2021 Year End Tax Planning for Businesses

The coronavirus pandemic (COVID-19) continued to impact businesses in 2021. In December of 2020 and March of 2021, COVID-19 relief provisions were enacted in the Consolidated Appropriations Act, 2021 (CAA 2021) and the American Rescue Plan Act of 2021 (ARP), respectively. Among other changes, CAA 2021 enacted a provision allowing businesses to fully deduct expenses paid with the proceeds of a forgiven Paycheck Protection Program loan, effectively overriding earlier guidance. The ARP then extended and modified certain refundable payroll tax credits through September 30, 2021. And more recently, Congress approved the Infrastructure Investment and Jobs Act which negatively impacts businesses claiming the employee retention credit.

Section 179 Expensing and Bonus Depreciation Deductions

Generally, the two biggest deductions that can reduce a business client's taxable income are the Code Sec. 179 expense deduction and the 100 percent bonus depreciation deduction. It's important to remember that bonus depreciation rules apply unless a taxpayer specifically elects out of those rules. A business may want to elect out of bonus depreciation if the business expects a tax loss for the year and the bonus depreciation would just increase that loss. By not taking bonus depreciation in the current year, a business can push depreciation deductions into future years where it expects to have taxable income that the depreciation can offset. Of course, where the business is operated through a flow-through entity, additional considerations must be given to the tax situation of the owner of the flow-through entity (e.g., the owner's tax bracket this year versus later years) and whether the owner might benefit from the bonus depreciation deductions.

Under the Code Sec. 179 expensing option, a business can immediately expense the cost of up to $1,050,000 of "Section 179" property placed in service in 2021. This amount is reduced dollar for dollar (but not below zero) by the amount by which the cost of the Section 179 property placed in service during the year exceeds $2,620,000.

In order to qualify for the Code Sec. 179 deduction, the property must be acquired by purchase for business use and placed in service before the end of 2021. Qualified real property is also eligible for Code Sec. 179 deduction as are certain improvements to nonresidential real property. However, the deduction is limited to a business's aggregate taxable income for the year derived from the active conduct of a trade or business. Thus, unlike depreciation, the Section 179 expense cannot be used to reduce income below zero.

If a client is looking for business-related property to purchase in order to reap the maximum benefit of the Code Sec. 179 expense deduction and/or the bonus depreciation deduction, a vehicle purchase could result in a substantial tax savings. By purchasing a sport utility vehicle weighing more than 6,000 pounds, a client can obtain a bigger deduction than if a smaller vehicle is purchased. Because vehicles that weigh 6,000 pounds or less are considered listed property, deductions are limited to $18,200 for cars, trucks and vans acquired and placed in service in 2021. However, if the vehicle weighs more than 6,000 pounds, up to $26,200 of the cost of the vehicle can be immediately expensed.

It's also important to remember that, if a client leases a passenger automobile with a value of more than $51,000, the deduction available for that lease expense must be reduced. The lessee is required to include in gross income an amount determined by applying a formula to the amount obtained from a table provided by the IRS in published guidance. Rev. Proc. 2021-31 contains the inclusion amounts for 2021.

Energy Efficient Building Deduction

The Consolidated Appropriations Act of 2021 made the Code Sec. 179D energy efficient building deduction permanent. Thus, if a business owner made certain energy-efficient improvements during the year, such as installing property that is part of (1) an interior lighting system, (2) heating, cooling, ventilation, and hot water systems, or (3) the building envelope, a deduction equal to $1.80 times the square footage of the building may be available.

COVID-Related Employer Tax Credits

Refundable payroll tax credits are available for businesses with under 500 employers that offered paid sick or family leave through September 30, 2021 (i.e., qualified leave wages), to employees who took paid leave due to COVID-19. In addition, an employee retention tax credit (ERTC) is available for the first three quarters of 2021 for businesses which were impacted by COVID-19 but kept employees on the payroll.

Generally, Form 941, Employer's Quarterly Federal Tax Return, is used to claim these payroll tax credits for qualified leave wages paid. Employers report income and social security and Medicare taxes withheld from employee wages, as well as the employer's share of social security and Medicare taxes on the Form 941, although other federal employment tax returns may also be used. In anticipation of claiming the credit, employers can (1) reduce federal employment taxes, including withheld taxes that would otherwise be required to be deposited with the IRS, and (2) when the amount of the credit exceeds the applicable federal employment taxes, request an advance payment of the credit from the IRS for the amount of the credit remaining after reducing federal employment tax deposits, by filing the applicable version of Form 7200, Advance Payment of Employer Credits Due to COVID-19 PDF for the relevant calendar quarter.

In July, the IRS significantly revised Form 941-X to allow for correcting COVID-19 related employment tax credits reported on Form 941. Practitioners should review their client's Forms 941 filed during the year to ensure that all payroll tax credits for which the client is eligible have been claimed.

For the first three quarters of 2021, employers can take tax credits for wages paid for up to 80 hours of paid sick leave in an amount equal to either: (1) the employee's regular wage, capped at $511/day, up to a total of $5,110 if the employee was sick or quarantining, awaiting the results of a COVID test, obtaining or recovering from a vaccine; or (2) two-thirds of the employee's regular wage, capped at $200/day, up to a total of $2,000, if the employee was taking time to care for someone quarantining or to provide care due to COVID-19 school or child care provider closures. In addition, employers may receive tax credits for up to 12 weeks of paid family leave provided to employees who are unable to work for any of the reasons listed above. These credits are equal to two-thirds of an employee's regular wages, capped at $200/day up to a total of $12,000.

The ERTC is available to employers which either (1) had their operations fully or partially suspended under government orders, or (2) experienced a decline in gross receipts for a quarter in 2021 of 20 percent or more compared to the same quarter in 2019 (i.e., a "significant decline in gross receipts). However, if the business did not exist as of the beginning of the same calendar quarter in calendar year 2019, then the same calendar quarter in 2020 is used. The ERTC generally equals 70 percent of the first $10,000 in wages, including certain health plan expenses, per employee in each of the first three quarters of 2021. A special rule applies for a "recovery startup business." For the third and fourth quarters of 2021, such businesses are allowed a credit amount of $50,000 per quarter. A recovery startup business is defined as any employer which (1) began carrying on any trade or business after February 15, 2020, (2) for which the average annual gross receipts for the three tax year period ending with the tax year which precedes such quarter does not exceed $1,000,000, and (3) with respect to such quarter, the operation of the trade or business is not subject to a government-ordered suspension or a significant decline in gross receipts.

The ERTC is only available for the first 3 quarters of 2021. In Notice 2021-49, the IRS points out that, as a result of the interaction of Code Sec. 51(i)(1) and the constructive ownership rules of Code Sec. 267, wages paid to majority owners, their spouses, and children generally are not qualified wages for purposes of the employee retention tax credit.

Paycheck Protection Program

Many businesses obtained Small Business Administration loans through the Paycheck Protection Program (PPP) in order to help them through the pandemic. The PPP ended on June 30, 2021. Borrowers may be eligible to have their loans forgiven, and businesses that received a PPP loan of $150,000 or less can file a simplified loan forgiveness application on SBA Form 3508S. A forgiven PPP loan is not includible in income and, pursuant to changes made by CAA 2021, no deduction will be denied, no tax attribute will be reduced, and no basis increase will be denied by reason of the exclusion from gross income of a forgiven PPP loan. In addition, under a safe harbor provided in Rev. Proc. 2021-20, PPP loan recipients that did not deduct certain otherwise deductible expenses paid or incurred in 2020 based on guidance available at that time can elect to deduct these expenses on their 2021 tax return rather than by filing an amended return or administrative adjustment request.

Retirement Plans and Employee Benefits

The employment landscape has changed significantly since the beginning of the COVID pandemic. Many businesses are facing a worker shortage and are reevaluating what it will take to get employees in the door. A business may reap substantial tax benefits, as well as non-tax benefits, by offering a retirement plan and/or other fringe benefits to employees. Businesses that offer such benefits have a better chance of attracting and retaining talented workers which, in turn, reduces the costs of searching for and training new employees. Contributions made to retirement plans on behalf of employees are deductible and the business may be eligible for a tax credit for setting up a qualified plan.

In addition, business owners and spouses can take advantage of the retirement plan themselves. Where a spouse is not currently on the payroll of a business, consideration should be given to adding the spouse as an employee and paying a salary up to the maximum amount that can be deferred into a retirement plan. If the spouse of a business owner is 50 years old or over and receives a salary of $26,000, all of it could go into a 401(k), leaving him or her with a retirement account but no current year taxable income.

To help employees with medical expenses, a business might consider setting up a high deductible health plan paired with a health savings account (HSA). The benefits to the business include savings on health insurance premiums that would otherwise be paid to traditional health insurance companies and having employee wage contributions to the plan not being counted as wages and thus neither the employer nor the employee is subject to FICA taxes on the payroll contributions. As for employees, they can reap a tax deduction for funds contributed to the HSA, and there is no use-it-or-lose-it limit like there is for most flexible spending arrangements (FSAs). Thus, the funds can grow tax free and be used in retirement.

Another employee benefit a business might consider is the establishment of a flexible spending arrangement (FSA). An FSA allows employees to be reimbursed for medical expenses or dependent care expenses and is usually funded through voluntary salary reduction agreements with the employer. The employer has the option of making or not making contributions to the FSA. Contributions made by the business can be excluded from the employee's gross income and thus no employment or federal income taxes apply to the contributions. Reimbursements to the employee are tax free if used for qualified medical or dependent care expenses, and the FSA can be used to pay qualified expenses even if the employer or employee haven't yet placed the funds in the account.

Finally, The Victims of Terrorism Tax Relief Act of 2001 enacted Code Sec. 139, a little-known or used provision that employers may be able to use to compensate employees tax-free for extra expenses incurred due to the COVID-19 pandemic. This could include expenses incurred to set up a home office or to rent a place in which to quarantine or even for medical care. Under Code Sec. 139(a), gross income does not include any amount received by an individual as a qualified disaster relief payment. The term "qualified disaster relief payment" means any amount paid to or for the benefit of an individual:

- to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster;
- to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement, is attributable to a qualified disaster; or

- by a federal, state, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare.

In Rev. Rul. 2003-12, the IRS notes that Code Sec. 139 codifies (but does not supplant) the administrative general welfare exclusion with respect to certain disaster relief payments to individuals. According to the IRS, this exclusion from income applies only to the extent any expense compensated by such payment is not compensated for by insurance or otherwise. Additionally, qualified disaster relief payments do not include qualified wages paid by an employer, even those that are paid when an employee is not providing services.

The term "qualified disaster" includes a disaster determined by the President to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Since President Trump declared the COVID-19 pandemic a national emergency under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, the provisions of Code Sec. 139 should apply to payments made by employers to employees to compensate them for additional expenses incurred as a result of the pandemic.

Qualified Business Income Deduction

For an individual operating as a sole proprietorship, a partner in a partnership, a member in an LLC taxed as a partnership, or as a shareholder in an S corporation, the qualified business income (QBI) deduction under Code Sec. 199A can significantly help reduce taxable income. The QBI deduction allows eligible taxpayers to deduct up to 20 percent of their QBI, plus 20 percent of qualified real estate investment trust dividends and qualified publicly traded partnership income. A W-2 wage limitation amount may apply to limit the amount of the deduction. The W-2 wage limitation amount must be calculated for taxpayers with a taxable income that exceeds a statutorily-defined amount (i.e., the threshold amount). For any tax year beginning in 2021, the threshold amount is $329,800 for married filing joint returns, $164,925 for married filing separately, and $164,900 for all other returns.

Since the QBI deduction reduces taxable income, and is not used in computing adjusted gross income, it does not affect limitations based on adjusted gross income such as the medical expense deduction or the calculation of social security income that is includible in income. The QBI deduction does not apply to a "specified service trade or business," which is defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. Engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

Rental Real Estate

For clients with real estate businesses that generated losses, it's important to determine whether such losses from the activity are deductible. Generally, passive activity losses are only deductible against passive activity income. However, a deduction of up to $25,000 ($12,500 if married filing separately) may be allowed against nonpassive income to the extent an individual actively participates in the rental real estate activities. However, the deduction is subject to a phaseout for individuals with modified adjusted gross income above $100,000 (or $50,000 if married filing separately).

Rental real estate enterprises operated by individuals and owners of passthrough entities may also qualify for the QBI deduction if certain criteria are met. For example, a taxpayer's rental activity must be considerable, regular, and continuous in scope. In determining whether a rental real estate activity meets this criteria, relevant factors include, but are not limited to, the following:

- the type of rented property (commercial real property versus residential property);
- the number of properties rented;
- the taxpayer's or taxpayer's agent's day-to-day involvement;
- the types and significance of any ancillary services provided under the lease; and
- the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

A rental real estate activity will be treated as a business eligible for the QBI deduction if certain safe harbor requirements are satisfied, such as:

- separate books and records are maintained to reflect the income and expenses for each rental real estate enterprise;
- for rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise (with slightly less stringent requirements for rental real estate enterprises that have been in existence for at least four years);
- contemporaneous records have been maintained, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services; and
- certain compliance requirements are met.

Thus, to qualify for the QBI deduction, it's important to determine if the safe harbor conditions are met and, if not, whether such conditions can be met by year end. Alternatively, even if the safe harbor requirements are not met, certain actions may be taken to ensure that a taxpayer's real estate business falls within the "trade or business" guidelines for taking the deduction.

Meal and Entertainment Expenses

Generally, the business deduction allowable for food or beverage expenses is limited to 50 percent of the amount which would otherwise be allowable as a deduction. However, CAA 2021 enacted a more lenient rule for expenses relating to food and beverages purchased from restaurants in 2021 and 2022. Under this rule, a 100 percent deduction is allowed, providing the expense is properly documented. As part of that documentation, the business purpose of the meal must be provided. The term "restaurant" in this case means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises. However, a restaurant does not include a business that primarily sells pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk.

Electing the De Minimis Safe Harbor Deduction

If a business has not already done so, it may be advantageous to elect to apply the de minimis safe harbor in Reg. Sec. 1.263(a)-1(f)(1)(ii)(D) to amounts paid to acquire or produce tangible property to the extent such amounts are deducted for financial accounting purposes or in keeping the business's books and records. If the business has an applicable financial statement (AFS), it can use the safe harbor to deduct amounts paid for tangible property up to $5,000 per invoice or item (as substantiated by invoice). If the business doesn't have an AFS, it can use the safe harbor to deduct amounts up to $2,500 per invoice or item (as substantiated by invoice).

Vehicle-Related Deductions and Substantiation Requirements

Deductions relating to vehicles are generally part of any business tax return. Since the IRS tends to focus on vehicle expenses in an audit and disallow them if they are not properly substantiated, it's important to remind business clients that the following should be part of their business's tax records with respect to each vehicle used in the business:

(1) the amount of each separate expense with respect to the vehicle (e.g., the cost of purchase or lease, the cost of repairs and maintenance, etc.);

(2) the amount of mileage for each business or investment use and the total miles for the tax period;

(3) the date of the expenditure; and

(4) the business purpose for the expenditure.

The following are considered adequate for substantiating such expenses:

(1) records such as a notebook, diary, log, statement of expense, or trip sheets; and

(2) documentary evidence such as receipts, canceled checks,
bills, or similar evidence.

Records are considered adequate to substantiate the element of a vehicle expense only if they are prepared or maintained in such a manner that each recording of an element of the expense is made at or near the time the expense is incurred.

Increasing Basis in Pass-thru Entities

If a client is a partner in a partnership or a shareholder in an S corporation, and the entity is expecting to pass through a loss for the year, it's important to determine if the partner or shareholder has enough basis to absorb the loss. If not, then actions should be taken before the end of the entity's tax year to increase basis, if possible. Generally, this is done by contributing or loaning money to the entity.

S Corporation Shareholder Salaries

For any business operating as an S corporation, it's important to ensure that shareholders involved in running the business are paid an amount that is commensurate with their workload. The IRS scrutinizes S corporations which distribute profits instead of paying compensation subject to employment taxes. Failing to pay arm's length salaries can lead not only to tax deficiencies, but penalties and interest on those deficiencies as well. The key to establishing reasonable compensation is being able to show that the compensation paid for the type of work an owner-employee does for the S corporation is similar to what other corporations would pay for similar work. Practitioners should document in their workpapers the factors that support the salary being paid to a shareholder.

Also, because there are stringent requirements for who may be an S corporation shareholder, its prudent to check annually as to the residency or citizenship status of S corporation shareholders and S stock beneficiaries (including contingent and residuary beneficiaries).

If you have any questions or need help reducing your taxes please call Gregory J. Spadea at 610-521-0604.