December 13, 2012 – 2012 Year-End Tax Planning for Businesses

In recent years, end-of-the-year tax planning for businesses has been complicated by uncertainty over the future availability of many tax incentives. This year is no different. In 2010, Congress extended many business tax incentives for one or two years. Now, those incentives have expired or are scheduled to expire. Whether they will be extended beyond 2012 is unclear as Congress debates with the fate of the fate of the Bush-era tax cuts and across-the-board spending cuts scheduled to take effect in 2013. In the meantime, you need to be aware of the expiring provisions and explore developing a multiyear tax strategy that takes into account various scenarios for the future of these incentives.

Code Sec. 179 expensing. Code Sec. 179 gives businesses the option of claiming a deduction for the cost of qualified property all in its first year of use rather than claiming depreciation over a period of years. For 2010 and 2011, the Code Sec. 179 dollar limitation was $500,000 with a $2 million investment ceiling. For 2012, the amounts are less generous. The dollar limitation for 2012 is $139,000 with a $560,000 investment ceiling. Under current law, the Code Sec. 179 dollar limit is scheduled to drop to $25,000 for 2013 with a $200,000 investment ceiling.

Businesses should consider accelerating purchases into 2012 to take advantage of the still generous Code Sec. 179 expensing. Qualified property must be tangible personal property, which you actively use in your business, and for which a depreciation deduction would be allowed. Qualified property must be newly purchased new or used property, rather than property you previously owned but recently converted to business use. Examples of types of property that would qualify for Code Sec. 179 expensing are office equipment or equipment used in the manufacturing process. Additionally, Code Sec. 179 expensing is allowed for off-the-shelf computer software placed in service in tax years beginning before 2013.

If your equipment purchases for the year exceed the expensing dollar limit, you can decide to split your expensing election among the new assets any way you choose. If you have a choice, it may be more valuable to expense assets with the longest depreciation periods. As long as you start using your newly purchased business equipment before the end of the tax year, you get the entire expensing deduction for that year. The amount that can be expensed depends upon the date the qualified property is placed in service; not when the qualified property is purchased or paid for.

Congress could raise the Code Sec. 179 dollar limit and investment ceiling for 2013. In July 2012, the Senate voted to increase the Code Sec. 179 dollar amount to $250,000 with an $800,000 investment limitation for tax years beginning after December 31, 2012. The House voted to increase the Code Sec. 179 dollar amount to $100,000 with a $400,000 investment limitation for tax years beginning after December 31, 2012.

Bonus depreciation. The 50 percent bonus first-year depreciation deduction is scheduled to expire after 2012 (2013 in the case of certain longer-production period property and certain transportation property). Unlike the Section 179 expense deduction, the bonus depreciation deduction is not limited to smaller companies or capped at a certain dollar level. To be eligible for bonus depreciation, qualified

property must be depreciable under Modified Accelerated Cost Recovery System (MACRS) and have a recovery period of 20 years or less. The property must be new and placed in service before January 1, 2013 (January 1, 2014 for certain longer-production period property and certain transportation property).

Businesses also need to keep in mind the relationship of bonus depreciation and the vehicle depreciation dollar limits. Code Sec. 280F(a) imposes dollar limitations on the depreciation deduction for the year a taxpayer places a passenger automobile in service within a business, and for each succeeding year. Code Sec. 168(k)(2)(F)(i) increases the first-year depreciation allowed for vehicles subject to the Code Sec. 280F luxury-vehicle limits, unless the taxpayer elects out, by $8,000, to which the additional first-year depreciation deduction applies. The maximum depreciation limits under Code Sec. 280F for passenger automobiles first placed in service by the taxpayer during the 2012 calendar year are: $11,160 for the first tax year ($3,160 if bonus depreciation is not taken); $5,100 for the second tax year; $3,050 for the third tax year; and $1,875 for each tax year thereafter. The maximum depreciation limits under Code Sec. 280F for trucks and vans first placed in service during the 2012 calendar year are $11,360 for the first tax year ($3,360 if bonus depreciation is not taken); $5,300 for the second tax year; $3,150 for the third tax year; and $1,875 for each tax year thereafter. Sport utility vehicles and pickup trucks with a gross vehicle weight rating in excess of 6,000 pounds are exempt from the luxury vehicle depreciation caps.

New de minimis rule in repair regulations. Comprehensive repair and capitalization regulations issued by the IRS in late 2011 open up a new planning opportunity. A new de minimis expensing rule allows a taxpayer to deduct certain amounts paid or incurred to acquire or produce a unit of tangible property if the taxpayer has an Applicable Financial Statement (AFS), written accounting procedures for expensing amounts paid or incurred for such property under certain dollar amounts, and treats the amounts as expenses on its AFS in accordance with its written accounting procedures. An overall ceiling limits the total expenses that a taxpayer may deduct under the de minimis rule. The de minimis expensing rule applies to amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012.

Let's look at an example. A taxpayer purchases 10 VoIP phones for its business at $200 each for a total cost of $2,000. Each phone is a unit of property and is not a material or supply. The taxpayer has an applicable financial statement and a written policy at the beginning of the tax year to expense amounts paid for property costing less than $500. The taxpayer treats the amounts paid for the phones as an expense on its applicable financial statement. Assume further that the total aggregate amount treated as de minimis and not capitalized, including the amounts paid for the phones, are less than or equal to the greater of 0.1 percent of total gross receipts or 2 percent of the taxpayer's total financial statement depreciation. *The result:* the de minimis rule applies and the taxpayer is not required to capitalize any portion of the $2,000 paid for the 10 phones.

Dividends. Under current law, tax-favorable dividends tax rates are scheduled to expire after 2012. Qualified dividends are eligible for a maximum 20 percent tax rate for taxpayers in the 25 percent and higher brackets; zero percent for taxpayers in the 10 and 15 percent brackets. In July, the House voted to extend the current dividend tax treatment through 2013. The Senate, however, voted to extend the tax favorable rates only for individuals with incomes below $200,000 (families with incomes below $250,000). For income in excess of $200,000/$250,000 the tax rate on capital gains and dividends would be 20 percent.

If Congress taxes no action, qualified dividends will taxed at the ordinary income tax rates after 2012 (with the highest rate scheduled to be 39.6 percent not taking into account the 3.8 percent Medicare contribution tax for higher income individuals). Qualified corporations may want to explore declaring a special dividend to shareholders before January 1, 2013.

Expired business tax incentives. Many temporary business tax incentives expired at the end of 2011. In past years, Congress has routinely extended these incentives, often retroactively, but this year may be different. Confronted with the federal budget deficit and across-the-board spending cuts scheduled to take effect in 2013, lawmakers allow some of the business tax extenders to expire permanently. Certain extenders, however, have bipartisan support, and are likely to be extended. They include the Code Sec. 41 research tax credit, the Work Opportunity Tax Credit (WOTC), and 15-year recovery period for leasehold, restaurant and retail improvement property.

Small employer health insurance credit. A potentially valuable tax incentive has often been overlooked by small businesses, according to reports. Employers with 10 or fewer full-time employees (FTEs) paying average annual wages of not more than $25,000 may be eligible for a maximum tax credit of 35 percent on premiums paid for tax years beginning in 2010 through 2013. Tax-exempt employers may be eligible for a maximum tax credit of 25 percent for tax years beginning in 2010 through 2013.

The Code Sec. 45R credit is subject to phase-out rules. The credit is reduced by 6.667 percent for each FTE in excess of 10 employees. The credit is also reduced by four percent for each $1,000 that average annual compensation paid to the employees exceeds $25,000. This means that the credit completely phases out if an employer has 25 or more FTEs and pays $50,000 or more in average annual wages.

Let's look at an example. A for-profit employer has 10 FTEs and pays average annual wages of $250,000 in tax year 2012. The employer's qualified employee health care costs for tax year 2012 are $70,000. The employer's Code Sec. 45R credit is $24,500 ($70,000 x 35 percent).

The credit is scheduled to climb to 50 percent of qualified premium costs paid by for-profit employers (35 percent for tax-exempt employers) for tax years beginning in 2014 and 2015. However, an employer may claim the tax credit after 2013 only if it offers one or more qualified health plans through a state insurance exchange.

Today's uncertainty makes doing nothing or adopting a wait and see attitude very tempting. Instead, multi-year tax planning, which takes into account a variety of possible scenarios and outcomes, should be built into your approach. Please contact our office for more details on developing a tax strategy in uncertain times that includes consideration of certain tax-advantaged step that may be taken before year-end 2012.