Wealth Planning **Update**

Small business tax deductions and credits

Eight tax considerations for small business owners.

As we enter the fourth calendar quarter, tax planning often takes center stage (it should be center stage year round). If you're a small business owner, there are many tax deductions and credits to be aware of. We are highlighting several here that have broad application. Be sure to speak with your tax advisor before you take action.

Tax breaks for small businesses fall into two categories: credits and deductions. Tax credits directly reduce the amount of tax you owe, giving you a dollar-for-dollar reduction of your tax liability. Tax deductions reduce how much of your income is subject to taxes, which may or may not reduce your actual tax bill. Below are some of the most common credits and deductions, although this is by no means an exhaustive list.

Tax credits

① Research and development (including payroll tax credit)

This credit is available to companies in a variety of industries for increasing specified research and experimental expenses from year to year, including those for qualified software development. A qualified small business can elect to use the credit (up to $250,000) to offset the employer portion of social security tax liability on wages. Many small businesses (especially start-ups) operate at a loss or don't throw off sufficient income to effectively utilize the income tax credit currently. The payroll tax credit election allows for current utilization—a real cash flow benefit.

In the past, small businesses had been limited in their ability to claim the R&D credit due to net operating losses or even alternative minimum tax (AMT) positions. However, the Protecting Americans from Tax Hikes (PATH) Act of 2015 included these valuable changes:

- Eligible businesses with less than $50 million in gross receipts can take the R&D credit against AMT liability.
- Certain small businesses with less than $5 million in gross receipts can take the R&D credit against payroll taxes.

② Health care

The small business health care tax credit can benefit eligible employers who provide health coverage for their employees. Generally, to be eligible for the credit, your business must have fewer than 25 full-time equivalent employees, pay an average salary of less than $54,200 a year (in 2019), and pay at least half of your employees' health insurance premiums. In addition, you must use a SHOP Marketplace Plan for the health coverage.

If your business qualifies, the maximum credit is 50% of employer-paid premiums (35% for tax-exempt employers—this is a refundable credit). You can claim the credit for only two consecutive taxable years. Even if your business does not owe tax, you can carry the credit back or forward to other tax years. Keep in mind, even if your business does not qualify for the credit, you may still be able to deduct the cost of contributing to monthly employee premiums from your federal income as a business expense (and the premiums in excess of the credit amount should be deductible if you qualify). (See "Health insurance premiums" on next page.)

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Deductions

③ Bonus depreciation/Section 179

Under IRC Sec. 168, business owners can write off the entire cost of qualifying purchases under the 100% bonus depreciation rules enacted with the Tax Cuts and Jobs Act. That means your business can generally expense 100% of the cost of any property with a recovery period of 20 years or less and deduct it in the year the property is placed in service.

Under IRC Sec. 179, you may elect to expense all or part of the cost of any Sec. 179 property in the year it is placed in service. As of 2019, the maximum deduction is $1 million with a phase-out threshold between $2.5 and $3.0 million.

Section 179 property includes (new or used but new to you):

- Machinery, equipment, computers, furniture and vehicles
- Qualified real property, which may include improvements made to nonresidential real property

The benefit to Sec. 179 over Sec. 168 is that it is easier to fine-tune annually (elected property by property), doesn't complicate UNICAP for those businesses subject to IRC Sec. 263A, and covers certain qualified real property not eligible for 100% bonus depreciation.

④ Business loan interest

The TCJA introduces some limitation for deduction business interest expense. However, if your business has average annual gross receipts of $25 million or less over a three-year period, you may be eligible to deduct the full amount of business loan interest from qualifying loans. (Large businesses can only deduct interest amounting to 30% of their adjusted taxable income.) In addition, if you take out a personal loan but use some of the money for business expenses, you may be able to deduct the interest on the business portion.

You'll want to keep good records to make sure you comply with any IRS requirements. For example, keep your loan agreement handy and be sure to document that your lender is processing your payments.

⑤ Health insurance premiums

Even if your small business doesn't qualify for the health care tax credit, you may still be able to deduct health insurance premiums as a business expense. For example, you can take a deduction for:

- Payments made for group health insurance premiums
- Payments made through formal medical reimbursement plans, such as Health Reimbursement Arrangements (HRAs)
- Contributions to Health Savings Accounts (HSAs) (subject to annual limits)

It's important to note that, for S-corporations, if you own more than 2% of the company's shares, you must include the cost of your health insurance in your income. This means the amount you pay for health insurance is subject to income tax, but not FICA. You may, however, be able to then take a personal income tax deduction on the health insurance premiums paid by the business.

Finally, sole proprietorships, partnerships, S corporations and C corporations all (or their pass-through owners) may be able write off long-term care insurance premiums to some extent or another. Premium payments are a generally deductible business expense, similar to traditional health insurance premiums. For C corporations, this applies to the owners, their spouses and dependents, and all employees. For partnerships and S-corporations, only premium payments for non-partners or non-2%-owners are fully deductible. For all others considered self-employed for purposes of this fringe benefit, the premium is added to the applicable owner's income (similar to health insurance premiums) and there are age-based premium amount limitations further subject to itemization rules.

⑥ Business travel and meals

Travel expenses are the ordinary and necessary expenses of traveling away from your normal place of business for business purposes. They can include travel by airplane, train, bus or car; fares for taxis or other types of transportation; shipping of baggage and other materials; use of your car or a rental car while at your business destination; and meals and lodging. While you cannot deduct entertainment expenses, you can deduct 100% of your business travel costs and 50% of your qualifying meal expenses.

⑦ Retirement plans

Planning for retirement is often left behind by business owners because it's not seen as a necessary business expense. However, a qualified retirement plan can allow you to start growing tax-advantaged retirement savings while providing valuable business deductions starting this year if you act quickly.

There are many options available, and each has its pros and cons. While IRAs are arguably the easiest way to get started, you may be able to save more with a defined benefit or pension plan. Some plans have to be established before year end but others give you until the tax-filing deadline of next year.

Retirement Plan Details

	SEP IRA	Traditional/Solo 401(k)	SIMPLE IRA	Defined Benefit Plan
Generally best for	Businesses with few to no employees. Flexible and easy to administer.	Solo 401(k) is for businesses with no employees. Traditional 401(k) plans are for larger firms.	Businesses with fewer than 100 employees. Easy to administer.	Business owner who wants to maximize contributions and can manage the administrative costs
Effect on income tax for employees	Owner may deduct on 1040.	Employee contributions are pretax (Traditional). Reduce taxable income.	Owner can deduct on 1040. No deduction for employee, but contributions are pretax.	N/A. Employer only contributions.
Effect on income tax for employers	100% deductible contributions (limits may apply).	100% deductible contributions (limits may apply).	100% deductible contributions (limits may apply).	Deductible contributions with limits based on actuary computation.
References	IRS Pub 4333 (SEPs for small business)	IRS Pub 560. IRC Sec 401. www.irs.gov/retirement-plans/one-participant-401k-plans	IRS Pub 560. IRS Pub 4334 (SIMPLE Plans)	IRS Pub 560

⑧ Qualified business income

The qualified business income deduction generally allows you to deduct—on your individual tax return—up to 20% of your qualified business income or 20% of your taxable income net of any capital gain, whichever is lower. There can be income limitations, however ($321,400, if married filing jointly, or $160,700 for all other filing statuses in 2019). Eligible businesses include pass-through entities, including partnerships and S corporations, as well as other unincorporated entities such as sole proprietorships and single-member LLCs. The qualified business income deduction started in tax year 2018 and, as of now, it will end after tax year 2025.

Generally, qualified business income refers to profits from your business. It does not include salary or wages you received either as W-2 wages from an S-corporation or guaranteed payments from a partnership.

In practical terms, this deduction means you may be able to reduce your estimated taxes. However, be careful because the penalty for underpayment of estimated taxes can hurt.

The combination of tax credits and deductions can go a long way toward minimizing your small business tax liability. With the year winding down, there's still time to take advantage of small business tax breaks.

Speak with your BMO financial professional and tax advisor soon to discuss the best options for your business.

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