Wealth Planning Services

Tax Update # 22: 2014 Year-End Business Income Tax Planning

Year-end 2014 brings planning opportunities and challenges, and there is much for taxpayers and their tax advisors to consider in taking action before 2014 ends. This summary explores some of the **2014 year-end income tax planning opportunities available to certain businesses.** Of course, every taxpayer's situation is unique and a year-end planning strategy, whether for an individual, family, or business, should be customized in consultation with a qualified professional. Harbour Capital Advisors (HCA) stands ready to assist clients with year-end planning issues and opportunities.

For a summary of individual income tax-savings opportunities, please request a copy of our separate **Tax Update # 21: 2014 Year-End Individual Income Tax Planning**. For a summary of estate and gift tax-savings opportunities, please request a copy of our separate **Tax Update # 23: 2014 Year-End Estate and Gift Tax Planning**. Note that all tax information contained herein is general in nature, is provided for informational and educational purposes only, and should not be construed as legal or tax advice.

Deferring Income into 2015

Deferring income to the next taxable year is a time-honored year-end planning tool. If you expect your taxable income to be higher in 2014 than in 2015, or if you anticipate being in the same or a higher tax bracket in 2014 than in 2015, you may benefit by deferring income into 2015. Of course, exposure to the alternative minimum tax (AMT) could result in a need to accelerate income instead. Some ways to defer income include:

Use of Cash Method of Accounting: By using the cash method of accounting instead of the accrual method of accounting, you can generally put yourself in the best position for accelerating deductions and deferring income. There is still time to accomplish this strategy, because an automatic change to the cash method can be made by the due date of the return including extensions. The following three types of businesses can make an automatic change to the cash method: (1) small businesses with average annual gross receipts of $1 million or less (even those with inventories that are a material income-producing factor); (2) certain C corporations with average annual gross receipts of $5 million or less in which inventories are not a material income producing factor; and (3) certain taxpayers with average annual gross receipts of $10 million or less. Provided inventories are not a material income-producing factor, sole proprietors, limited liability companies (LLCs), partnerships, and S corporations can change to the cash method of accounting without regard to their average annual gross receipts.

Installment Sales: Generally, a sale occurs when you transfer property. If a gain will be realized on the sale, income recognition will normally be deferred under the installment method until payments are received. So if you are expecting to sell property at year-end, and it makes economic sense, consider selling the property using the installment method to defer payments (and tax) until next year or later.

Delay Billing: Delay year-end billing to clients so that payments are not received until 2015. When it makes business sense, you may want to consider using an installment sale.

Interest and Dividends: Interest income earned on Treasury securities and bank certificates of deposit with maturities of one year or less is not includible in income until received. To defer interest income and assuming alignment with investment goals, consider buying short-term bonds or certificates that will not mature until next year. If you have control as to when dividends are paid, arrange to have them paid to you after the end of the year.

Accelerating Income into 2014

You may benefit from accelerating income into 2014. For example, you may anticipate being in a higher tax bracket in 2015, or perhaps you need additional income in 2014 to take advantage of an offsetting deduction or credit that will not be available to you in future tax years. Note, however, that accelerating income into 2014 will be disadvantageous if you expect to be in the same or lower tax bracket for 2015. If you report income and expenses on a cash basis, issue bills and attempt collection before the end of 2014. Also, see if some of your clients or customers are willing to pay for January 2015 goods or services in advance. Any income received using these steps will shift income from 2015 to 2014.

Business Deductions

Self-Employed Health Insurance Premiums: Self-employed individuals are allowed to claim 100% of the amount paid during the taxable year for insurance that constitutes medical care for themselves, their spouses, and their dependents as an above-the-line deduction, without regard to the general 10%-of-AGI floor.

Equipment Purchases: If you purchase equipment, you may make a "Section 179 election," which allows you to expense (*i.e.,* currently deduct) otherwise depreciable business property. For 2014, you may elect to expense up to $25,000 of equipment costs (with a phase-out for purchases in excess of $200,000) if the asset was placed in service during 2014.

In 2015, the dollar amounts for §179 expensing are scheduled to be $25,000, with a phase-out amount of $200,000. Although the amount eligible to be expensed and the phase-out amount were significantly greater in prior years and there is a chance the 2014 and 2015 figures will go up if Congress acts soon, it is uncertain whether any such legislation will be passed and if so whether that legislation would have retroactive application.

In addition, careful timing of equipment purchases can result in favorable depreciation deductions in 2014. In general, under the "half-year convention," you may deduct six months' worth of depreciation for equipment that is placed in service on or before the last day of the tax year. [If more than 40% of the cost of all personal property placed in service occurs during the last quarter of the year, however, a "mid-quarter convention" applies, which lowers your depreciation deduction.]

A popular strategy in recent years has been to purchase a vehicle for business purposes that exceeds 6,000 pounds. It is possible that the vehicle can qualify for the full equipment expensing dollar amount, which for SUVs (rated between 6,000 and 14,000 pounds gross vehicle weight) would be limited to $25,000 (assuming 100% business use).

NOL Carryback Period: If your business suffers net operating losses for 2014, you generally apply those losses against taxable income going back two tax years. Thus, for example, the loss could be used to reduce taxable income—and thus generate tax refunds—for tax years as far back as 2012. Certain "eligible losses" can be carried back three years; farming losses can be carried back five years.

Bad Debts: You can accelerate deductions into 2014 by analyzing your business accounts receivable and writing off those receivables that are totally or partially worthless. By identifying specific bad debts, you should be entitled to a deduction. You may be able to complete this process after year-end if the write-off is reflected in the 2014 year-end financial statements.

Home Office Deduction: Expenses attributable to using the home office as a business office are deductible under §280A if the home office is used regularly and exclusively: (1) as a taxpayer's principal place of business for any trade or business; (2) as a place where patients, clients, or customers regularly meet or deal with the taxpayer in the normal course of business; or (3) in the case of a separate structure not attached to the residence, in connection with a trade or business. If you have been using part of your home as a business office, we should talk about the amount of any deduction you would like to take because recent guidance provides a safe harbor which could be used to minimize audit risk.

Capitalization of Tangibles: Final regulations providing guidance on the application of §162(a) and §263(a) to amounts paid to acquire, produce, or improve tangible property, expand the definition of materials and supplies to include property with an acquisition or production cost of $200 or less, clarify the application of the optional method of accounting for rotable and temporary spare parts, and simplify the application of the *de minimis* safe harbor to materials and supplies. The regulations generally apply to taxable years beginning on or after January 1, 2014.

Business Credits

Small Employer Pension Plan Startup Cost Credit: For 2014, certain small business employers that did not have a pension plan for the preceding three years may claim a non-refundable income tax credit for expenses of establishing and administering a new retirement plan for employees. The credit applies to 50% of qualified administrative and retirement-education expenses for each of the first three plan years. However, the maximum credit is $500 per year.

Credit for Employee Health Insurance Expenses of Small Employers: Eligible small employers are allowed a credit for certain expenditures to provide health insurance coverage for their employees. Generally, employers with 10 or fewer full-time equivalent employees (FTEs) and an average annual per-employee wage of $25,400 or less are eligible for the full credit. The credit amount begins to phase out for employers with either 11 FTEs or an average annual per-employee wage of more than $25,400. The credit is phased out completely for employers with 25 or more FTEs or an average annual per-employee wage of $50,800 or more. Beginning in 2014, the credit is available on a sliding scale for up to 50% of the employer's contribution toward employee health insurance premiums (35% for tax-exempt organizations), is only allowable if the health insurance is purchased through a SHOP Exchange, and is only available for two consecutive taxable years.

Inventories

Subnormal Goods: You should check for subnormal goods in your inventory. Subnormal goods are goods that are unsalable at normal prices or unusable in the normal way due to damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange. If your business has subnormal inventory as of the end of 2014, you can take a deduction for any write-downs associated with that inventory provided you offer it for sale within 30 days of your inventory date. The inventory does not have to be sold within the 30-day timeframe.

Planning Around Expired Tax Relief Provisions

S Corporation Built-In Gains Tax: An S corporation generally is not subject to tax; instead, it passes through its income or loss items to its shareholders, who are taxed on their *pro rata* shares of the S corporation's income. However, if a business that was formed as a C corporation elects to become an S corporation, the S corporation is taxed at the highest corporate rate on all unrealized gains that were built in at the time of the election if the gains are recognized during a special holding period which is generally 10 years. Although the special holding period was significantly shorter in recent years, it is uncertain whether legislation will be passed to shorten the special holding period for 2014 or subsequent years and, if passed, whether that legislation would have retroactive application.

Exclusion of Gain Attributable to Certain Small Business Stock: Qualified small business stock sales taking place in 2014 could be subject to a few different gain exclusion incentives. An individual ordinarily may exclude a certain percentage of the gain from qualified small business stock that is held for more than five years (subject to a cap). “Qualified small business stock” is stock of a corporation the assets of which do not exceed $50 million when the stock is issued. The key to this provision is when the stock was acquired, not when it is sold. A 50% exclusion of gain applies for stock acquired after August 10, 1993, and before February 18, 2009; a 75% exclusion applies for stock acquired after February 17, 2009, and before September 28, 2010; a 100% exclusion applies for stock acquired after September 27, 2010, and before January 1, 2014. Therefore, if you plan to sell in 2014 and have owned the qualified small business stock for more than five years, your benefit can vary greatly. For example, if you acquired the stock on January 1, 2009, and sold on or after January 2, 2014, you receive a 50% gain exclusion. If you bought the stock after February 17, 2009, but before December 31, 2009, your 5-year holding period may or may not have been satisfied if sold in 2014. If it has, then a 75% exclusion will apply. No sales in 2014 can qualify for a 100% exclusion as the acquisition date must have been after September 27, 2010, and the 5-year holding period will not be satisfied until September 27, 2015.

Qualified Dividends: Qualified dividends are subject to rates similar to the capital gains rates. Qualified dividend income is subject to a 15% rate for taxpayers below the recently reinstated 39.6% tax bracket. For taxpayers in the 39.6% bracket, the capital gains rate is 20%. Note that qualified dividends may be subject to an additional 3.8% net investment income tax. Qualified dividends are typically dividends from domestic and certain foreign corporations. So if you have any control over the receipt of dividends, and you are not in the highest bracket for 2014, the dividends should be accelerated into 2014 in order to take advantage of the 15% rate.

Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property: The rule that the basis of an S corporation shareholder's stock is decreased by charitable contributions of property by the S corporation in an amount equal to the shareholder's *pro rata* share of the adjusted basis of the contributed property expired for contributions made in taxable years beginning after December 31, 2013. As a result, absent congressional action retroactively extending the prior rule for charitable contributions made in 2014, your stock basis will be reduced by your *pro rata* share of the S corporation's charitable contributions. For example, if you contributed property with a $200 adjusted basis and $500 fair market value to a charity, your stock basis will be reduced by $500 instead of $200 unless Congress enacts legislation extending the prior rule.

Employer-Provided Child Care Credit: For 2014, employers may claim a credit of up to $150,000 for supporting employee child care or child care resource and referral services. The credit is allowed for a percentage of "qualified child care expenditures," including for property to be used as part of a qualified child care facility, for operating costs of a qualified child care facility, and for resource and referral expenditures.

Employer Wage Credit for Employees in the Military: Some employers continue to pay all or a portion of the wages of employees who are called to active military service. If the employer has fewer than 50 employees and has a written plan for providing such differential wage payments, the employer is eligible for a credit. The amount of the credit is equal to 20% of the first $20,000 of differential wage payments to each employee for the taxable year. The credit expired after 2013, and it is uncertain whether legislation providing for this credit will be passed and if so whether such legislation will provide for the credit retroactively.

Work Opportunity Credit: The work opportunity credit is an incentive provided to employers who hire individuals in groups whose members historically have had difficulty obtaining employment. The credit gives a business an expanded opportunity to employ new workers and to be eligible for a tax credit against the wages paid. The credit is determined based on first-year wages paid for employees hired on or before December 31, 2013. The credit expired after 2013, and it is uncertain whether legislation providing for this credit will be passed and if so whether such legislation will provide for the credit retroactively.

Health Care Planning

SHOP Exchanges: Beginning in 2014, the Small Business Health Options Program begins to allow certain small businesses to obtain health insurance for their employees through an exchange with health insurance coverage beginning in 2015. Currently, the program is designed for employers with 50 or fewer full-time equivalent employees. Coverage must be offered to all full-time employees working 30 or more hours per week. Each state will offer its own SHOP marketplace. Self-employed persons with no employees cannot use the SHOP Exchange.

Health Care Credits: Small businesses with less than 25 employees may qualify for health care tax credits using the health insurance marketplace. These premium tax credits can cover up to 50% of the cost of employee health insurance. The uncovered amount can be deducted from your taxes as usual.

Beginning in 2015, the tax credits are available through plans offered on the SHOP marketplace exclusively.

Pay to Play Excise Tax: In 2015, if you have 100 or more employees, you could be subject to an excise tax, which could be as much as $2,000 per employee, for failure to provide an adequate health care plan to your employees. The first 80 workers are excluded from the penalty excise tax. As a larger employer, you should be considering your health care needs in light of this potential excise tax liability.

Reporting

FATCA: The Foreign Account Tax Compliance Act (FATCA) requires reporting and possible withholding on payments made to foreign entities, whether the foreign payees are financial institutions or not. In 2014, you needed to be fully compliant with FATCA beginning July 1st for withholding purposes. Information reporting requirements apply to foreign payments made in 2014, but the reports are not due until March 15, 2015. Implementing a compliance process for FATCA can be costly. Your compliance processes need to be in place.

Uncertain Tax Positions: The final instructions for Schedule UTP state that a corporation must file Schedule UTP with its income tax return if it: (1) files Form 1120, Form 1120-F, From 1120-L, or Form 1120-PC; (2) has assets of $10,000,000 or more beginning with the 2014 tax year; (3) issued (or a related party issued) audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year; and (4) has one or more tax positions that must be reported on Schedule UTP. A taxpayer that files a protective Form 1120, 1120-F, 1120-L, or 1120-PC and satisfies the conditions set forth above also must file Schedule UTP.

Electronic Deposits

Electronic Funds Transfer: As of January 1, 2011, a corporation must make its deposits of income tax withholding, FICA, FUTA, and corporate income tax by electronic funds transfer (EFT), including through the IRS's Electronic Federal Tax Deposit System (EFTPS).

Conclusion

While we are getting very close to the end of the year, there is still time for businesses to implement strategies to minimize their 2014 tax liability. If you have questions about topics reviewed above or other tax planning matters, please contact Hunter Payne at 703.992.6485.

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