Tax Impact

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Tax Tips

Year-end tax planning strategies for businesses

As 2023 comes to a close, now is a good time for businesses to consider year-end moves that can help reduce their tax bills. Following are several ideas to consider. But every business is different, so whether these strategies will help depends on your circumstances.

Defer income, accelerate deductions

A tried-and-true tactic for minimizing your tax bill is to defer income to next year and accelerate deductible expenses into this year. For example, if your business uses the cash method of accounting, consider deferring income by postponing invoices until late in the year or accelerating deductions by paying certain expenses before year end.

If your business uses the accrual method of accounting, you have less flexibility to control the timing of income and expenses, but there are still some things you can do. For example, it's possible to deduct year-end bonuses accrued this year even if they aren't paid until next year (if they're paid by March 15, 2024).

Accrual-basis businesses may also be able to defer income from certain advance payments — such as licensing fees, subscriptions, membership dues, and payments under guaranty or warranty contracts — until next year. These payments may be deferred to the extent they're recorded as deferred revenue on an "applicable financial statement" of the business — for example, an audited financial statement or a financial statement filed with the Securities and Exchange Commission.

Deferring income and accelerating deductions isn't right for every business. In some cases, it may be advantageous to do the opposite — that is, to accelerate income and defer deductions. This may be the case if, for example, you believe your business will be in a higher tax bracket next year.

Purchase assets by year end

One of the most effective ways to generate tax deductions is to buy equipment, machinery and other fixed assets. Ordinarily these assets are capitalized and depreciated over several years, but there are a few options for deducting some or all of these expenses immediately, including:

Section 179 expensing. This break allows you to deduct up to $1.16 million in expenses for qualifying tangible property and certain computer software for 2023. It's phased out on a

Can you write off bad business debts?

Year end is a good time to review your receivables and determine whether any business debts have become worthless or uncollectible. If they have, you may be able to reduce this year's tax bill by claiming a bad debt deduction.

To qualify for the deduction, you'll need documentation or other evidence that the debt is bona fide. You'll also need evidence that there's no reasonable expectation of payment (such as the debtor's insolvency or bankruptcy) or documentation that you've taken reasonable steps to collect the debt. You should also have documentation that the debt was charged off this year, which is required for partially worthless debts and a best practice for totally worthless debts.

Finally, to deduct a bad debt you must have previously included the receivable in your taxable income. Thus, an accrual-basis business can deduct an otherwise eligible bad debt if it's already accrued the receivable, but a cash-basis business can't.

dollar-for-dollar basis to the extent Sec. 179 expenditures exceed $2.89 million for 2023.

Bonus depreciation. This year, you can deduct up to 80% of the cost of eligible tangible property, which includes most equipment and machinery, as well as off-the-shelf computer software and certain improvements to nonresidential building interiors. Now's the time to take advantage of bonus depreciation, since the deduction limit will drop to 60% next year, 40% in 2025 and 20% in 2026. After that it will be eliminated, unless Congress passes new legislation that would extend it.

A tried-and-true tactic for minimizing your tax bill is to defer income to next year and accelerate deductible expenses into this year.

De minimis safe harbor. This provision allows you to expense certain low-cost items used in your business, even if they'd ordinarily be treated as fixed assets that are capitalized and depreciated. If your business has applicable financial statements, you can deduct up to $5,000 per purchase or invoice for these items to the extent that you deduct them for accounting purposes. If you don't have applicable financial statements, then the limit is $2,500. Despite the term "de minimis," the safe harbor makes it possible to immediately deduct a significant amount of property. For example, if you buy 10 computers for your business for $2,500 each, you can deduct as much as $25,000 up front.

Each of these options has advantages and disadvantages and is subject to various rules and limitations. Consult your tax advisor to choose the most effective strategies for your business.

Set up a retirement plan

If you don't have a retirement plan, establishing one can be a great way to generate tax benefits. It can also improve employee recruitment and retention efforts.

Certain employers are entitled to tax credits for starting a new plan, and in some cases, you can take deductions this year for contributions made after year end. Some plans, including simplified employee pensions (SEPs), can be adopted *and* funded after year end and still create deductions for this year.

See the big picture

Whichever year-end tax strategies you explore, it's critical to understand how they interact with other provisions of the tax code. For example, claiming significant amounts of bonus depreciation can hamper your ability to deduct interest. That's because business interest deductions are limited to 30% of adjusted taxable income (ATI) and depreciation is deducted in calculating ATI. Your tax advisor can help you select the optimal combination of year-end planning strategies for your business. ■

Does a charitable remainder trust belong in your estate plan?

When it comes to tax-saving strategies, sometimes the current economic and financial environment can make one strategy more effective than another. That's certainly the case with a charitable remainder trust (CRT).

Indeed, CRTs are generally more attractive when interest rates are higher — and the prime lending rate is currently at its highest level since 2001. So, if you're charitably inclined, a CRT may be beneficial to include in your estate plan.

Types of CRTs

A CRT is an irrevocable trust to which you contribute stock or other assets. The trust pays you (or your spouse or other beneficiaries) income for life or a term of up to 20 years, then distributes the remaining assets to one or more charities. When you fund the trust, you're entitled to a charitable income tax deduction (subject to applicable limits) equal to the present value of the charitable beneficiaries' remainder interest.

There are two types of CRTs, each with its own pros and cons:

1. Charitable remainder annuity trusts (CRATs). A CRAT pays out a fixed percentage (ranging from 5% to 50%) of the trust's initial value and doesn't allow additional contributions once it's funded.

2. Charitable remainder unitrust (CRUTs). A CRUT pays out a fixed percentage (ranging from 5% to 50%) of the trust's value, recalculated annually, and allows additional contributions.

CRATs offer the advantage of uniform payouts, regardless of fluctuations in the trust's value. CRUTs, on the other hand, allow payouts to keep pace with inflation because they increase as the trust's value increases. And, as noted, CRUTs allow you to make additional contributions. One potential disadvantage of a CRUT is that payouts shrink if the trust's value declines.

Why CRTs work better when rates are high

To ensure that a CRT is a legitimate charitable giving vehicle, IRS guidelines require that the present value of the charitable beneficiaries' remainder interest be at least 10% of the trust assets' value when contributed. Calculating the remainder interest's present value is complicated, but it generally involves estimating the present value of annual payouts from the trust and subtracting that amount from the value of the contributed assets.

The computation is affected by several factors, including the length of the trust term (or the beneficiaries' ages, if payouts are made for life), the size of annual payouts and an IRS-prescribed Section 7520 rate. If you need to increase the value of the remainder interest to meet the 10% threshold, consider shortening the trust term or reducing the payout percentage.

In addition, the higher the Sec. 7520 rate at the time of the contribution, the lower the present value of the payouts and, therefore, the larger the remainder interest. In recent years, however, rock-bottom interest rates made it difficult, if not impossible, for many CRTs to qualify. As interest rates rise, it becomes easier to meet the 10% threshold and increase annual payouts or the trust term without disqualifying the trust.

Not right for all situations

Just because interest rates are currently high doesn't mean you should rush to add a CRT to your estate plan. On the contrary, a CRT requires careful planning and solid investment guidance to ensure that it will meet your philanthropic needs. But when it's properly structured and funded, a CRT may provide substantial benefits. Discuss your situation with your estate planning advisor. ■

Renting to relatives?

Beware of the tax pitfalls of family member rentals

If you own residential real estate, you may be considering renting it to family members. As rents continue to rise in many parts of the country, renting property at a discount may seem like a good way to help relatives in need. But these arrangements are fraught with tax perils.

A misstep can lead to the loss of significant tax deductions. Let's take a look at the tax treatment of rentals to unrelated parties and then examine how renting to family changes the rules.

Business vs. personal

If you use real estate strictly for business purposes — that is, as a rental property — you're entitled to deduct mortgage interest, property taxes, utilities, depreciation, maintenance and other expenses. If your expenses exceed your rental income, you can even claim a loss (subject to passive loss limitations).

However, if you use property as a personal residence and rent it out for fewer than 15 days per year, you don't report the rental income.

You also can't deduct any expenses as rental expenses. But if you itemize, you can still claim personal deductions — to the extent allowable — for mortgage interest and property taxes.

If you use the property as a personal residence but rent it out for 15 or more days per year, it's treated as a mixed-use property. You report the rental income, and you must allocate your expenses between the property's personal and business uses.

> ***When you rent property to family members, you risk losing the ability to deduct rental expenses.***

The portion of mortgage interest and property taxes allocable to personal use may be claimed as itemized deductions. These expenses and others allocable to rental use are deductible as rental expenses up to the amount of rental income; in other words, they may not create a loss. Disallowed deductions may be carried forward to future years.

Family matters

When you rent property to family members, you risk losing the ability to deduct rental expenses. That's because use by family members is considered personal use, even if your relative pays rent, unless two requirements are met:

1. The family member uses the property as a principal residence (that is, not as a vacation home or other second home), and
2. The family member pays fair market rent (that is, the rent isn't discounted).

If these requirements aren't met, you'll still have to report the rental income (if the property is rented out for 15 or more days per year). But you won't be able to deduct rental expenses.

To avoid losing valuable tax benefits, it's critical to set the rent at or above fair market value and document fair market rent with comparable rental rates in the area. You should also avoid making gifts to family members to help them pay the rent. The IRS will likely view such gifts as the equivalent of discounted rent.

Know what you're getting into

This isn't to suggest that you should avoid helping family members with their housing expenses. Taxes, of course, aren't the only relevant consideration here. But if you do decide to rent real estate to relatives at a discount, be sure that you understand the tax costs. Your tax advisor can be a valuable resource. ■

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Take advantage of the 0% tax rate

It may surprise you to learn that certain investment income is tax-free. Currently, the tax rate on long-term capital gains and qualified dividends is 0% for single taxpayers with taxable income up to $44,625 and joint filers with taxable income up to $89,250. And those thresholds are larger than they initially appear, once you factor in the standard deduction or itemized deductions.

The 0% tax rate is particularly valuable for recent retirees who can delay Social Security benefits and aren't yet required to take required minimum distributions (RMDs) from IRAs or other retirement accounts. Let's consider Harry and Meg, a married couple who recently retired at age 64. In the early years of their retirement, the couple relies exclusively on dividends and capital gains to fund their living expenses. (They delay Social Security benefits to age 70 and aren't required to take RMDs from their IRAs until age 73.) They can earn up to $116,950 in qualified dividends and long-term capital gains tax-free (the $89,250 limit plus the $27,700 standard deduction for joint filers). ■

Businesses: It's not too late to claim Employee Retention Tax Credits

Congress created the Employee Retention Tax Credit (ERTC) during the pandemic to encourage businesses to keep employees on the payroll during portions of 2020 and 2021, even if they weren't working. For each of the first three quarters of 2021, for example, eligible employers could claim ERTCs for up to $7,000 in qualified wages per employee. Eligible employers had to show that either 1) their operations were fully or partially suspended due to a pandemic-related government shutdown order, or 2) they suffered significant declines in gross receipts.

If your business was eligible for ERTCs in 2020 or 2021, it's still possible to claim them by amending your payroll tax returns for the relevant periods. Generally, you have up to three years from a return's original due date to file an amended return. So, for example, you have until January 31, 2024, to claim ERTCs for the last quarter of 2020, until April 30, 2024, to claim ERTCs for the first quarter of 2021 and until July 31, 2024, to claim ERTCs for the second quarter of 2021. ■

Get a quick refund of corporate tax

Corporations that overpaid estimated taxes this year can apply for a quick refund if the overpayment is more than $500 and at least 10% of their expected tax liability at the time the application is filed. Corporations can apply any time after the close of their tax years by filing Form 4466. The IRS is required to act on the request within 45 days. ■