

TaxTips

small business owners winter 2018/2019

The party's over

Deduction for entertainment expenses no longer allowed

Starting in 2018, deductions for activities that are generally considered to be entertainment, amusement or recreation expenses, or with respect to a facility used in connection with such activities, are disallowed. Forget front row concert tickets or box seats at the MLB game on another company's dime.

Before the new law, if you took a potential client golfing to discuss a future relationship, this cost was 50% deductible as entertainment associated with the active conduct of a trade or business, but only if adequate

records were kept. Now there is no such deduction. The government likes this provision because it eliminates the subjective determination of whether such expenses are sufficiently business-related.

However, if you reward an employee with an expense-paid vacation, you can still deduct this type of entertainment since it is treated as compensation to the employee. If you gave the same type of reward to a contractor, you would have to issue a 1099-Misc in order to gain a deduction.

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Celebrations like holiday parties and annual picnics are still fully deductible because they are for the primary benefit of employees. Yet membership dues for any club organized for business, pleasure, recreation or other social purpose are not deductible and never have been allowed.

Give me a call to discuss how these types of expenses might affect your tax liability for the year.

To be or not to be

What type of business is best?

The idea of starting a business is scary enough; then comes the difficult decision of what type of business entity to establish. You'll need to consider your financial needs, risk and ability to grow. Choosing correctly at the start is critical because it can be difficult to change your legal structure after you have registered your business.

A sole proprietorship is quick and inexpensive to form. You have complete control over your business. You are entitled to all profits from the business. Nonetheless, you are also liable for all business debts and have an unlimited personal liability, which may be undesirable. This type of entity may also make it difficult to raise capital if needed.

A partnership has several options: (1) a general partnership with overall equal division of profits, liability and management or (2) a limited partnership with one partner controlling the operations and other partners with limited roles. Partners must file taxes twice, once for the partnership and once for the individual. Also, if disputes arise between partners, there could be some drama. Similarly, with this type of business, you could be held liable for actions made by your business partner.

A multi-member limited liability company (LLC) is a hybrid between a partnership and a corporation, and it can be taxed as either. This entity provides options for the actual business structure with the limited liability of a corporation and the operational flexibility and tax structure of a partnership.

If liability and outside funding are your main concerns, then a C corporation might be your best fit. A C corporation provides limited liability. Other pros of a C corporation are the ability to generate capital. Plus, the current tax rate is capped at 21%. Conversely, C corporations are subject to double taxation — once when the corporation makes a profit and again when it pays dividends to shareholders. In addition, a

C corporation can require a large initial investment of time and money for start-up and administrative costs.

An S corporation is also a good option for limited liability; yet, an S corporation has stricter operational processes including shareholder compensation requirements. Also, foreign ownership of shares is prohibited. On a positive note, this type of corporation eliminates any double taxation since the income is passed through to the shareholders to report on their personal returns.

The best option for you will depend on your personal and business goals and how they align with what each type of entity has to offer.

Is your pay reasonable?

Maybe it's time to reexamine

Tax laws define reasonable compensation as the amount that would ordinarily be paid for like services by like enterprises under like circumstances.

Building a compensation plan into your business right from the start is a good idea. Depending on your business structure, there are many compensation options, including:

- Standard salary — simple, easy to manage
- Salary and dividends — a mix of both wages and dividends (dividends are usually taxed at a lower rate than wages)
- Stock or stock options
- Salary with bonus option — gives yourself leeway when the business might not have a good year financially

It's important to have proper documentation and pay yourself an amount that aligns with the size of your business, the market and related profitability. By not doing so, you are asking for trouble from the IRS in terms of additional taxes, penalties and interest.



Reasonable compensation is also a hot topic of discussion because it comes into play for determining the new qualified business income (QBI) deduction. In general terms, the QBI deduction is limited to the lesser of 20% of qualified business income or 50% of the total W-2 wages paid by the business once taxable income exceeds threshold amounts. Rules are in place to deter high-income taxpayers from attempting to convert wages or other compensation for personal services into income eligible for the deduction.

The complexities surrounding this deduction can be challenging but we can work through the mechanics to make sure you receive maximum results.

Vehicle depreciation

Higher deduction allowed

If you acquire and place into service a new or used passenger vehicle in 2018 and use it over 50% for business, you can depreciate up to \$18,000 if you elect to claim first-year bonus depreciation. This is a dramatic increase from last year's amount of \$11,160. Even if you choose not to claim the bonus, the first-year deduction is \$10,000 (\$3,160 for 2017). The new law also adds the ability to take the bonus depreciation for a used automobile as long as you or your business has never used it previously.

You should also note that the above vehicle depreciation caps do not apply to trucks, vans or SUVs that are rated at 6,000 pounds loaded gross vehicle weight. For example, if you purchase an SUV costing \$70,000 and use it 60% for business, you could potentially deduct \$42,000 of depreciation for that first year!

All tax rules have their quirks, so make sure to give me a call if this sounds like something you might be considering.

Employee achievement awards

Are they deductible?

An employee achievement award is an item of tangible personal property that an employer transfers to an employee for a length-of-service or safety achievement. It must be awarded as part of a meaningful presentation and under conditions and circumstances that don't create a significant likelihood that the payment is disguised compensation.



Your deduction for the cost of all employee achievement awards made to an employee in a tax year is limited to \$400 if the award isn't a qualified plan award and \$1,600 if it is a qualified plan award. The employee does not include this type of reward in income.

New laws this year clarified that excludible employee achievement awards *do not* include cash or cash equivalents; gift cards, coupons or certificates; vacations, meals or lodging; tickets to the theater or sporting events; stocks, bonds and other securities; and other similar items.

Arrangements that confer only the right to select and receive tangible personal property from a limited array of items pre-selected or pre-approved by the employer (i.e., catalog of gifts) do qualify as excludible employee achievement awards.

Employee vs. independent contractor

Which is best for your business?

All business owners hope to succeed at scoring good talent. Now, should that accomplishment come from hiring an employee, enlisting the services of an independent contractor, or both?

An employee is a smart choice if you want complete control over that person. You decide the hours of work, tools and equipment used, training provided and more. Hiring an employee could be the better choice if the job is essential to your business and not a peripheral job, such as a cleaning crew. On the other hand, employees come with an abundance of legal and regulatory responsibilities on your end. Both the federal and state governments regulate the payment of wages, salaries, overtime and other work-related rules. You also must comply with payroll tax, unemployment insurance and worker's compensation insurance requirements.

You can assign duties to an independent contractor, impose a deadline and work product; nevertheless, you cannot tell that person how to get the job done. Independent contractors can work for others, usually set their own hours and often provide their own tools or equipment. This type of arrangement could be ideal if the work can be done by a professional who doesn't need much supervision. An independent contractor could also be a good choice when the work is a short-term project that will be completed in a defined period of time. Oftentimes, your only financial responsibility is providing the independent contractor with a Form 1099-Misc each year.

The decision to hire an employee or an independent contractor is done on a case-by-case basis; many businesses use a mix of both. Be aware that the IRS considers a worker to be an employee unless you can prove otherwise.

What are leasehold improvements?

New law oversight

Generally, leasehold improvements are enhancements to a leased space that are paid for by a tenant or landlord, such as the addition of built-in cabinetry, electrical light fixtures or carpeting.

Prior to 2018, if you made any improvement (not including any enlargement of the building, any elevator or escalator, any structural component benefiting a common area or internal structural framework) to an interior portion of a leased nonresidential building more than three years after the building was first placed in service, you could recover this cost through depreciation over 15 years. In addition, these types of improvements qualified for §179 and bonus depreciation.

With the new tax laws, Congress tried to simplify things and consolidate various types of leasehold improvements into one general category — qualified improvement property (QIP). Qualified improvement property is less restrictive in that the timing of the improvement must be only after the building was placed in service, not more than three years later.

However, upon simplification, beginning in 2018, an oversight in the law has left qualified improvement property with a 39-year life for depreciation. This negates any option for §179 or bonus depreciation for QIP. We are hoping for a technical correction soon so that the cost of leasehold improvements can be deducted more quickly and qualify for additional depreciation deductions.

