Tax Impact

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Tax Tips

Is your business getting the credits it deserves?

It's a challenging time to grow a business. So, any help you can get in the form of tax credits, tax exemptions, grants, low-cost financing and other incentives can make a big difference. Unfortunately, these incentives often go unclaimed. Why? In most cases, businesses have to ask for them — either by claiming benefits on a tax return or negotiating with a state or local government — and that means they have to know about them.

The credits and incentives available to businesses are too numerous to mention — plus, they vary from state to state, locality to locality and even year to year. But the work involved in identifying and claiming these incentives can pay off, especially in today's competitive environment. Let's examine two types of incentives available — statutory and discretionary — and outline some potential benefits.

1. Statutory incentives

Some incentives — such as federal or state tax credits or exemptions — are available "as of right." In other words, if your business meets the requirements set forth in the statute or regulation, you just need to claim the benefits on a timely filed tax return to receive them.

State and federal tax credits and exemptions are usually designed to provide incentives for businesses to engage in certain activities or to invest in certain economically distressed areas. Examples include:

State and federal R&D tax credits. Too often, businesses don't claim valuable R&D tax credits because they assume they're not eligible. There's a common misconception that these credits are only for scientific or technological research by large pharmaceutical, biotech, software and aerospace companies. In reality, these credits may be available to any business that invests in developing new products or techniques, improving processes, or even developing software for internal use. The potential benefits can be significant. The federal credit for "increasing research activities," for example, is generally equal to 20% of the amount by which qualified research expenditures exceed a base amount derived from a business's historical R&D expenditures.

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Businesses may overlook the R&D credit because they're small or unprofitable, and don't think the credit would benefit them. But the credit is

available to businesses of any size. And even companies with no income tax liability may benefit by claiming R&D credits. For one thing, these credits may be carried forward to offset taxable income in future years. Plus, eligible start-up companies can claim the federal R&D credit against up to $250,000 in employer-paid payroll taxes.

Work Opportunity Tax Credit (WOTC). The WOTC is a federal credit, ranging from $2,400 to $9,600 per eligible new hire from certain disadvantaged groups. Examples include convicted felons, welfare recipients, veterans and workers with disabilities. To qualify for the credit, you must complete certain paperwork and take additional other steps before extending a job offer. Many states offer similar credits.

Empowerment zone incentives. Certain incentives are available to companies that operate in federally designated, economically distressed "empowerment zones." Tax credits may be worth up to $3,000 for each employee who works and resides within the zone.

Industry-based and investment credits. Many states and other jurisdictions offer tax credits and other incentives to attract certain types of businesses, such as manufacturing or film and television production. States and other jurisdictions may also offer investment tax credits for capital investments within their borders.

2. Discretionary incentives

Discretionary tax breaks, on the other hand, must be negotiated with government representatives. Typically, these incentives are intended to persuade a business to stay in, or relocate to, a certain state or locality.

To secure these incentives, therefore, a business must convince the government entity that it'll create jobs, generate tax revenues, stimulate economic development or otherwise benefit the jurisdiction. Discretionary incentives may include income and payroll tax credits, property tax abatements, sales tax exemptions, and utility rate reductions.

Don't lose out on sales tax exemptions

States with sales taxes (which is most of them) provide exemptions for certain purchases. Common exemptions include:

- Purchases by retailers (from a manufacturer or distributor, for example) for the purpose of resale,
- Purchases by manufacturers of equipment, raw materials or components used in the manufacturing process,
- Purchases by specific tax-exempt entities, such as nonprofit organizations, charitable or educational institutions, or government entities, and
- Certain purchases by agricultural businesses, such as farming equipment and fuel, feed, seeds, fertilizer, and chemical sprays.

Businesses should familiarize themselves with the exemptions available in the states where they do business, determine whether they qualify and satisfy any requirements for claiming an exemption. For example, they might need to present the seller with a resale or exemption certificate.

Don't leave money on the table

These are just a few examples of the many tax credits and other incentives available to businesses. Every year, billions of dollars go unclaimed because businesses are unaware of tax credits and incentives or erroneously believe they're ineligible. Your tax advisors can help ensure that your business receives all the tax breaks it deserves. ■

Managing capital gains

The right timing can result in significant tax savings

If you plan to sell capital assets, a little planning can do wonders for your tax bill. Capital assets include a wide range of property held for personal or investment purposes, including stocks, bonds, real estate, jewelry and collectibles. Here are a few rules of thumb that may reduce your capital gains taxes.

Avoid short-term gains

For tax purposes, capital gains are treated differently based on how long you've held an asset. Short-term gains (on assets held for one year or less) are taxed at ordinary income rates (currently as high as 37%), while long-term gains (on assets held for more than one year) generally are taxed at a favorable 15% rate. There are some exceptions: Taxpayers in the lowest two tax brackets qualify for a 0% rate, while certain high-income taxpayers are taxed at 20%.

Also, net capital gains on collectibles — such as art, antiques, precious metals, stamps, coins and gems — are taxed at a maximum rate of 28%. Gains attributable to depreciation of real estate are taxed at a maximum rate of 25%.

Finally, be aware that if the net investment income tax applies, your gains may be subject to an additional 3.8% tax.

Consider the timing of the sale

If you plan to sell a capital asset at a gain, it's generally preferable to wait until you've held it for more than a year to take advantage of the favorable long-term capital gain rates. But if you're considering selling it at a loss, the timing of the sale is critical.

Under certain circumstances it may be preferable to make the sale before you've held the asset for more than one year. Why? Because when you determine your net capital gain or loss in a particular year, the first step is to offset gains and losses of the same type — that is, short-term losses against short-term gains and long-term losses against long-term gains.

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Consider this example. So far this year, Jim, who's in the 32% tax bracket, has recognized $5,000 in short-term capital gain and $5,000 in long-term capital gain. If he doesn't sell any more capital assets this year, the short-term gain will be taxed as ordinary income and the long-term gain will be taxed at 15%.

Jim also owns stock, purchased on September 1, 2021, which has declined in value by $5,000. If he sells the stock by September 1, 2022, it'll generate a $5,000 short-term loss that will erase his $5,000 short-term gain, leaving him with the lower-taxed long-term gain of $5,000. However, if Jim waits until after September 1 to sell the stock, the sale will generate a long-term loss, which must be offset against the long-term gain, leaving him with $5,000 in short-term gain taxed as ordinary income.

From a tax planning perspective, it's usually best to recognize both capital gains and capital losses in the same tax year, since the losses can be used to offset the gains, reducing your tax bill. But there may be situations in which it's preferable

to postpone gains until the following year. That's because you're permitted to deduct up to $3,000 in net capital losses from your ordinary income (such as wages and interest).

For example, let's say you have a $3,000 net capital loss this year, and you're also contemplating selling stock that would generate a $3,000 long-term capital gain. If you sell the stock this year, the gain will offset the loss, and you'll lose the $3,000 deduction from ordinary income. But if you wait until next year to sell the stock, you'll preserve the $3,000 deduction, reducing this year's tax bill.

Sell highest-cost shares first

If you plan to sell shares of stock or other securities that you purchased at different times for different prices, you can generally lower your taxes by selling the shares that will produce the smallest gain or largest loss. When you sell securities, by default, brokers often apply the first-in, first-out accounting method, which assumes that the first shares purchased are the first shares sold. Often (but not always) those shares have a lower cost-basis, increasing your taxable gain.

If possible, ask your broker to use the specific identification method. This allows you to minimize your taxes by instructing the broker to sell the shares with the highest cost basis.

Look before you leap

Be sure you understand the tax consequences before you sell any capital assets. Often, even small changes in the timing of a sale can mean big tax savings. Your tax advisor can help determine the right course of action considering your overall financial plan. ■

Net gifts differ from standard gifts

Thanks to the generous federal gift and estate tax exemption ($12.06 million in 2022) and the annual gift tax exemption ($16,000 per recipient in 2022), most gifts are shielded from tax. However, if you're concerned about the impact of transfer taxes on your gifts, consider making "net gifts."

Understanding how a net gift reduces tax

The easiest way to demonstrate the benefits of a net gift is through an example. Suppose you want to make a $1 million gift to your adult daughter. For purposes of this example, also assume that you've already exhausted your federal gift and estate tax exemption amount, so the gift is fully taxable. At the current 40% marginal rate, the tax on your $1 million gift would be $400,000. However, if your daughter agrees to pay the gift tax as a condition of receiving the gift, then the value of the gift would be reduced by the amount of tax. This, in turn, would reduce the amount of gift tax owed.

Rather than get caught up in an endless loop of calculating the tax, reducing the gift's value, recalculating the tax and so on, there's a simple formula for determining your daughter's tax liability: Gift tax = tentative tax / (1 + tax rate). In our example, the tentative tax is $400,000 (the tax that would have been owed on an outright gift), so the gift tax on the net gift would be $400,000 / 1.4 = $285,714. You can confirm that the math works out by assuming that you give your daughter $1 million and that she agrees to pay $285,714 in gift taxes. That tax liability reduces the gift to $1 million – $285,714 = $714,287, resulting in a tax liability of 40% × $714,287 = $285,714.

By using a net gift technique, you reduce the effective tax rate on the $1 million transfer from

40% to only 28.57%. Note that if the gift is in the form of appreciated assets rather than cash, the recipient's payment of the tax liability can result in capital gains taxes for the donor.

Going a step further

It may be possible to reduce the effective gift tax rate even further by using a net, net gift. Under this technique, in addition to assuming liability for gift taxes, the recipient also agrees to pay any estate tax liability that might arise by virtue of the so-called "three-year rule."

Under that rule, gifts made within three years of death are pulled back into the donor's estate and subject to estate taxes. The U.S. Tax Court has given its blessing to the net, net gift technique, allowing the value of a gift to be reduced by the actuarial value of the recipient's contingent obligation to pay estate taxes that would be owed if the donor were to die within three years of making the gift.

Don't try this at home

Making net gifts can ultimately reduce gift tax liability, but it's not a simple technique. Plus, it's important to correctly document the transaction to pass muster with the IRS. Your estate planning advisor can be a valuable resource. ■

HSAs can also be powerful retirement saving tools

Health Savings Accounts (HSAs) are designed as tax-advantaged savings vehicles for funding uninsured health care expenses. But for those in relatively good health, they also may serve as an attractive retirement savings vehicle. Briefly, HSAs are available to people covered by a high-deductible health plan. Contributions to an HSA are tax deductible, and withdrawals used to pay for qualified unreimbursed medical expenses are tax-free.

You can make tax-deductible contributions to an HSA and take tax-free withdrawals to pay for uninsured medical expenses. For 2022, a "high deductible" plan is one with a deductible of $1,400 or more for individual coverage or $2,800 or more for family coverage. In addition, annual out-of-pocket expenses must not exceed $7,050 for individual coverage or $14,100 for family coverage.

This year, you can contribute up to $3,650 to an HSA — $7,300 if you have family coverage — plus an additional $1,000 if you'll be 55 or older by the end of the year. If you're fortunate enough not to need all of the funds in the account for medical expenses, they'll continue to grow on a tax-deferred basis, providing a valuable supplement to your other retirement accounts. ■

Married filing separately: Is it ever a good idea?

For most married couples, filing jointly results in the lowest tax bill, especially when one spouse earns much more than the other. Suppose one spouse has $250,000 in taxable W-2 income and the other has $50,000 in taxable W-2 income. Presuming that the couple doesn't itemize and they have no charitable contributions, if they file a joint return their tax liability is approximately $55,000. Filing separately would increase their total tax liability by more than $8,500. If their taxable W-2 incomes are $150,000 each, however, their combined tax liability would be the same, regardless of filing status.

In some cases, there may be advantages to filing separately. An example is when one spouse has excessive medical expenses. Medical expenses are deductible only to the extent that they exceed 7.5% of adjusted gross income (AGI). By filing separately, that spouse can reduce his or her AGI, boosting the deduction for medical expenses. Of course, to determine whether this strategy will work, you'll need to weigh the tax benefits of the increased deduction against the tax increase (if any) resulting from filing separate returns. ■

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