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 itemized deductions, subject to various limitations and disallowances. This is especially significant given that for tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for miscellaneous itemized deductions that are subject to the 2% floor is suspended.

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 $127,200 in 2017 ($128,400 in 2018), 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 2017, the Section 179 small business expensing limitation was $510,000 of the cost of qualifying property placed in service for the taxable year. The $510,000 amount was reduced (but not below zero) by the amount by which the cost of qualifying property during the taxable year exceeded $2,030,000.

For years beginning after December 31, 2017, the maximum amount a taxpayer may expense under Section 179 is increased to $1 million and the phase-out threshold amount is increased to $2.5 million. For years beginning after 2018, these amounts are indexed for inflation and rounded to the next $10,000.

For 2017, 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 (e.g., qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property) along with air conditioning and heating units.

Qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements are still eligible for 15-year straight line cost recovery in 2017.

Under the Tax Cuts and Jobs Act, qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property have now been combined into the single category of qualified improvement property. The Act also adds roofs, heating, ventilation and air-conditioning property, fire protection systems, alarm systems and security systems to the list of qualifying property.

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 of the asset is depreciable under the normal rules.*

BONUS DEPRECIATION

The bonus depreciation percentage is 50% for property placed in service through September 26, 2017. Under the Tax Cuts and Jobs Act, the bonus depreciation percentage is increased to 100% for property place 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 have 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 Act is the expansion of the definition of qualified property to include used property, as long the taxpayer did not use the property before purchase.

Prior to the Act, bonus depreciation was available for eligible property with a recovery period of less than 20 years. This includes equipment, furniture and fixtures, computer software and qualified improvement property. Under the pre-Act rules, qualified improvement property includes 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 is eligible for 15-year or 39-year depreciation.

The Act 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 presently unclear, 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 Act retains the first-year depreciation amount of $8,000 for passenger automobiles.

Corporate taxpayers can continue 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 Act also repeals 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.

The interest is a direct reduction of the business's income and, in 2017, the full deduction of business interest is permitted.

The Act limits the deduction for net interest expenses to the sum of business interest income, 30% of the business's "adjusted taxable income" – 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.

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 Tax Cuts and Jobs Act) 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 Act suspended the deduction of miscellaneous itemized expenses subject to the 2% floor, 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 2017 wages and self-employment earnings subject to the 12.4% Social Security tax is $127,200 ($128,400 in 2018). 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 2017 federal effective tax rate on self-employment income can be as high as 56%, compared to approximately 48% 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 will decrease overall as a result of the Tax Cuts and Jobs Act.

EMPLOYER'S DEDUCTIONS FOR ENTERTAINMENT, COMMUTING BENEFITS AND MEALS

As a result of the Tax Cuts and Jobs Act, business expense deductions are eliminated for most entertainment costs and commuting benefits (qualified transportation under IRC section 132(f)) after 2017. Also, certain employer-provided meal expenses will be eliminated after 2025.

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 ("NOLs") can be carried back two years and carried forward 20 years under the rules in effect for 2017.

The Tax Cuts and Jobs Act 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.

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 2016 in order to qualify for 2017 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 one 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 Code Section 45B 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 $52,400 in 2017 (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 current law, 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.

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

For both 2017 and 2018, the 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 2017, 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 AFFECTING 2017-2018

In an effort to mitigate the adverse impact of Hurricanes Harvey, Irma and Maria on businesses, the President signed into law the Disaster Tax Relief and Airport and Airway Extension Act of 2017 ("Disaster Tax Relief Act"), which provides tax relief for hurricane victims located in federally declared disaster areas (as defined by FEMA at www.fema.gov/disasters).

The Disaster Tax Relief Act established a credit for hurricane-affected businesses that compensated their employees during the period the business was inoperable. The credit is 40% of each employee's qualified wages, limited to $6,000 per employee. Qualified wages are those wages paid during the period that the business was inoperable regardless of whether the eligible employee was actually working during this period. Eligible employers are those who have business operations in a hurricane disaster area on the date the respective hurricane occurred and was inoperable on any day after the date the hurricane occurred and before January 1, 2018. Eligible employees are those employees who worked for an eligible employer in the hurricane disaster zone. To avoid double-counting, the work opportunity tax credit may not be claimed for the same employees whose wages are factored into the employee retention credit.