Wealth Planning Services

Tax Update # 41: 2016 Year-End Business Income Tax Planning

Year-end 2016 brings planning opportunities and challenges, and there is much for taxpayers and their tax advisors to consider in taking action before 2016 ends. This summary explores some of the **2016 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.

Moreover, year-end tax planning is complicated by what the new Administration and Congress could do next year. During his campaign, President-elect Trump outlined a number of tax proposals for individuals and businesses. Keep in mind, however, that what is proposed by an Administration and/or Congress and what legislation ultimately looks like can differ dramatically, especially when (i) Congress and the new Administration may have differing views on what tax reform should look like and (ii) a 60-vote supermajority (to override filibuster) in the Senate on a given bill may be difficult to obtain (which may not be necessary if "reconciliation" is utilized). However, during his campaign, President-elect Trump called for, among other things:

- Reducing the number of individual income tax brackets and lowering the individual income tax rates for most taxpayers (with a new rate structure of 12, 25, and 33 percent)
- Repealing the alternative minimum tax (AMT)
- Limiting itemized deductions and increasing the standard deduction
- Eliminating the head-of-household filing status and all personal exemptions
- Repealing the Federal estate and gift tax (and introducing a "carryover basis" rule for inherited assets of more than $10 million)
- Lowering the corporate tax rate to 15 percent (from 35 percent)
- Sharing the corporate rate break with owners of "pass through" entities on reinvested profits
- Doubling the Code Sec. 179 small business expensing election to $1 million
- Allowing repatriation of corporate profits held offshore at a one-time tax rate of 10 percent
- Repealing the Affordable Care Act (ACA) (including presumably the ACA's tax-related provisions)

Given that it is too early to predict what legislation will look like and when it will pass, this summary focuses instead on current law (as scheduled for 2016 and 2017). For a summary of individual income tax-savings opportunities, please request a copy of our separate **Tax Update # 40: 2016 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 # 42: 2016 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 2017

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 2016 than in 2017, or if you anticipate being in the same or a higher tax bracket in 2016 than in 2017, you may benefit by deferring income into 2017. 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 2017. 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 2016

You may benefit from accelerating income into 2016. For example, you may anticipate being in a higher tax bracket in 2017, or perhaps you need additional income in 2016 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 2016 will be disadvantageous if you expect to be in the same or lower tax bracket for 2017. If you report income and expenses on a cash basis, issue bills and attempt collection before the end of 2016. Also, see if some of your clients or customers are willing to pay for January 2017 goods or services in advance. Any income received using these steps will shift income from 2017 to 2016.

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. Note that at the end of 2015, Congress retroactively restored the expensing limitation to $500,000 (with a phase-out of $2,000,000) for 2015, to match the limitations in place between 2010 and 2014. These limits, indexed for inflation, are now permanent. For 2016, you may elect to expense up to $500,000 of equipment costs (with a phase-out for purchases in excess of $2,010,000) if the asset was placed in service during 2016. In 2017, the dollar amounts for §179 expensing are scheduled to be $510,000, with a phase-out amount of $2,030,000.

Note that for assets placed in service in 2016, taxpayers can expense 50% of their business equipment purchases under §168(k). Congress has extended this bonus depreciation provision for property placed in service through 2019, with 50% bonus depreciation for property placed in service in 2015, 2016, and 2017; 40% in 2018; and 30% in 2019.

In addition, careful timing of equipment purchases can result in favorable depreciation deductions in 2016. 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 2016, 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 2014. Certain "eligible losses" can be carried back three years; farming losses can be carried back five years.

Bad Debts: You can accelerate deductions into 2016 by analyzing your business accounts receivables 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 2016 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.

Business Credits

Small Employer Pension Plan Startup Cost Credit: For 2016, 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 $25,900 for 2016 ($26,150 for 2017) 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 $25,900 for 2016 ($26,150 for 2017). The credit is phased out completely for employers with 25 or more FTEs or an average annual per-employee wage of $51,800 for 2016 ($52,400 for 2017) or more. The credit (i) 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), (ii) is only allowable if the health insurance is purchased through a SHOP Exchange, and (iii) 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 2016, 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 its income or loss items through 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 within 5 years of the election.

Exclusion of Gain Attributable to Certain Small Business Stock: Qualified small business stock sales taking place in 2016 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. Therefore, if you plan to sell in 2016 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, 2011, and sold on or after January 2, 2016, you receive a 100% gain exclusion. If you bought the stock after September 27, 2010, but before December 31, 2011, your 5-year holding period may or may not have been satisfied if sold in 2016. If it has, then a 100% exclusion will apply.

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 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 2016 (but you will be in 2017), the dividends should be accelerated into 2016 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, 2014, but was reinstated retroactively and permanently by Congress at the end of 2015. Now, 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 $200.

Employer-Provided Child Care Credit: For 2016, 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 a written plan for providing such differential wage payments, the employer, regardless of size, 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 2014 but was retroactively and permanently reinstated by Congress at the end of 2015. Only employers with fewer than 50 employees are eligible to claim the credit for payments made on or prior to December 31, 2015. After December 31, 2015, the credit is available to employers of any size.

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 expired after 2014 but was reinstated retroactively by Congress and extended through 2019. The credit is determined based on first-year wages paid for employees hired on or before December 31, 2019. The credit was also expanded to apply to employers who hire qualified long-term unemployed individuals (individuals who have been unemployed for at least 27 consecutive weeks, including any period in which the individual received unemployment compensation) after December 31, 2015. The credit for hiring such long-term unemployed individuals is 40% of the first $6,000 of wages.

Health Care Planning

SHOP Exchanges: The Small Business Health Options Program allows certain small businesses to obtain health insurance for their employees through an exchange with health insurance coverage. 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. The tax credits are available through plans offered on the SHOP marketplace exclusively.

Pay or Play Excise Tax: For the 2017 plan year, if you have 50 or more employees, you could be subject to an excise tax, which could be as much as $2,260 per employee, for failure to provide an adequate health care plan to your employees. The first 30 workers are excluded from the penalty excise tax. Larger employers should be considering their health care plan needs in light of this potential excise tax liability.

Electronic Deposits

Electronic Funds Transfer: 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 2016 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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