualified improvement property included the interior portion of the building which is non-residential real estate placed in service after the year the building was first placed in service. The qualified improvement cannot enlarge the building, nor can it be an elevator, escalator or internal framework. The remaining portion of the above qualified property was eligible for 15-year or 39-year depreciation.

The TCJA expanded the definition of qualified property eligible for the 100% bonus depreciation deduction to include qualified film, television, and live theatrical production property. It is still unsettled, under the new law, whether the life of this property class is 15 years or 39 years but tax law specialists have commented that future technical corrections should include adding the 15-year life to maintain eligibility for bonus depreciation.

The TCJA retained the first-year depreciation amount of \$8,000 for passenger automobiles.

Corporate taxpayers were able to elect to accelerate the use of AMT credits in lieu of bonus depreciation for 2017. In view of the elimination of the corporate AMT, the TCJA also repealed a corporate taxpayer's opportunity to claim prior-year minimum tax credits in place of bonus depreciation.

Prior-year minimum tax credit can still offset the taxpayer's regular tax liability. For tax years beginning after 2017 and before 2022, the prior-year minimum credit would be refundable in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the credit for the tax year over the amount of the credit allowable for the year against regular tax liability.

BUSINESS INTEREST

If you have debt traced to 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 a business expense, rather than an itemized deduction. Business interest also includes finance charges on items which an owner purchases for the business using a credit card. These purchases are treated as additional loans to the business, subject to tracing rules which permit a deduction of that portion of the finance charges relating to the business items purchased.

Commencing January 1, 2018, the TCJA limits the deduction for net interest expense to the sum of business interest income, 30% of the "adjusted taxable income" of the business — earnings before interest, taxes, depreciation, amortization and depletion ("EBITDA") and floor plan financing interest. After 2021, the earnings limitation takes into account only depreciation, amortization and depletion ("EBIT"). The initial EBITDA formula is more generous to taxpayers.

The limitation applies to interest expense incurred in connection with both related-party and unrelated-party debt. Any interest disallowed can be carried forward indefinitely. For pass-through entities, the limitation is applied at the entity level, rather than the owner level.

Certain industries are exempt from this limitation, as are small businesses with average annual gross receipts of \$25 million or less, measured by the average receipts for the prior three years. This amount will be adjusted annually for inflation starting in 2019.

HOME OFFICE DEDUCTIONS

If 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 two requirements to qualify for the home office deduction:

- You must use part of your home regularly and 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 a 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 exclude all of the taxable gain on the sale of the principal residence will be limited because 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 limitations calculated for that year. Expenses which would have been otherwise deductible, such as real estate taxes and qualified home mortgage interest, are not subject to these limitations.

Taxpayers can choose a simplified option to calculate the home office deduction. The requirements for the deduction remain the same for both methods, but the recordkeeping and calculation is simplified.

Under the streamlined option, the standard deduction is \$5 per square foot used for the business, up to a maximum of 300 square feet; home-related itemized deductions are claimed in full on Schedule A (subject to limitations under the TCJA) and there is neither depreciation nor depreciation recapture for any year the simplified option is used. The taxpayer may elect either the simplified method or the regular method for a taxable year on a timely filed original federal income tax return (including extensions). Once selected, a taxpayer may not change the method for that particular year but may use a different method in a subsequent year.

The TCJA suspended the deduction of miscellaneous itemized expenses subject to the 2% floor on Schedule A, which includes employees' unreimbursed job expenses. In contrast, business owners who report activity on Schedule C will retain the ability to deduct their home office expenses.

START-UP EXPENSES

The amount of capitalized business start-up expenses eligible for deduction in the year the active business commences (rather than 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 requires no formal election. Nevertheless, taxpayers wishing to elect out must affirmatively choose to capitalize the costs on a timely filed federal income tax return (including extensions). The election either to deduct or to capitalize start-up costs is irrevocable and applies to all of the taxpayer's start-up costs. Capitalized start-up costs must be amortized over 180 months.

ORGANIZATION COSTS

A taxpayer may expense up to \$5,000 of organization costs (reduced by an amount which exceeds \$50,000). The excess must be amortized over 180 months. Expensing is automatic and no formal election is necessary. Affirmatively electing to amortize the organization costs on a timely filed return (including extensions) will be considered "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 of your children 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 deduct the premiums paid for eligible long-term care insurance policies as self-employed health insurance subject to certain limitations. Medicare premiums also qualify for this deduction.

Note: *These rules only apply for any calendar month in which the taxpayer is 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 that you have tax basis and are "at-risk" for the losses. If you have a loss from any of these entities which may be limited, you may want to make a capital contribution (or a loan) before year-end to enable the deduction of the loss. Nevertheless, those losses may still be subject to and limited by the passive activity loss rules. For further information, see the chapter on passive and real estate activities.

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 pass-through income. Since you are taxed on your share of the income of pass-through entities, regardless of whether or not distributions were made, you may have paid tax in a prior year, or will pay in the current year, on income that you have not received. Therefore, you can 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 certain special considerations for distributions from S corporations.

SELF-EMPLOYMENT 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 2018 wages and self-employment earnings subject to the 12.4% Social Security tax is \$128,400 (\$132,900 in 2019). 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, the 2018 federal effective tax rate on self-employment income is 50%, compared to approximately 46% for wage income (after including your employee's 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 paid. For further information, see the chapter on tax rate overview. In 2018, the individual tax rates decreased overall as a result of the Tax Cuts and Jobs Act.

EMPLOYER'S DEDUCTIONS FOR ENTERTAINMENT, COMMUTING BENEFITS AND MEALS AND EMPLOYEE ACHIEVEMENT AWARDS

As a result of the Tax Cuts and Jobs Act, business expense deductions are eliminated for most entertainment costs and commuting benefits (qualified transportation fringe benefits under IRC Sec. 132(f)) after 2017.

Meal expenses provided to employees on the employer's premises for the convenience of the employer or through an employer-maintained on-site facility are now subject to a 50% limitation. The deduction for expenses paid through an employer-maintained, on-site facility (cafeteria) will be eliminated after 2025.

The new law also prohibits the employer's deduction of cash, gift cards and other non-tangible personal property as employee achievement awards. The prohibition includes vacations, meals,

lodging and tickets to theatre or sporting events. Certain awards may be deductible for the employer and excludable from the employee's wages if the award is tangible personal property.

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

Through 2017, net operating losses ("NOLs") could be carried back two years and forward 20 years. The TCJA now limits the NOL deduction to 80% of taxable income, repeals the two-year carryback period (except for certain farming losses) and allows NOLs arising in tax years beginning after December 31, 2017 to be carried forward indefinitely. Property and casualty insurance companies continue to use preferential rules, similar to those in effect in 2017.

EXCESS BUSINESS LOSS DISALLOWANCE

The TCJA imposed a limitation on non-corporate taxpayers engaged in business for tax years beginning after December 31, 2017 and ending before January 1, 2026.

A non-corporate taxpayer is now prohibited from deducting in a particular year a loss exceeding their excess business loss or EBL, which is the excess of the sum of:

- The aggregate gross receipts from such trades or businesses; and
- \$500,000 for married filing jointly taxpayers or \$250,000 for other taxpayers.

Taxpayers may offset losses of one business against the income of another business and any loss disallowed under this rule becomes an NOL and is carried forward to future years to offset both business and non-business income. Excess business losses ("EBLs") for partnerships or S corporations are determined at the entity level and the limitation is applied at the individual level.

A taxpayer must apply the at-risk and passive loss limits of IRC Sec. 469 before calculating the EBL disallowance of IRC Sec. 461(l). Under this hierarchy, if a loss is disallowed under the at-risk or passive loss rules, income or loss from that activity would not be considered in the calculation of the taxpayer's excess business loss, if any.

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" which affected tax years beginning on or after January 1, 2014. These regulations distinguished the circumstances under which business owners must capitalize costs from those in which they can deduct expenses for acquiring, maintaining, repairing, and replacing tangible property.

The final regulations included an expensing rule which provides a safe harbor for taxpayers to deduct certain amounts paid to acquire or produce tangible property. If the company has an Applicable Financial Statement ("AFS") and a written accounting policy for expensing amounts paid or incurred for such property, up to \$5,000 per item or per invoice can be deducted. Therefore, taxpayers should have had this written policy in place by the end of 2017 in order to qualify for 2018 and beyond. Elections are made on an annual basis.

Note: *The AFS is defined as an audited financial statement.*

There are certain relief provisions applicable to smaller businesses.

A company without an AFS may deduct up to \$2,500 per item or invoice as long as it has a written expensing policy in place at the beginning of the tax year.

In addition, taxpayers should consider whether to adopt the \$200 safe-harbor expensing rule for materials and supplies.

Caution: *The specific facts and circumstances of each business taxpayer will dictate which safe harbors, tax return elections and accounting method changes might be required or appropriate. Some elections require a simple attachment to the business's tax return; others may necessitate filing a Form 3115 as a change of accounting method.*

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.

An applicable large employer is defined as one that employs within the preceding calendar year an average of at least 50 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 which 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.

The ACA requires employers with 50 or more employees to provide the cost of the applicable employer-sponsored coverage on the employee's Form W-2, "Wage and Tax Statement." Employers should be aware that there is no longer a good faith exception to missing or incorrect data on Forms 1094-C and 1095-C; therefore, employers

should have reliable reporting alternatives in place.

- Small Business Health Care Tax 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 IRC Sec. 45R credit for two consecutive years beginning with the first tax year on or after 2014. A taxpayer may have claimed the credit for tax years beginning in 2010 through 2013 without those years counting towards the two consecutive-year period.

An eligible small employer is one with no more than 25 full-time equivalent employees who earn an average annual wage not exceeding \$54,000 in 2018 (this number is indexed for inflation). The employer must also have a qualifying arrangement in which it pays a uniform percentage of not less than 50% of the premium cost of a qualified health plan that it offers to its employees through a small business health options program ("SHOP") marketplace.

The maximum credit is 50% of the premiums paid for small business employers and 35% for small tax-exempt employers. Small business employers can carry the credit back or forward and are permitted to deduct the premiums paid in excess of the credit as a business expense.

- Individual Mandate

Under the prior law, individuals had to 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.

The Act reduces the individual mandate penalty to zero beginning in 2019. This repeal is permanent. Therefore, beginning with the 2019 tax year, individuals will no longer be penalized if they fail to maintain adequate health insurance.

For 2018, the last year in effect, the individual mandate penalty is the greater of \$695 per adult and \$347.50 per child under age 18 or 2.5% of the excess of the taxpayer's household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return. There is a family maximum penalty of \$2,085.

The employer mandate and corresponding reporting requirements remain in effect. Employers must have decided if they would "pay or play." In other words, they must have chosen either to meet the minimum essential coverage requirements for 2018, or incur a penalty. Business owners should reconsider 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.

The 21st Century Cures Act enacted in December 2016 includes, among other things, a provision allowing small businesses to continue to offer health-reimbursement arrangements to employees under certain circumstances without violating market reforms under the ACA and risking an excise tax per affected participant.

OTHER LEGISLATION

Family and Medical Leave Tax Credit

The TCJA affords businesses a new tax credit to those companies that offer paid family and medical leave to their employees. For wages paid in tax years 2018 or 2019, an employer can claim a tax credit for a portion of the wages it pays to employees during any period during which those employees are on leave. Notably, although the Family and Medical Leave Act of 1993 ("FMLA") requires businesses with at least 50 employees to provide 12 weeks of leave to employees under certain circumstances, the TCJA does not require employers to pay wages during that leave.

To qualify for the credit, employers, (whether or not subject to the FMLA), must (1) have a written leave policy; (2) provide all full-time employees at least two weeks of annual paid family and medical leave; and (3) offer part-time qualifying employees working at least 30 hours per week a commensurate amount of leave on a pro rata basis.

To be eligible for the credit, the qualified employee's compensation during leave has to be at least 50% of his or her regular salary.

The credit is 12.5% of the wages paid to the employees while on leave and increases by 0.25 percentage points (up to 25%) for each percentage point which the rate of payment exceeds 50%. The credit applies to a maximum of 12 weeks of annual pay.

A qualifying employee is any employee who:

- Has been employed for at least one year prior to taking leave; and
- For the preceding year, did not earn more than \$72,000 in 2017 (not "highly compensated").

For purposes of this credit, "family and medical leave" is time off for one or more of the following reasons:

- Birth of an employee's child and to care for the newborn.
- Placement of a child with the employee for adoption or foster care.

- To care for the employee's spouse, child, or parent who has a serious health condition.
- A serious health condition that makes the employee unable to perform the functions of his or her position.
- Any qualifying event due to an employee's spouse, child, or parent being on covered active duty – or being called to duty – in the Armed Forces.
- To care for a service member who is the employee's spouse, child, parent, or next of kin.

An employer cannot claim both a credit and a deduction for family and medical leave wages; it can choose either the deduction or the credit. The FMLA allows employees to elect (or employers to require) that they apply any accrued vacation or leave time. However, this type of leave does not qualify for the tax credit unless the leave had been restricted to one or more of the of the family and medical leave purposes. Any leave paid or required to be paid by a state or local government will also not be taken into account. The credit should be based on the employer-provided leave exceeding any applicable state law requirements.

Pass-Through Tax Treatment

The TCJA made significant changes to the tax treatment of income from pass-through entities. For taxable years beginning after December 31, 2017 and before January 1, 2026, the TCJA allows a deduction of 20% of the taxpayer's domestic qualified business income ("QBI") from a partnership, an LLC treated as a partnership, an S corporation, or a sole proprietorship. See the chapter on passive and real estate activities for details.