

Dear Client:

The year is winding down and now is a good time to consider steps to cut your 2023 tax bill while there's still time. Here are some planning strategies to consider, assuming our current federal tax regime remains in place through 2024.

## Establish a Tax-favored Retirement Plan

If your business doesn't already have a retirement plan, now might be the time to take the plunge. Current rules allow for significant deductible contributions. For example, if you are self-employed and set up a SEP plan for yourself, you can contribute up to 20% of your net self-employment income, with a maximum contribution of \$66,000 for 2023. If you are employed by your own corporation, up to 25% of your salary can be contributed, with a maximum contribution of \$66,000 for 2023.

Other small business retirement plan options include the 401(k) plan, which can be set up for just one person; the defined benefit pension plan; and the SIMPLE-IRA, which can be a good choice if your business income is modest. Depending on your circumstances, non-SEP plans may allow bigger deductible contributions.

**There May Still Be Time to Establish a Plan and Make a Deductible Contribution for Last Year.** The general deadline for setting up a tax-favored retirement plan, such as a SEP or 401(k) plan, is the extended due date of the tax return for the year you or the plan sponsor want to make the initial deductible contribution. For instance, if your business is a sole proprietorship or a single-member LLC that is treated as a sole proprietorship for federal income tax purposes (Schedule C), you have until 10/16/23 to establish a plan and make the initial deductible contribution if you extend your 2022 Form 1040.

**Evaluate Your Options.** Contact us for more information on small business retirement plan alternatives, and be aware that if your business has employees, you may have to cover them too.

## Take Advantage of Generous Depreciation Tax Breaks

Current federal income tax rules allow generous first-year depreciation write-offs for eligible assets.

**Section 179 Deductions.** For qualifying property placed in service in tax years beginning in 2023, the maximum allowable Section 179 deduction is \$1.16 million. Most types of personal property used for business are eligible for Section 179 deductions, and off-the-shelf software costs are eligible too.

Section 179 deductions also can be claimed for certain real property expenditures called *Qualified Improvement Property* (QIP), up to the maximum annual Section 179 deduction allowance (\$1.16 million for tax years beginning in 2023). There is no separate Section 179 deduction limit for QIP expenditures, so Section 179 deductions claimed for QIP reduce the maximum Section 179 deduction allowance dollar for dollar.

Note: QIP includes any improvement to an interior portion of a nonresidential building that is placed in service after the date the building is first placed in service, except for expenditures attributable to the enlargement of the building, any elevator or escalator, or the building's internal structural framework.

Note that Section 179 deductions also can be claimed for qualified expenditures for roofs, HVAC equipment, fire protection and alarm systems, and security systems for nonresidential real property. To qualify, these items must be placed in service after the nonresidential building has been placed in service.

Warning: Section 179 deductions can't cause an overall business tax loss, and deductions are phased out if too much qualifying property is placed in service in the tax year. The Section 179 deduction limitation rules can get really tricky if you own an interest in a pass-through business entity (partnership, LLC treated as a partnership for tax purposes, or S corporation). Contact us for details on how the limitations work and whether they will affect you or your business entity.

**First-year Bonus Depreciation.** 80% first-year bonus depreciation is available for qualified new and used property that is acquired and placed in service in calendar-year 2023. That means your business might be able to write off 80% of the cost of some or all of your 2023 asset additions on this year's return. However, you should generally write off as much as you can via Section 179 deductions before taking advantage of 80% first-year bonus depreciation.

**De minimis Safe Harbor Election to Fully Deduct Purchases below a Threshold Amount.** Taxpayers can elect to expense the costs of lower-cost assets provided the costs aren't required to be capitalized under the UNICAP rules. Taxpayers that have an Applicable Financial Statement (AFS) can deduct units of property valued at up to \$5,000. For taxpayers without an AFS, the *de minimis* safe harbor threshold is \$2,500 per unit of property. An AFS is (1) a Form 10-K, (2) an audited financial statement used for obtaining credit, reporting to owners, or other substantial nontax purposes, or (3) a financial statement other than a tax return required to be provided a federal or state government or agency (other than the IRS or SEC).

Note: Small taxpayers meeting the three-year average gross receipts test threshold of \$29 million in 2023 are not required to apply the UNICAP rules.

**Bottom Line.** To take advantage of favorable federal income tax depreciation rules, consider making eligible asset acquisitions between now and year end. The bonus depreciation percentage decreases to 60% for assets placed in service in 2024. So, if you are thinking about acquiring qualifying assets, getting them placed in service in 2023 rather than 2024 means that the higher bonus depreciation rate will apply. Contact us for full details on applicable depreciation rules and planning opportunities.

## Time Business Income and Deductions for Tax Savings

If you conduct your business as a sole proprietorship or using a pass-through entity (S corporation, partnership, or LLC classified as such), your shares of the business's income and deductions are taxed at your personal rates. Assuming no legislative changes, next year's individual federal income tax rates will be the same as this year's, with significant bumps in the rate bracket thresholds thanks to inflation adjustments.

The traditional strategy of deferring income into next year while accelerating deductible expenditures into this year makes sense if you expect to be in the same or lower tax bracket next year. Deferring income and accelerating deductions will, at a minimum, postpone part of your tax bill from 2023 until 2024. And, after the inflation adjustments to 2024 rate bracket thresholds, the deferred income might be taxed at a lower rate. That would be nice!

On the other hand, if you expect to be in a higher tax bracket in 2024, take the opposite approach. Accelerate income into this year (if possible) and postpone deductible expenditures until 2024. That way, more income will be taxed at this year's lower rate instead of next year's higher rate. Contact us for details on how to implement business income and deduction timing strategies.

**Timing of Year-end Bonuses.** Year-end bonuses can be timed for maximum tax effect by both cash and accrual basis employers. Cash basis taxpayers should pay bonuses before year end to maximize the deduction available in 2023 if they expect to be in the same or lower tax bracket next year. Cash basis taxpayers that expect to be in a higher tax bracket in 2024 because of significant revenue increases, should wait to pay 2023 year-end bonuses until January 2024. Accrual basis taxpayers deduct bonuses in the year when all events related to the bonuses are established with reasonable certainty. However, for accrual basis taxpayers, the bonus must be paid no later than 2 ½ months of the accrual year end for a current year deduction (by March 15 for calendar year- end taxpayers). Accrual method employers who want to defer deductions to a higher-taxed future year should consider changing their bonus plans before year-end to set the payment date later than the 2 ½ month window or consider changing the bonus plan's terms to make the bonus amount indeterminable at year end.

## State Income Tax Deduction Work-around

The pass-through state income tax deduction essentially allows business owners to deduct state income tax on their business income without limit. This deduction allows a pass-through entity to elect to pay the state income tax due on the business income that would otherwise be paid on the owner's personal tax returns. The federal itemized deduction cap of \$10,000 (\$5,000 if MFS) for state and local taxes doesn't apply when a pass-through entity pays state and local tax on its earnings at the entity level. As of 2023, 36 states and one locality have passed legislation allowing the pass-through tax deduction work-around, and some states have even passed retroactive legislation. Please contact us to determine whether your business is subject to state income taxes in a state that allows the pass-through state income tax deduction election.

## Maximize the Qualified Business Income (QBI) Deduction

The deduction based on QBI from pass-through entities was a key element of 2017 tax reform. For tax years through 2025, the deduction can be up to 20% of a pass-through entity owner's QBI, subject to restrictions that can apply at higher income levels and another restriction based on the owner's taxable income.

For QBI deduction purposes, pass-through entities are defined as sole proprietorships, single-member LLCs that are treated as sole proprietorships for tax purposes, partnerships, S corporations, and LLCs that are classified as partnerships or S corporations for tax purposes.

For 2023, if taxable income exceeds \$364,200 for taxpayers that are married filing jointly (about half that for others), the QBI deduction is limited if the taxpayer is engaged in a service-type trade or business (such as law, accounting, health, or consulting). At that income level, the deduction may also be limited by the amount of W-2 wages paid by the business, and/or the unadjusted basis of qualified property (such as machinery and equipment) held by the business. The limitations are phased in; for example, the limits start to apply to joint filers when taxable income exceeds \$364,200 and are fully phased in when taxable income is \$100,000 above the threshold. For other filers, the limits are fully phased in when taxable income is \$50,000 above their threshold. The phase in range ends at \$464,200 for married filing jointly filers and at about half that for all others.

Note: The QBI deduction is only available to individuals, trusts, and estates.

Because of the various limitations on the QBI deduction, tax planning moves (or non-moves) can have the side effect of increasing or decreasing your allowable QBI deduction. For example, claiming big first-year depreciation deductions can reduce QBI and lower your allowable QBI deduction. So, if you can benefit from the deduction, you must be careful in making tax planning moves. We can help you put together strategies that give you the best overall tax results.

## Claim 100% Gain Exclusion for Qualified Small Business Stock

There is a 100% federal income tax gain exclusion for eligible sales of Qualified Small Business Corporation (QSBC) stock that was acquired after 9/27/10. QSBC shares must be held for more than five years to be eligible for the gain exclusion. Contact us if you think you own stock that could qualify for the break.

Also, contact us if you are considering establishing a new corporate business the stock of which might be eligible for the gain exclusion. Advance planning may be required to lock in the exclusion privilege.

## Employing Family Members

Employing family members can be a useful strategy to reduce overall tax liability. If the family member is a bona fide employee, the taxpayer can deduct the wages and benefits, including medical benefits, paid to the employee on Schedule C or F as a business expense, thus reducing the proprietor's self-employment tax liability. In addition, wages paid to your child under the age of 18 are not subject to federal employment taxes, will be deductible at your marginal tax rate, are taxable at the child's marginal tax rate, and can be offset by up to \$13,850 (your child's maximum standard deduction for 2023). However, your family member must be a bona fide employee, and basic business practices, such as keeping time reports, filing payroll returns, and basing pay on the actual work performed, should be followed.

## Conclusion

This letter only covers a few tax planning moves that could potentially benefit your business for this year. Please contact us if you have questions, want more information, or would like us to help in evaluating your best business tax planning options for 2023.

Very truly yours,

## Practitioner's Reference Sheet for Year-end Tax Planning Letter for Small Businesses

**Establish a Tax-favored Retirement Plan:** IRC Secs. 401(k), 404(h), 408(p), and 414(v); Notice 2022-55.

**Take Advantage of Generous Depreciation Tax Breaks:** IRC Secs. 168(k) and 179; Regs. 1.168(k)-2 and 1.263(a)-1(f); and Rev. Proc. 2022-38.

**Time Business Income and Deductions for Tax Savings:** IRC Secs. 404(a)(11), 446, 448, and 453. Other ways to defer income include setting up a retirement plan and/or making additional deductible retirement plan or IRA contributions for the year; making like-kind exchanges of appreciated real estate instead of taxable sales; and arranging for installment sales of property.

**State Income Tax Deduction Work-around:** See Checkpoint *State Charts*. Under Jurisdictions, select "All States". Under Tax Types, select "Personal Income". Under Chart type, select "Computation of Tax" and then "SALT Deduction Cap Workaround".

**Maximize the QBI Deduction:** IRC Sec. 199A and Regs. 1.199A-1 through -6. Note that the overall QBI deduction limitation says the deduction cannot exceed the lesser of (1) 20% of QBI from qualified businesses plus 20% of qualified REIT dividends plus 20% of qualified Publicly Traded Partnership (PTP) income or (2) 20% of taxable income calculated before any QBI deduction and before any net capital gain (net long-term capital gains in excess of net short-term capital losses plus qualified dividends). [See IRC Sec. 199A(a) and (b).]

**Claim 100% Gain Exclusion for Qualified Small Business Stock:** IRC Sec. 1202.

**Employing Family Members:** Frahm (TC Memo 2007-351) and Embroidery Express, LLC (TC Memo 2016-136).