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

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.

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 $118,500 in 2016 ($127,200 in 2017), you can also reduce the Social Security tax.

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.*

BUSINESS EQUIPMENT

Effective for tax years beginning after December 31, 2014, PATH permanently extends the Section 179 small business expensing limitations to $500,000 of the cost of qualifying property placed in service 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 are indexed annually for inflation.

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, which prior to 2015 allowed expensing for computer software and qualified real property (e.g., qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property) have been extended permanently.

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.*

The 15-year straight line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements has also been extended.

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.

Bonus depreciation is available for eligible property, such as qualified improvement property and computer software, with a recovery period of less than 20 years.

Under the new 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 qualified improvement property would be eligible for 39-year depreciation or 15-year depreciation provided it also met the test to be qualified real property.

Taxpayers can continue to elect to accelerate the use of AMT credits in lieu of bonus depreciation.

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 that 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 the full deduction of business interest is permitted. Taxpayers should keep in mind that state laws concerning the deductibility of business interest expense may differ.

HOME OFFICE DEDUCTIONS

If you use part of his 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 2 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 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 fully use the taxable gain exclusion 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 on 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; 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 a particular year but may use a different method 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 (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 no longer requires a 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 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 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

Your net earnings from self-employment are subject to Social Security and Medicare taxes. As a self-employed individual, your share of these taxes is almost doubled since you pay both the employer's and employee's portions of these taxes. However, if you are also a salaried employee, any 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 2016 wages and self-employment earnings subject to the 12.4% Social Security tax is $118,500 ($127,200 in 2017). 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 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.

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 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" 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 invoice can be deducted. Therefore, taxpayers should have had this written policy in place by the end of 2015 in order to qualify for 2016 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. As of January 1, 2016, 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 the filing a Form 3115 as a change of accounting method.*

New for 2016
In December 2016, the IRS extended the 5-year eligibility limitation waiver for certain automatic changes of accounting made to comply with these regulations. Specifically, the IRS extended the liberal waiver rule for one year beginning before January 1, 2017. A transition rule now generally allows taxpayers whose non-automatic consent requests were pending on December 20, 2016 to switch to the automatic consent procedures.

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 reporting began 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." Employers should be aware that the 2015 good faith exception to missing or incorrect date on Forms 1094-C and 1095-C has terminated; therefore, they should be consider reliable reporting alternatives for 2017.

- 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 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 who earn an average annual wage not exceeding $52,000 in 2016 (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

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 2016, the penalty is the greater of $695 or 2.5% of taxable income. There is a family maximum penalty of $2,085. The 2016 amounts will be adjusted for inflation.

Planning Opportunity: *By January 1, 2017, employers facing the increased costs of health insurance coverage must have decided if they would "pay or play." In other words, they must have chosen either to meet the minimum essential coverage requirements, or incur a penalty. Business owners should consider 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 was enacted in December 2016 and generally allows small businesses to continue to offer health-reimbursement arrangements to employees without violating market reforms under the ACA and risking an excise tax of $100 per day per affected participant.

LEGISLATION AFFECTING 2016

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 was signed into law on July 31, 2015 and changed tax return due dates and extensions for tax years beginning after December 31, 2015, 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. 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 maintain 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 for a partnership with a calendar year-end. Partnerships will be granted a 6-month extension, so the extended due date will be September 15. S corporations' original due date of March 15 remains unchanged.

PATH includes a new requirement requiring employers to file their copies of Form W-2 with the Social Security Administration by January 31, 2017. The new January 31 filing deadline also applies to certain Forms 1099-MISC reporting non-employee compensation such as payments to independent contractors. Only one 30-day extension is available to file Form W-2 by submitting Form 8809 before January 31, but it is not automatic.

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, 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.

New for 2017

In October 2016, the IRS issued final regulations on IRC section 385 which pertains to debt-equity rules. The regulations establish threshold documentation requirements that must be satisfied for certain related-party interest in a corporation to be treated as debt, and treat as stock certain related-party instruments that would otherwise be classified as debt. The regulations were intended to tone down the broad reach of the earlier imposed regulations.