TAX CHANGES FOR 2024

TAXGURU LLC

BUSINESSES: IMPORTANT TAX CHANGES IN 2024

Here's what small business owners need to know about tax law changes and inflation adjustments for the year ahead.

Section 179 Expensing and Bonus Depreciation

Generally, the two most popular tax deductions for businesses are the Code Sec. 179 expense deduction and the bonus depreciation deduction. For years beginning in 2023, the bonus depreciation phase out begins, and businesses can deduct only 80 percent (rather than 100 percent) of the purchase price of qualified property. The percentage continues to decrease by 20 points until it is completely phased out in 2027. Thus, businesses have a greater incentive to take advantage of the bonus depreciation in earlier years if they can.

The bonus depreciation rules apply unless a taxpayer elects out of those rules. An election out may be advisable where a business has a loss for the year and will get no benefit from the loss. Most businesses no longer have the option to carryback a net operating loss (NOL) and NOLs arising in tax years ending after 2020 can only be carried forward. Exceptions apply to certain farming losses and NOLs of insurance companies other than a life insurance company. Also, the NOL deduction for tax years beginning after December 31, 2020, is limited to 80 percent of the excess (if any) of taxable income (determined without regard to certain deductions) over the total NOL deduction from NOLs arising in tax years beginning before January 1, 2018.

By not taking bonus depreciation in the current year, a business can defer depreciation deductions into future years when it expects to have taxable income that can be offset by the depreciation deductions. 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 and whether the owner can benefit from the flow-through of the bonus depreciation deductions.

Since the Code Sec. 179 expense deduction can't reduce taxable income, this is a better option for clients with taxable income. For 2023, the maximum Code Sec. 179 expense deduction is $1,160,000. 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 $2,890,000.

Tax Guru's tax planning checklist of additional action items may help you save tax dollars.

Retirement Plans and Employee Benefits

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 $30,000, 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 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 are excludible 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.

A credit is available to small businesses for the startup costs of establishing a qualified retirement plan. Previously, this credit applied to 50 percent of such startup costs, up to $5,000 for each of the first three years beginning with the plan effective date. The SECURE 2.0 Act expanded this credit for employers with 50 or fewer employees. Beginning in 2023, such employers can claim the credit for 100 percent of their plan startup costs, subject to the $5,000 maximum per year for the first three years. Businesses with 51 to 100 employees remain eligible for the 50 percent credit. An additional credit of up to $1,000 per employee is also available, calculated as a percentage of the amount contributed by the employer on behalf of employees. The applicable percentage is 100 percent in the first and second years, 75 percent in the third year, 50 percent in the fourth year, and 25 percent in the fifth year. No credit is available for tax years thereafter.

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 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 2023, the threshold amount is $364,200 for married filing joint returns, $182,100 for married filing separately, and $182,100 for all other returns.

Rental Real Estate Considerations

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, in order to qualify for the deduction, 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:

(1) the type of rented property (commercial real property versus residential property);

(2) the number of properties rented;

(3) the taxpayer's or taxpayer's agent's day-to-day involvement;

(4) the types and significance of any ancillary services provided under the lease; and

(5) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

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;

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 and Benefits

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, it's prudent to check annually as to the residency or citizenship status of S corporation shareholders and S stock BENEFICIARIES (including contingent and residuary beneficiaries).

Energy Efficient Commercial Buildings Deduction

A business that owns or leases a commercial building may qualify for the deduction under Code Sec. 179D for the cost of "energy efficient commercial building property" (EECBP) placed in service during the tax year. EECBP includes property installed as part of the building's interior lighting systems; heating, cooling, ventilation, and hot water (HVAC) systems; or the building envelope that is certified as being installed as part of a plan to reduce the total energy and power costs for these systems. An alternative deduction is available for energy efficient lighting, HVAC, and building envelope costs placed in service in connection with a qualified retrofit plan. The amount of the Code Sec. 179D deduction generally equals the lesser of (1) the cost of the EECBP placed in service during the tax year or (2) the energy savings per square foot, reduced by the aggregate amount of the Code Sec. 179D deductions taken with respect to the building for the previous 3 tax years.

Clean Vehicle Credits

The 2022 IRA expanded the new clean vehicle credit under Code Sec. 30D, which is available to individuals but can also be claimed by businesses that purchase and place in service a new clean vehicle. The law also introduced the qualified commercial vehicle credit for businesses that purchase and place in service a commercial clean vehicle.

The Code Sec. 30D credit is not available to taxpayers whose adjusted gross income (AGI) for the year is over $300,000 (married filing jointly), $225,000 (head of household), and $150,000 (single). Price limits (i.e., MSRP limitations) also apply depending on the type of the vehicle ($80,000 for vans, SUVs, and pickup trucks; $55,000 for other vehicles).

Credits for Production of and Investment in Clean Electricity

The production tax credit under Code Sec. 45 is an inflation-adjusted per-kilowatt hour (kWh) credit for electricity generated wind, biomass, geothermal, solar, small irrigation, landfill and trash, hydropower, and marine and hydrokinetic renewable energy, and sold to an unrelated person during the tax year. Projects must begin construction before January 1, 2025, and the credit applies for the first 10 years of a system's operation. For systems more than 1 megawatt in size, prevailing wage and apprenticeship requirements apply. In addition, bonus credit amounts apply for projects of any size that meet certain domestic content requirements or are placed in service within an "energy community" (i.e., brownfield sites and certain other areas).

The investment tax credit under Code Sec. 48 is a credit for a percentage of the cost of solar energy property, geothermal property, fiber-optic solar property, fuel cell property, microturbine property, small wind property, offshore wind property, combined heat and power property, and waste energy recovery property that is installed during the tax year. Construction must begin before January 1, 2025. The provision provides a base credit rate of 2 or 6 percent of the basis of energy property or a bonus credit rate of 10 or 30 percent of the basis of energy property if prevailing wage and apprenticeship requirements are met. Bonus credit amounts apply for projects that meet certain domestic content requirements or are placed in service within an energy community.

Research and Development Expenditures

The deduction for research and development expenses previously allowed expired at the end of 2021 and such expenses must now be amortized over five years. However, a business that engages in certain types of research may qualify for an income tax credit based on its qualified research expenses. The credit is calculated as the amount of qualified research expenditures above a base amount that is meant to represent the amount of research expenditures in the absence of the credit. Because some small businesses may not have a large enough income tax liability to take advantage of their research credit, the law allows that small business (i.e., a business with less than $5 million in gross receipts and that is under five years old) to apply up to $500,000 of the research credit toward its social security payroll tax liability.

> **Observation:** There is a chance that the R&D expensing provision that terminated at the end of 2021 may be restored. There have been ongoing discussions between Republicans and Democrats about a potential last minute end-of-year tax deal regarding a reinstatement of the R&D deduction, which businesses are anxious to see reinstated, in exchange for an enhanced child tax credit that is similar to the enhanced child tax credit that applied for 2021.