# MANAGEMENT & TAX CONCEPTS

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## IS YOUR COMPANY ELIGIBLE FOR THESE "SMALL BUSINESS" TAX BREAKS?

MORE IN THIS ISSUE...




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# Is your company eligible for these "small business" tax breaks?

**Do you own a small business? If so, you may qualify for a variety of tax breaks that can slash your tax bill and reduce your administrative costs. And thanks to the Tax Cuts and Jobs Act, "small" is a lot bigger than it used to be.**

Previously, for tax purposes, small businesses ranged from $1 million to $10 million in gross receipts, depending on which section of the tax code was involved. But now, small businesses are uniformly defined as companies (other than tax shelters, see "Tax shelters need not apply" on page 3) with average annual gross receipts of $25 million or less for the prior three-year period. And this threshold is adjusted for inflation — currently, businesses with gross receipts up to $26 million are eligible.

## SMALL BUSINESS ADVANTAGES

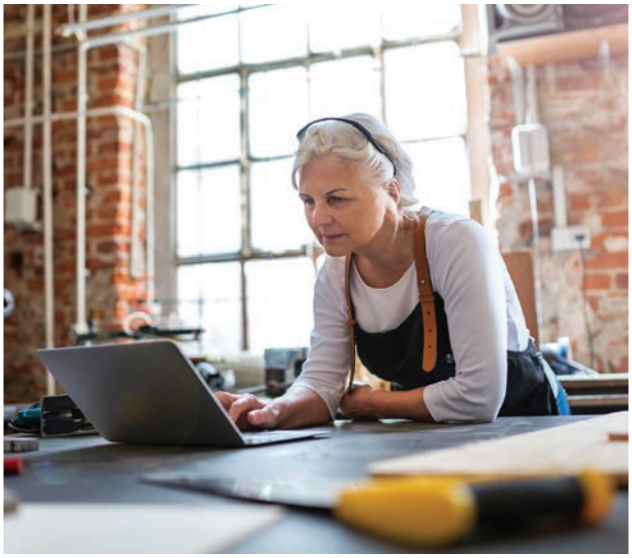
If your business qualifies as "small," you enjoy several important tax advantages, including:

**Cash accounting.** You're permitted to use the cash method of accounting for tax purposes, even if you have inventories or use the accrual method for financial reporting. With certain exceptions, larger businesses — particularly those that carry inventory — must use accrual accounting. In many cases, the use of the cash method allows you to defer more taxable income than you would under the accrual method.

**Inventory simplification.** You're generally exempt from complex inventory accounting rules and may account for inventories by:

- Treating them as nonincidental materials and supplies, or
- Conforming to the inventory method you use in your financial statements or books and records.

Treating inventories as nonincidental materials or supplies allows you to deduct their cost when they're "used or consumed." Recently finalized regulations clarify that materials aren't used and consumed until the inventory is sold. Many companies had hoped to treat raw materials as used and consumed when converted into work-in-progress or



finished goods, allowing them to deduct the cost earlier.

**Relief from UNICAP rules.** You're exempt from the uniform capitalization (UNICAP) rules, which require companies to capitalize certain direct and indirect production costs to inventory, rather than deduct them when incurred. Not only can these rules increase your tax liability, but they also make tax reporting more complex.

**Unlimited business interest deductions.** You're not subject to the cap on business interest write-offs, which generally limits deductions of net business interest expense to 30% of adjusted taxable income (50% for 2019 and 2020).

**Completed contract method.** If your business is in construction, manufacturing or another industry where long-term contracts are common, you may use the completed contract method rather than the percentage-of-completion method to account for long-term contracts expected to be completed within two years. The completed contract method makes it possible to defer tax until the contract is substantially complete, while the percentage-of-completion method can accelerate the tax.

## Tax shelters need not apply

Tax shelters don't qualify for "small business" status, even if their gross receipts are below the threshold. And while the term usually connotes an investment vehicle that shields earnings from taxes, the definition is broad enough to encompass ordinary businesses.

For example, tax shelters include "syndicates," defined as entities other than C corporations (that is, partnerships, S corporations or LLCs) in which more than 35% of their losses are allocable to limited partners and "limited entrepreneurs." Very generally, a limited entrepreneur is a person who owns an interest — other than as a limited partner — and doesn't actively participate in management.

Because a business can only be a syndicate in a year that it suffers a loss, this definition can be burdensome to businesses that meet the definition one year but not the next year (because it's profitable). To ease this burden, the final regulations give businesses the option to use the prior year's income, rather than the current year, to determine tax shelter status.

*If your business qualifies as "small," you enjoy several important tax advantages.*

## COMPUTING GROSS RECEIPTS

As noted, your company is considered a small business in a given tax year if its average gross receipts for the prior three-year period are $26 million or less. Under previous rules, a company wouldn't qualify as a small business if it failed the gross receipts test in *any prior year*. So, for example, a company with average gross receipts for the three-year period (ending December 31, 2020), of $20 million, wouldn't qualify if its average gross receipts for the three-year period ending December 31, 2018 were $27 million.

Current rules, however, only take into account gross receipts for the three-year period immediately preceding the current tax year. So, the company in the above example would qualify as a small business. Special rules apply to companies in existence less than three years. Keep in mind, that when determining your company's gross receipts, you may need to include those earned by certain related entities, such as those with common control.

## SIZING UP YOUR BUSINESS

If your company passes the less-than-$26 million gross receipts test, you should explore the potential benefits of small business status. To claim these benefits, it may be necessary to file Form 3115 — *Application for Change in Accounting Method* — with the IRS. •

# Crafting a buy-sell agreement

**Most companies with more than one owner should have a buy-sell agreement in place. Here are some of the key considerations involved in developing this legal document.**

## BENEFITS TO REAP

A well-designed buy-sell agreement provides many benefits, including:

- Keeping ownership of the business within the family or another select group, for example, people actively involved in the enterprise,
- Preventing an owner's former spouse from acquiring a business interest in the event of a divorce,
- Providing owners and their heirs with liquidity to pay estate taxes and other expenses in the event of death or disability,
- Establishing the value of the business for gift and estate tax purposes (if certain requirements are met), and
- Minimizing disputes over ownership succession issues.

Typically, buy-sell agreements achieve these objectives by requiring or permitting the company or the remaining owners to purchase the interest of an owner who dies, becomes disabled or leaves the business. They also may provide the company or the remaining owners with a right of first refusal in the event an owner wishes to sell his or her interest.

## THE TAX OUTCOME

Generally, buy-sell agreements are structured in one of two ways: "redemption" or "cross-purchase." Either of these will permit or require the *company* to purchase a departing owner's shares. The latter confers that right or obligation on the remaining owners.

From a tax perspective, cross-purchase agreements are generally preferable. The remaining owners receive the equivalent of a "stepped-up basis" in the purchased shares. That is, their basis for those

shares will be determined by the price paid, which is the current fair market value. Having the higher basis will reduce their capital gains if they sell their interests down the road. Also, if the remaining owners fund the purchase with life insurance, the insurance proceeds are generally tax-free.

Redemption agreements, on the other hand, may trigger a variety of unwanted tax consequences, including corporate alternative minimum tax, accumulated earnings tax or treatment of the purchase price as a taxable dividend.

The disadvantage of a cross-purchase agreement is that the owners, rather than the company, are responsible for funding the purchase of a departing owner's interest. And if they use life insurance as a funding source, each owner will need to maintain insurance policies on the life of each of the other shareholders, a potentially cumbersome and expensive arrangement.

## ESTATE PLANNING GOALS

A buy-sell agreement can fit into the owners' estate planning objectives. If your estate plan was drafted years ago, you may need to update it based on more recent gift and estate tax changes.

Specifically, the gift and estate tax exemption and the generation-skipping transfer tax exemption amounts have increased to $11.7 million, or $23.4 million for married couples, for 2021.

## THE SELLING PRICE

The valuation provision of a buy-sell agreement is critical to avoiding unpleasant surprises or conflicts. Generally, the fairest and most effective method of setting the purchase price is to conduct periodic independent business valuations and to base the price on fair market value.

Many agreements set the price using a formula tied to earnings, cash flow, book value or some other objective measure. Although formulas offer simplicity and lower costs, they can't account for subjective characteristics or other factors that drive business value. As a result, they often underestimate or overestimate business value, which can lead to disputes when the buy-sell agreement is invoked.

## KEEP IT ON YOUR RADAR

Once your buy-sell agreement is finalized, don't put it on a mental "shelf" for reference in the future. Stay alert for an event that could trigger the agreement such as grave illness, disablement or an owner voluntarily leaving the business.

You also may want to make sure your agreement covers events such as changes in an owner's marital status. And to help prevent fraud or inappropriate behavior, many agreements include "conviction for committing a crime or becoming involved in a scandal" as a triggering event. •

Pandemic planning

# Stay on track with your college savings plans

**The COVID-19 pandemic has affected families' finances in many ways. One negative impact for some families has been a disruption in their well-laid college savings plans.**

The economic crush of the pandemic may have put saving for your child's college education on the back burner, at least for the short term. If you can't fully fund your kids' education savings plans yet, it's wise to continue putting something away for college if you can — even if it's less than before.

## CONSIDER A 529 PLAN

A Section 529 plan remains one of the best ways for families to save money for college while saving on taxes at the same time. Earnings in the account grow on a tax-deferred basis and distributions are tax-free if the funds are used to pay for qualified education expenses. The definition of these expenses is quite broad and includes not just tuition and fees but also books, room and board, school supplies, technology (such as a computer and printer), and Internet access.

All 50 states and the District of Columbia offer at least one 529 plan, and you don't have to live in a state to open a plan there. Students don't have to attend college in the state where their 529 plan is opened, either.


The main types of 529 plans are:

**Prepaid tuition plans.** These plans enable you to purchase future tuition at today's prices, giving you more certainty about future education expenses. For example, you could purchase four years of college for a newborn now at today's tuition rate, potentially saving tens of thousands of dollars in the long run.

**Investment savings plans.** These are similar to retirement savings accounts like IRAs and 401(k)s. You can invest your college savings in stocks, bonds and other instruments to try to maximize returns, and your account balance will rise or fall depending on the performance of your investments. Of course, this would potentially put your college savings at varied degrees of risk.

Section 529 plan funds can be used to pay for qualified education expenses at most U.S. colleges and universities, as well as some schools located overseas and many vocational-technical schools. This enables you to choose the best plan for your family and not worry about limiting college options in the future.

## RULES OF THE PLAN

Unlike qualified retirement plans, there are no annual limits on contributions to 529 plans, though there are limits on aggregate contributions. These vary by state but can exceed $500,000. Plan contributions can be made by other family members, too, including grandparents if they want to help with your children's college expenses. And there are no income limits for opening and contributing to a 529 plan.

Note that contributions to 529 plans aren't tax-deductible at the federal level, though some states offer a deduction or other tax incentives for contributing. If plan funds are used for anything other than qualified education expenses such as those listed above, the earnings portion of the withdrawals only (not principal) will be subject to current income taxes and a 10% penalty.

## GET CREATIVE

If the pandemic has made it difficult for you to save for college, one idea is to contribute the amount of your stimulus payment (if you received one) to college savings if you can afford to do so. Similarly, you could take the same action with your increased child tax credit if you qualify for this.

Speak with your financial-tax advisors about the tax implications of 529 plans and the best financial and college saving strategies for your family. •

# Enhanced charitable deductions in 2021

**If you're charitably inclined, keep in mind that last year's CARES Act — supplemented by the Consolidated Appropriations Act of 2021 (CAA) — enhanced several charitable tax incentives for donations made through the end of 2021. Here's a summary:**

**What's the deduction limit?** For individuals who itemize, eligible charitable donations in 2021 are deductible up to 100% of adjusted gross income (AGI), a jump from 60% in 2020. The higher limit generally applies to *cash* gifts to public charities, such as religious organizations, hospitals and educational institutions. It doesn't apply to 1) noncash gifts, 2) gifts to private foundations or other nonpublic charities (with limited exceptions), or 3) gifts to certain public charities, namely, donor-advised funds (DAFs) and supporting organizations.

**And for non-itemizers?** For non-itemizers who otherwise wouldn't be entitled to deduct charitable donations, the CARES Act provided a $300 above-the-line deduction (that is, a deduction from gross income in determining AGI) for 2020. The legislation wasn't clear as to whether married couples filing jointly were entitled to a $600 deduction. However, in its 2020 instructions to Form 1040, the IRS provided that the $300 limit applied both to individuals and to married couples filing jointly. The CAA extended the deduction to 2021 and doubled the limit to $600 for joint filers. Like the 100%-of-AGI deduction limit, the above-the-line deduction generally applies to cash gifts to public charities other than DAFs and supporting organizations.

> *For those who itemize, eligible charitable donations in 2021 are deductible up to 100% of AGI.*

**What about business donations?** In 2021, corporations may deduct charitable donations up to 25% of their taxable income, up from 10%. Like the enhanced contribution limits for individuals, the 25% limit on corporate donations generally applies only to cash gifts to public charities other than DAFs or supporting organizations. In addition, for both corporate and noncorporate businesses, the limit on charitable deductions for qualified donations of food inventory is increased this year from 15% to 25% of taxable income.


Given the enhanced limits on charitable deductions, it may be tempting to make very large donations this year. Keep in mind, however, that depending on your tax circumstances, there may be advantages to spreading charitable deductions over several years. Your tax advisors can help you formulate a tax-effective strategy. •

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