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Keys to Year-End Tax Savings for Businesses

Whatever 2021 holds, these tips can help lower your tax liability

2020 has been an unpredictable year. Businesses have faced all-encompassing challenges ranging from protecting employee health and safety to managing unexpected costs to dealing with severe fluctuations in supply and demand for products and services. Some businesses were able to enter new markets and achieve fresh levels of growth, while others had to make tough choices just to endure.

The outlook for 2021 is uncertain. While COVID-19 continues to surge through the U.S., a new administration is preparing to take office, and control of the Senate—which will have major implications for the future of tax reform—remains undecided. In this environment, many businesses are left wondering which strategies will be effective to help lower their tax liability and increase savings.

Regardless of which stage of recovery your business is in, or what is on the horizon, consider whether any of the year-end tax strategies outlined below could help your business start off 2021 on the right track.

When determining which strategies to leverage, a business should consider whether it expects one of the following scenarios to occur:

1. Income is constant or lower in 2021 than in 2020, or tax rates are expected to remain constant or decrease as compared to 2020.
2. Income is higher in 2021 than in 2020, or income tax rates are expected to increase as compared to 2020.

Scenario 1: Income or income tax rates are expected to be constant or decrease in 2021

Defer Income: If income or tax rates are expected to remain the same or drop in 2021, businesses may wish to defer income to 2021, given the time value of money or given that the income would be taxed at a lower rate than it would if the income were recognized in 2020. For cash-basis taxpayers, which recognize revenue and expenses at the time money is actually exchanged, deferring income is fairly easy as taxpayers can delay sending bills until 2021. For accrual-basis taxpayers—where revenue and expenses are recognized when earned or incurred—deferral of income can be more complex. However, the 2017 tax reform bill known as the Tax Cuts and Jobs Act (TCJA) amended the rules governing when an accrual-basis taxpayer should recognize income, i.e., such taxpayers can choose an accounting method that allows the business to report the advance payment amount as gross income as of the time that amount is reflected as revenue on the taxpayer's applicable financial statements. This provision effectively allows for a one-year deferral for the reporting of advance payments.

Accelerate Deductions: Companies may wish to make payments on expenses that would be deductible in 2020 rather than 2021. For cash-basis taxpayers, paying their bills quickly and using credit to cover deductible expenses is one way to ensure those purchases take place before the end of 2020. Again, for accrual-basis taxpayers, this is more complicated, but not impossible with the right accounting strategies.

Expense Capital Assets: Taxpayers should consider reviewing their capitalized costs on their balance sheets such as prepaid expenses or software development costs and consider possible changes to accounting methods. Also, given the new liberalized bonus deprecation rules, businesses could look to place tangible assets in service by December 31, 2020 that could secure an immediate deduction for 2020.

Close on Taxable Business Acquisitions: Taxpayers looking to make business acquisitions that would result in part of the purchase price being allocated to tangible personal property, such as machinery, computers or other equipment, may wish to try to do so before the end of 2020 so they can expense the purchase immediately and claim a deduction on their tangible personal property tax in 2020 rather than in 2021. The TCJA amended the rules to allow bonus depreciation for used property with a MACRS life of 20 years or less.

Scenario 2: Taxable income or the income tax rate is expected to increase in 2021

Accelerate Income: When a taxpayer expects to be taxed at a higher rate in the next year, the strategies discussed in

Scenario 1 are reversed. In this case, rather than deferring income to 2021, a taxpayer may wish to recognize income before 2020 ends, so that it is taxed at the presumed lower rate. Accrual-basis taxpayers might be able to accelerate income by completing work contracts and billing clients or customers before the end of 2020. Cash-basis businesses simply need constructive receipt (i.e., the funds are under their control) of payment before year end to recognize income in 2020.

Deduct Deferrals: While accelerating income, taxpayers should ascertain whether it is possible to defer taxable expenses until 2021 or simply defer placing 2020 purchases in service until 2021 when their overall income tax rate is higher, for example, by delaying placing purchases in service for equipment or supplies that will generate a deduction in the following year.

Capitalize Assets: With respect to capitalized assets, taxpayers may wish to consider waiting to place assets in service until after December 31, 2020 to postpone any resulting deductions.

Delay Business Acquisitions: Businesses should consider delaying until 2021 the completion of any acquisitions that could result in a tangible personal property deduction.

Other Year-End Tax Strategies to Consider

- R&D Tax Credit: A company that has dedicated resources to developing new or improving existing products, processes or software may qualify for the R&D tax credit, which could result in significant tax savings. Taxpayers seeking to maximize the benefit of immediately deducting R&D expenditures should consider the effective date of the required amortization rule (i.e., December 31, 2021) and, if possible, accelerate their R&D activities prior to 2022.

- Section 199A: Certain non-corporate taxpayers may be entitled to a deduction of up to 20% of their qualified business income. Pass-through businesses may be able to increase the Section 199A deduction by increasing W-2 wages before the end of 2020.

- Bonus Planning: There may be opportunities for a business to claim deductions on bonuses or postpone them until 2021, depending on the individual taxpayer's situation. An accrual basis corporation can take a deduction for its current tax year for a bonus not actually paid to its employee until the following tax year if:

    o The employee does not own more than 50% in value of the corporation's stock,

    o The bonus is properly accrued on its books before the end of the current tax year,

    o The overall bonus pool is fixed at year-end, and

    o The bonus is actually paid within the first two and a half months of the following tax year (for a calendar year taxpayer, no later than the first half of March 2021).

For cash-basis employees, the bonus will not be taxable income until the following year.

- S Corporation Planning: Consider advancing funds to the business in the form of capital or a loan to increase the tax basis of the shareholder to allow for losses by creating sufficient tax basis before the end of 2020. Also, consider advising shareholders how much additional time needs to be spent before the end of the year working in the business to avoid application of the passive activity loss rules.

- Partnership Losses: A partner's share of partnership losses is deductible only to the extent of his or her partnership basis at the end of the year in which the loss is incurred. The basis amount can be increased by a capital contribution, which increases the partner's share of partnership liabilities, but a decrease in a partner's share of the partnership liability will reduce basis. While all liability allocations increase basis for distribution purposes, recourse or at-risk liabilities increase tax basis for loss purposes.

- Timing Distributions of Appreciated Property: Delaying a distribution of appreciated property or a corporate liquidation into 2021 can defer taxes on that distribution for an entire year.

- Increase Business Interest Deductions: Review the options for taking advantage of the benefits of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, as well as regulations on the deduction of business interest expense. These options include increasing the percentage multiplied against adjusted taxable income from 30% to 50% for most taxpayers in 2019 and all taxpayers in 2020.

- Section 382 Studies: Certain techniques are available to increase the annual limitation on net operating losses.

- Entity Simplification or Restructuring: In the context of closely held businesses, taxpayers can increase their tax basis for loss utilization and tax-free distributions and allow for additional interest expense by combining income in a closely held context. In the context of large corporate entity structures, entity simplification or restructuring could help to identify worthless stock deductions for a domestic subsidiary in a consolidated or affiliated group context, and for foreign subsidiaries.

- Transaction Cost Analysis: Most taxpayers incur many fees for all types of merger and acquisition transactions, as well as for the raising of capital and debt exchanges. Millions of dollars of otherwise capitalized and non-deductible losses could be freed up and utilized immediately to offset taxable income for the year or to create a net operating loss.

- Qualified Small Business Stock: Qualifying taxpayers can exclude gains of up to the greater of $10 million or 10 times their tax basis for stock that has been held for five years and that otherwise meets all the corporate qualifications.

- IRS Account and Interest Recovery Services: Consider undertaking a project to identify potential IRS errors in processes and posting payments and to recover misapplied payments and interest as tax savings in this area could offset other year-end tax costs.

This article outlines some—but not all—considerations for year-end tax planning. A trusted advisor can help businesses determine which strategies would be effective in helping them lower their total tax liability for the year ahead.