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2013 Year-End Tax Planning for Businesses

Dear Client:

In recent years, end of year tax planning for businesses has been further complicated by uncertainty over the future availability of many tax incentives. The 2013 year-end is no different. In the early hours of January 1, 2013, the Senate passed the American Taxpayer Relief Act of 2012, which permanently extended the so-called Bush-era tax cuts. However, other popular provisions were only extended through 2013. Therefore, 2013 tax strategies include concerns over expiring provisions. But 2013 is also unique due to changes that are affecting businesses.

For example, as part of its primary purpose to facilitate health care reform, the Patient Protection and Affordable Care Act (PPAC) includes key tax provisions that affect businesses. Some requirements are already in effect, while other provisions apply starting in 2013 or later. Higher tax rates may be imposed on distributions to owners and the net investment income regulations have the potential to impact individuals who are owners of pass-through entities. In addition, the U.S. Supreme Court's ruling in mid-July on the unconstitutionality of the federal Defense of Marriage Act (DOMA) means changes to retirement plans and employee benefits for same-sex marriages. Also, compliance with final repair regulations affects virtually all businesses.

Expiring Provisions

Bonus Depreciation and Code Sec. 179 Expense Deduction

The 2012 Taxpayer Relief Act extends the additional 50 percent bonus depreciation allowance for one year to apply to qualifying property acquired and placed in service before January 1, 2014 (or before January 1, 2015, in the case of property with a longer production period and certain noncommercial aircraft). There is no limit on the total amount of bonus depreciation that may be claimed.

Qualified property. Property that is eligible for bonus depreciation must be new property (i.e., property the original use of which begins with the taxpayer) that is:

- tangible property
- that is depreciable under MACRS, with a recovery period not exceeding 20 years;
- purchased computer software;
- water utility property;
- or qualified leasehold improvement property.

The fifty-percent bonus depreciation deduction is taken before regular depreciation is computed for the year property is placed in service. As with any accelerated depreciation, however, a large current depreciation deduction results in smaller future deductions.

Vehicles. For passenger automobiles placed in service in 2013, the deduction limitations for the first three years are $3,160 ($11,160 if bonus depreciation applies), $5,100, and $3,050, respectively, and $1,875 for each succeeding year. For trucks and vans first placed in service in 2013, the deduction limitations for the first three years are $3,360 ($11,360 if bonus depreciation applies), $5,400, and $3,250, respectively, and $1,975 for each succeeding year.

The expense deduction allowed by Code Sec. 179 is independent of the bonus depreciation allowance. The Code Sec. 179 deduction is computed first, and the taxpayer's basis in the qualifying property is reduced by the amount of that deduction. Any bonus depreciation deduction is computed on the remaining basis in the property.

For tax years beginning in 2012 and 2013, the 2012 Taxpayer Relief Act increases the Code Sec 179 dollar limit to $500,000 and the investment limit to $2 million. For purposes of Code Sec. 179, qualifying property is depreciable tangible property that is purchased for use in an active trade or business. This includes off-the-shelf computer software placed in service before 2014.

A taxpayer may also elect to treat qualified real property as Code Sec. 179 property. However, only $250,000 of the cost of qualified real property may be expensed. Qualified real property generally consists of qualified leasehold improvements, qualified retail improvement property, and qualified restaurant improvement property.

Many times there are no advantages between choosing Code Sec. 179 expensing or bonus depreciation. For example, both deductions are allowed in full for AMT purposes. However, certain important distinctions do exist.

Unlike the Code Sec. 179 allowance, there is no taxable income or investment income limitation on the amount of additional first year depreciation claimed. However, like the Code Sec. 179 deduction, the entire additional first year depreciation allowance may be claimed in a short tax year. The Code Sec. 179 allowance may only be claimed on property that is used more than 50 percent for business purposes. On the other hand, the

additional first year depreciation allowance applies to eligible property whether it is used for trade or business purposes or investment/production of income purposes.

Used and new property section 1245 property qualifies for the Code Sec. 179 expense allowance without regard to the recovery period. Only new property with an MACRS recovery period of 20 years or less qualifies for additional first year depreciation. Therefore, a taxpayer should generally first expense property that does not qualify for bonus depreciation.

Both bonus depreciation and the increases in the Code Sec. 179 expense deduction and investment limits are meant to provide temporary incentives for business investment and are set to expire at the end of 2013. Unless there is further legislative action, the deduction limit is set at $25,000, and the investment limitation is set at $200,000 for tax years beginning in 2014.

Tax Credits

Research Credit. The 2012 Taxpayer Relief Act extends the research credit to apply to any amounts paid or incurred for qualified research and experimentation before January 1, 2014.

Work Opportunity Credit. The work opportunity credit for all targeted groups is extended through December 31, 2013. Therefore, the credit applies with respect to wages paid to persons who begin work for the employer before January 1, 2014.

Targeted groups include, among others:

- qualified individuals in families receiving certain government benefits;
- qualified individuals who receive supplemental social security income or long-term family assistance;
- veterans who are members of families receiving food stamps, who have service-connected disabilities, or who are unemployed;
- qualified summer youth employees; and
- ex-felons hired no more than one year after the later of their conviction or release from prison.

Differential Wage Credit for Activated Military Reservists. Eligible small employers can claim a tax credit for up to 20 percent of the military differential wage payments it makes to activated military reservists through December 31, 2013.

Recognition Period for S Corporation Built-in Gains

For tax years beginning in 2012 and 2013, for purposes of computing the built-in gains tax, the recognition period is the five-year period beginning with the first day of the first tax year for which the corporation was an S corporation.

The built-in gains tax can be triggered by downsizing or other business survival decisions, including the disposal of unused assets to raise needed cash. Consequently, the relief provided by the shorter recognition period may be valuable for small family or privately-owned businesses.

Small Business Stock

The 100-percent exclusion allowed for gain on the sale or exchange of qualified small business stock under Code Section 1202 has been extended. The stock must be acquired before January 1, 2014, and then held for more than five years by noncorporate taxpayers. Preferential AMT treatment also applies. The exclusion under Code Section 1202 after 2013 reverts to 50 percent.

Some Other Provisions Expiring at 2013 Year-End

- Enhanced deduction for charitable contributions of food inventory;
- Tax incentives for empowerment zones;
- Indian employment credit;
- Low-income tax credits for non-federally subsidized new buildings;
- Low-income housing tax credit treatment of military housing allowances;
- Adjusted-basis reduction of stock after S corporation charitable donation of property.

Revised Repair/Capitalization Rules

The IRS recently issued long-awaited comprehensive final rules on the treatment of payments to acquire, produce or improve tangible property. Starting January 1, 2014, businesses must use these new rules in determining whether they can deduct their costs as repairs under Code Sec. 162(a) or must capitalize the costs, to be recovered over a period of years under Code Sec. 263(a). Businesses will benefit if certain procedures for treating expenses are put into place by January 1, 2014. Some businesses will be better off if they start applying the new rules retroactively to the 2012 and 2013 tax years. Many of these decisions require advance planning.

Pass-through Issues

Many business operations are not taxed on the entity level as corporations but, instead, pass through taxable profits and losses to their unincorporated owners or to their S corporation shareholders. Starting in 2013, these owners face new year-end planning challenges in the form of a higher individual tax rate of 39.6 percent and additional surtaxes on passive income by way of the net investment income surtax of 3.8 percent and the Additional Medicare Tax of 0.9 percent on compensation, both aimed at the "higher-income" taxpayers. Deferring some of this income, or harvesting losses to offset some of the income, are traditional year-end planning techniques that take on added value for the 2013 year-end tax year.

Business tax planning involves, not only economic planning for that year, but also making wise tax decisions that will benefit the business for years to come. Tax-saving strategies must take into account short-term and long-term goals so that decisions made for the current tax year also represent sound tax decisions in following years. Often, because business planning opportunities must be viewed in conjunction with personal tax planning, a taxpayer should also consider planning tips affecting their individual return and investment considerations when making business decisions.

Please call our office to discuss the 2013 tax planning strategies that may apply to you.