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Tax Tips

Year-end tax planning for business

Flexibility can be a virtue

For most businesses, year-end tax planning involves a delicate balancing act, and the more flexibility that is built into the plan, the better. That's because the tax code is in a constant state of flux, which makes it challenging to identify the most effective strategies.

For example, a general rule of tax planning says that you should defer income to next year and accelerate deductible expenses into this year to minimize your tax bill. But if Congress sharply increases tax rates effective next year, you may be better off doing the opposite: accelerating income and deferring expenses to take advantage of this year's lower tax rate.

Another tax-planning strategy that may make sense to reconsider is maximizing depreciation-related tax breaks.

Bonus depreciation and Section 179 expensing

For many businesses, an effective strategy for generating tax deductions to reduce this year's tax bill is to invest in needed machinery, equipment or building improvements and place them in service by the end of the year. Often, these assets are eligible for 100% bonus depreciation or the Sec. 179 expensing election, allowing you to fully deduct the cost up front rather than depreciating it over a period of years or decades.

Most new and used machinery and equipment qualifies for 100% bonus depreciation or immediate expensing. In addition, many interior improvements to commercial buildings are eligible for bonus depreciation as qualified improvement property (QIP). (See "Can your business deduct the cost of interior improvements?" on page 3.)

A couple of things to keep in mind: First, Sec. 179 deductions in a given year are currently capped at $1.08 million and the deduction is gradually phased out when a taxpayer's qualifying expenditures exceed $2.7 million. (Both limits are annually adjusted for inflation.) Second, 100% bonus depreciation is scheduled to be phased out after this year. The deduction generally will be reduced to 80% for property placed in service in 2023, 60% in 2024, 40% in 2025 and 20% in 2026. After 2026, bonus depreciation will be eliminated absent Congressional action.

Not right for everyone

Bonus depreciation and Sec. 179 expensing can do wonders for your company's tax bill and cash flow, but claiming them isn't always the best strategy. It's important to look at your overall tax situation to see whether you'd be better off using regular depreciation rules to spread the deductions over several years. For example, it may be advantageous to forgo bonus depreciation or Sec. 179 expensing if:

You expect your tax rate to go up in the future. The benefit of a deduction is that it

Can your business deduct the cost of interior improvements?

If your business is planning interior renovations, there may be a tax advantage to completing them by the end of this year. Interior improvements properly classified as qualified improvement property (QIP) are eligible for bonus depreciation, which currently allows you to deduct 100% of the cost up front. After 2022, however, bonus depreciation deductions are scheduled to be gradually reduced and then eliminated after 2026.

QIP includes most improvements to the interior of an existing nonresidential building, such as drywall, ceilings, interior lighting, fixtures, interior doors, interior HVAC components, fire protection, mechanical, electrical and plumbing. It doesn't include improvements to elevators, escalators or the building's internal structural framework, nor does it include enlargement of the building.

QIP became eligible for bonus depreciation in 2018, so if you made qualifying improvements since that time, you may have an opportunity to recover deductions you missed and claim a tax refund.

reduces your taxable income and, therefore, your tax liability. The higher your marginal tax rate, the greater the amount of tax avoided.

If you believe your tax rate will increase in the near future — either because you expect to be in a higher tax bracket or you think Congress will raise tax rates — you may be better off deducting less (or investing in less) now. In this instance, you can claim larger depreciation deductions in future years when tax rates may be higher, thus making deductions more valuable.

You're improving the interior of a building that you plan to sell. If you've made a significant investment in QIP in a building you plan to sell, claiming bonus depreciation may set a dangerous tax trap. Why? Because your profits on the sale, to the extent they're attributable to bonus depreciation or any Sec. 179 deductions you've claimed, will be treated as "recaptured" depreciation taxable at ordinary income tax rates as high as 37%.

In contrast, if you deduct the cost of QIP under regular depreciation rules — typically, on a straight-line basis over 15 years — then any long-term gain attributable to such depreciation will be taxable at a top rate of 25% when the building is sold.

You're eligible for the qualified business income (QBI) deduction. The QBI deduction, sometimes referred to as the "pass-through" deduction, currently allows certain sole proprietors and owners of partnerships, limited liability companies and other pass-through entities to deduct up to 20% of their QBI. Among other restrictions, the deduction is capped at 20% of taxable income (excluding net capital gains).

Because bonus depreciation or Sec. 179 expensing reduces your taxable income, it may also reduce your QBI deduction. So, before claiming these deductions, be sure to weigh their potential benefits against the potential tax cost of a reduced QBI deduction.

Look at the big picture

As you can see, there isn't one right year-end tax strategy for every business. Your tax advisor can help you look at your overall tax picture and examine how various tax benefits interact with each other to determine the optimal tax-planning strategies for your business. ■

Year-end tax planning tips for investors

Savvy investors know that taxes can have a big impact on their returns. And while tax considerations should generally take a back seat to sound investment strategies, as you review your investment options think about moves that can slash your tax bill. Here are a few ideas to consider as we approach the end of 2022.

Harvest losses (or gains)

Before year's end, take inventory of the capital gains and losses you've recognized so far. If you expect to end the year with a net capital gain, consider "harvesting" losses by selling some investments that have declined in value and using those losses to offset the gain and reduce your taxable income.

What if you expect to end the year with a net capital loss? In that case, you might consider harvesting some gains from which the loss can be deducted. This strategy enables you to sell one or more investments that have appreciated in value without triggering capital gains tax.

You should, however, avoid offsetting your entire net capital loss. Why? Because you can use up to $3,000 in net capital loss to offset ordinary income, such as salary or interest ($1,500 if married filing separately). Any excess is carried forward and deducted from capital gains or ordinary income (up to the applicable limit) in future years. So, if you harvest gains to offset a net capital loss, try to preserve $3,000 of that loss to offset ordinary income, which is generally taxed at higher rates than capital gains.

Beware the wash sale rule

If you harvest losses or gains, you may be tempted to immediately buy back the investment to keep your portfolio's asset allocation intact. That way, you enjoy the tax benefits of recognizing the loss or gain without actually giving up the investment. This can be an effective strategy, but be sure to plan carefully to avoid violating the "wash sale" rule.

Under the rule, if you sell a stock or other security at a loss and purchase a substantially identical security within 30 days before or after the sale, the loss deduction is disallowed. To avoid this result, wait at least 31 days before you buy back the investment (though an unexpected price increase can wipe out the tax benefits). Or buy an investment that's similar, but not substantially identical. Keep in mind that the wash sale rule applies only to investments sold at a loss, not to those sold at a gain.

Donate appreciated assets to charity

If you're charitably inclined, consider donating long-term appreciated assets — such as stocks, bonds or real estate you've held for more than one year — to charity. You'll avoid tax on the gains you would have realized had you sold the assets, while enjoying a charitable deduction equal to the assets' fair market value (subject to certain limitations and assuming you itemize deductions).

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Avoid year-end mutual fund investments

Mutual funds typically distribute accumulated dividends and capital gains near the end of the year. There's a common misconception that investing in a fund just before a distribution gives you access to free money.

On the contrary, because the value of your shares is immediately reduced by the amount of the distribution, you'll essentially pay income tax on the distribution without receiving any benefit. If you instead invest *after* the distribution, you'll be in the same financial position, but without the added tax liability.

Maximize contributions to traditional IRAs and retirement plans

If you haven't maxed out your deductible or pretax contributions to traditional IRAs, 401(k) plans or other tax-advantaged retirement accounts, don't miss this opportunity to reduce this year's taxable income while building your nest egg. Far too many taxpayers fail to take advantage of their annual retirement contribution limits and miss out on reducing their taxable income.

Contributions to 401(k)s or similar employer plans generally must be made by December 31. But you can take a 2022 deduction for traditional IRA contributions made as late as April 18, 2023.

Strike a balance

Effective financial planning requires a balanced approach that considers both tax efficiency and sound investment principles. Your tax and investment advisors can help you strike a balance between the two. ■

Can your gifting program benefit from defined-value gifts?

It's no surprise that many individuals are making (or are considering making) substantial gifts to their family members to take advantage of the current federal gift and estate tax exemption. Indeed, the 2022 exemption of $12.06 million ($24.12 million for married couples) is the highest amount it's ever been. But absent action from Congress, the amount will drop to an inflation-adjusted $5 million in 2026.

If your estate consists of hard-to-value assets, including interests in a closely held business or family limited partnership (FLP), making gifts of these assets can be risky. If the IRS later

determines that the gifts were undervalued, you may be liable for gift tax (plus interest and possibly penalties). A defined-value gift may help you avoid unexpected tax liabilities.

Defining a defined-value gift

Simply put, a defined-value gift is a gift of assets that are valued at a specific dollar amount rather than a certain number of stock shares or FLP units or a specified percentage of a business entity.

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Structured properly, a defined-value gift ensures that the gift won't trigger an assessment of gift tax down the road. The key is to ensure that the defined-value language in the transfer document is drafted as a "formula" clause rather than an invalid "savings" clause.

A formula clause transfers a fixed dollar amount, subject to adjustment in the number of shares or units necessary to equal that dollar amount (based on a final determination of the value of those shares or units for federal gift and estate tax purposes). A savings clause, in contrast, provides for a portion of the gift to be returned to the donor if that portion is ultimately determined to be taxable.

Passing IRS muster

For a defined-value gift to be effective, it's critical to use precise language in the transfer documents. In a recent case, the U.S. Tax Court rejected an intended defined-value gift of FLP interests and upheld the IRS's assessment of gift taxes based on percentage interests. The documents called for the transfer of FLP interests with a defined fair market value "as determined by a qualified appraiser" within a specified time after the transfer.

The court found that the transfer documents failed to achieve a defined-value gift, because fair market value was determined by a qualified appraiser. The documents didn't provide for an adjustment in the number of FLP units if their value "is finally determined for federal gift tax purposes to exceed the amount described."

Wording the transfer documents

Making defined-value gifts may be right for you if you plan to transfer hard-to-value assets. Before taking action, contact your estate planning advisor, because this strategy requires precisely written transfer documents to be effective. ■

Now is a good time to check your FSA balance

If your employer provides you with a flexible spending account (FSA) for health care expenses, it's a good idea to check your account balance. Also, familiarize yourself with the terms of your employer's plan to see if it allows you to carry over some of your account balance (up to $500) to next year or offers a grace period (up to 2½ months) to spend the funds.

If some or all of your FSA balance will be forfeited at the end of the year, try to spend as much as possible on covered expenses by December 31. You can use FSA funds for a wide range of health care expenses, including over-the-counter medications, menstrual supplies, heating pads, orthopedic shoe inserts, certain skincare products, and masks and other COVID-19-related supplies. ■

Can you rely on IRS-issued FAQs?

IRS penalties for noncompliance with tax laws or regulations can be harsh, but in many cases it's possible to avoid them by showing "reasonable cause" for a particular tax position. Recently, the IRS announced that taxpayers may now assert reliance on IRS-issued frequently asked questions (FAQs) in demonstrating reasonable cause. The FAQs are posted at IRS.gov.

To avoid penalties, you'll still need to show that reliance on a particular FAQ was reasonable and in good faith. But the new policy may make it easier for many taxpayers to obtain penalty relief. ■

A Roth IRA for your child isn't as strange as it sounds

Roth IRAs can be a great way to teach your kids about saving and financial responsibility, while giving them a big head start on retirement planning. And because a child's tax rate is likely to be astronomically higher when it's time to withdraw the funds, the advantage of tax-free distributions is significant.

To be eligible, your child must have earned income that equals or exceeds the contributions to the Roth IRA. But the contributions don't have to come from the child's earnings; anyone can contribute to the child's account.

A Roth IRA can provide your child with a nice supplement to his or her other retirement savings. Consider this example: John opens a $1,000 Roth IRA for his daughter, Daisy, when she's 15 and contributes $50 per month until she turns 25. Daisy continues the $50 per month contributions for another 10 years, until her income reaches a level that disqualifies her from making Roth IRA contributions. Assuming a 7% rate of return, by the time Daisy retires 30 years later, the account will have grown to nearly $250,000. ■

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