November 16, 2022

2022 Year-end Tax Planning Strategies for Business Owners

US tax policy changes remain top of mind for many closely held business owners in 2022. Major tax changes for businesess in recent years have resulted in a major corporate tax rate reduction, generous expensing and depreciation rules for businesses and a pass-through qualified business deduction for non-corporate entities. More recent federal tax law proposals declare Congress' intent to increase corporate and personal income taxes, or at a minimum, a flirtation with the idea. In fact, the 2023 federal budget proposal or "The Green Book" proposes to increase the effective tax rate for C corporations to 28% for tax years beginning after December 31, 2022 (up from 21%), further signaling a desire to modify tax policy. There are also a few provisions in the Inflation Reduction Act that impact corporations, though it may only affect a few corporations. The Act's energy-related credits will not go into effect until 2023.

Lack of clarity regarding tax policy creates an air of uncertainty and, in some cases, a revolving door of urgent need for business owners to create trust and tax plans to shield assets from upcoming tax law changes. Compounding the issue of rising income taxes, the imminent decrease in the Federal Estate, Gift Tax Exemption (FEGTE) – which is the amount you can transfer during life or at death without triggering transfer tax) – in 2026 from current rate of $12.06MM to $5MM, increases anxiety and further demonstrates the need for business owners to review and revise current corporate structures and business transition plans. Regardless of the uncertainty and Congressional gridlock, it is important to stay calm and act prudently. There are several planning strategies business owners should consider prior to year-end to best position your business for future growth in 2023.

1. Review corporate structure and tax status

End of year is a good time to revisit whether your business structure is still the best fit. Closely held business owners have several options for structuring a business. Many businesses operate as a sole proprietorship with one owner servicing and managing the business. In fact, according to US Census data, 73% of businesses are sole proprietorships. Other businesses – especially those with more than one owner – are structured as partnerships, limited liability companies (LLCs), S corporations or C Corporations. The structure of your business also impacts how taxes are filed – so future tax rate changes may significantly impact your tax liability. The potential for an increase in the corporate tax rate, an increase in the individual tax rate for high earners, and the potential change in the preferential rate for qualified dividends all could have an impact. Tax savings are not the only factor to consider in structuring a business, so it is important to consult your tax advisor to discuss options.

2. Review retirement plan options

Qualified retirement plans can be a powerful way to lower current tax liabilities as well as provide opportunities for owners and employees to save significantly for retirement. Individuals who already have these plans should use the end of the year as an opportunity to fully fund their contributions or at least contribute enough to receive the entire company match, if applicable. If you have a Roth option for your retirement plan, review your current tax rate and try to determine whether your tax rate will be higher in retirement. If you think it will be, it may be wise to allot some of your retirement contributions to the Roth option and forego the current tax savings as contributions to a Roth do not generate a tax deduction. Since there are many unknowns when trying to predict your tax situation years down the road, it may make sense to hedge and to have some taxable retirement accounts and some that are not subject to tax at time of distribution.

End of year is a great time for businesses to provide end-of-year bonuses or retirement contributions to their employees and potentially receive take breaks on these funds, which can be financially appealing to business owners. Business owners may want a plan that maximizes their contributions up to the legal limit. For self-employed individuals, a simplified employee pension (SEP) IRA can be funded with 20% of self-employment earnings with a maximum of $58,000 for 2022. There is no year-end deadline and it may be established up to the extended due date of their income tax return. A solo 401(k) will allow for the largest pretax contribution as it recognizes that you are both employer and employee. Solo 401(k)s are suitable for sole proprietors, partnerships, C corporations and S corporation business owners. Additionally, a business can make a profit-sharing contribution to a retirement plan, up to 25% of payroll, lowering the businesses taxable income.

Regardless of your business structure, it is important to consult with your tax advisor to determine the effect of the Setting Every Community Up for Retirement Enhancement Act of 2019 (the "SECURE" Act) on any current or future employer sponsored plan. The SECURE Act applies to both large employers and small employers, but some of the changes are especially beneficial to smaller employers.

3. Create and implement business transition planning strategies

Business transition planning is not top of mind for most busy closely held business owners focused on maintaining and growing a successful business. Unless an unexpected event occurs such as receiving an unsolicited offer to buy the business or death or incapacity of a key person in the business, many owners are too swamped or too reluctant to turn their attention to creating and implementing a plan of action for when they are no longer running the business. Unfortunately, lack of advanced planning to position your exit from your business is one of the main reasons families receive less value for their business when "that" time comes – which inevitably will happen to all business owners.

In considering your "inevitable exit," it is important to understand the different transfer channels available to transition your business. For instance, many closely held business owners look to transfer the company to family members – especially when spouses, children, siblings, or other family members are instrumental in the daily operations of the business. Establishing, implementing, and communicating an innovative estate and tax plan that specifies roles and functions of family members can make for a smooth transition with less family strife, while at the same time providing significant income and transfer tax savings. Alternatively, if you would like to sell your business to a co-owner, employees or to an outside third party, advance planning is key to ensuring your transition goals are met. Regardless of the transfer channel you choose to exit your business, it is important to implement and routinely review and revise exit plans at the end of year – especially if there are proposed changes in tax law that may impact your ability to save taxes and maximize the amount of sale proceeds retained by you and your family.

4. Establish or revise wealth transfer strategies

As circumstances change throughout the year, it is prudent to establish or revise wealth transfer planning strategies available to minimize federal and state income and transfer taxes (estate, gift and generation skipping). As always, gifting at year-end – whether outright or in trust to individuals or charities – is a planning strategy available to reduce income tax and/or estate tax liability. You have until year-end to make annual exclusion gifts of up to $16,000 per person. If you are married, you may "gift split" and gift $32,000 to one person. Keep in mind, the gift must be out of your control by year-end.

As annual exclusion gifts do not count against your lifetime gift tax exemption, such gifting is a great way to transfer assets without subjecting the transfer to taxes. As mentioned previously, the current FEGTE in 2022 is $12.06MM with an increase for inflation to $12.92MM in 2023 but will automatically fall to $5MM in 2026 under current tax law. Creating an estate plan to establish long-term lifetime trusts or trusts at death via your will that hold business interests may significantly maximize your income and transfer tax savings – especially if looking to transition your business to the next generation. Once such plans are created, it is always prudent to periodically review and revise estate plans as circumstances change. Additionally, considering state residency changes may be a strategy to significantly decrease state income tax liability – especially if your business assets are held in long-term trusts that permit you to control the disposition or sale of the business and your business is not physically tied to your home state of residency. Consult estate and tax planning professionals prior to year-end to determine if such tax saving strategies work for you and your business.

5. Take advantage of the business expensing election (Section 179 election)

For qualified property placed in service in tax years beginning in 2022, the maximum amount that may be expensed under the dollar limitation of Code Sec. 179 is $1,080,000 – up $30,000 from 2021 – and the beginning-of-phaseout amount increased to $2.7MM, as adjusted for inflation. The expensing deduction can be claimed regardless of how long the property is held during the year. Therefore, property acquired and placed in service in the last days of the tax year, rather than at the beginning of the following year, can result in a full expensing deduction for the earlier year. The deduction includes both new and used qualified equipment. Also, the Tax Cuts and Jobs Act of 2017 (TCJA) expanded the definition of section 179 property to qualified improvements to nonresidential real property, including certain improvement to a building's interior and improvements such as roofs, HVACs, fire protection systems, alarm systems and security systems. It also now applies to non-customized computer software available to the public.

6. "Bonus" depreciation – use it or lose it!

Business owners taking advantage of 100% bonus depreciation deduction in the first year new or used machinery and equipment is purchased and placed in service is a common income tax savings strategy for the past several years. Unlike standard amortization, bonus depreciation immediately facilitates tax savings – which can be a valuable business incentive when costs are rising. Bonus depreciation deduction is permitted without any proration based on the length of time that an asset is in service during the tax year. As a result, a 100% write-off may be claimed even if qualifying assets are in service for only a few days.

Unfortunately, the advantages of bonus depreciation deduction will not last forever. The tax-saving opportunity of bonus deduction is set to expire at the end of 2022 unless additional action from Congress. Starting on January 1, 2023, bonus depreciation will begin to phase out over four years, ultimately ending in 2026. So, if you plan to make a significant investment in equipment, it may be prudent to make such purchases sooner rather than later.

7. Maximize the pass-through business income deduction (Section 199A deduction)

The qualified business income (QBI) deduction is available up to 20% of QBI from a qualified trade or business. Created by the TCJA in 2017 and available through 2025, owners of qualified businesses structured and operated as pass-through entities – including trusts and estates – may be eligible for the QBI deduction. To take advantage of the deduction in 2022, specified service businesses qualify if your taxable income is under $170,050 for individual filers and $340,100 for married taxpayers filing jointly.

The heart of planning for the QBI deduction is managing taxable income by accelerating deductions or deferring income and for those in a non-specified service trade or business, managing the wage/capital limitation. To reduce taxable income below the threshold amount, a few ideas to consider are making pension plan contributions, increasing payroll, accelerating business expenses, recognizing losses, avoiding recognizing gains, and making charitable contributions. If you are in a non-specified service trade or business, but you exceed the income limitations and thus are subject to the additional W-2 wage and capital (qualified property) limitation, you should consider making additional qualified capital purchases or increasing wages to increase your available QBI deduction. Future tax changes could impact the availability of this deduction for higher earners.

8. Time business income and deductions

With the potential for the individual income tax rates to increase for high earners, it can be beneficial to time business income and deductions to maximize income tax savings. For businesses that are pass-through entities whose business income and deductions pass to owners such as sole proprietorships, S corporations, partnerships and LLCs, recognizing income and deductions will be all about timing. If you expect to be in a higher tax bracket in 2023, accelerate income into 2022 if possible and postpone expenses until 2023. For example, if you provide business services to a client in 2022, you can wait to bill the client in 2023 – thereby deferring the income into the next year and lowering your tax liability in the current year. Alternatively, it may be prudent to accelerate income into the current year to maximize tax savings. For cash method taxpayers, business expenses are generally deductible when paid. To increase the recognition of expenses for the current year, consider paying invoices received before year-end and even prepaying some expenses where feasible. However, if a business could be subject to increased rates next year, consider deferring expense payments until next year to be taken against higher taxed income. Acceleration of expenses is more difficult for accrual method taxpayers.

The timing of year-end bonus payments is an area where both cash- and accrual-basis employers have some opportunity to time deductions. Cash-basis employers can deduct bonuses in the year they are paid, so they can time the payment for maximum tax effect. Accrual-basis employers, on the other hand, deduct a bonus in the accrual year. However, the bonus must be paid within 2.5 months after the end of the accrual employer's tax year for the deduction to be allowed in the earlier year. Accrual employers looking to defer a deduction to a higher-taxed future year should consider changing their bonus plan's terms to make the bonus amount not determinable at year end.

9. Splitting business income with family members

A business owner can split business income by gifting family members an interest in the business. An S-corporation business owner can gift non-voting shares without giving up control. A C corporation business owner can gift common stock, preferred stock or debt securities if the capital structure of the corporation permits. If the business is a partnership or an LLC taxed as a partnership, a partner can gift a portion of a partnership interest. There have been some proposals introduced in Congress that could limit the ability to take valuation discounts for lack of marketability and minority interest discounts. Take advantage of these discounts while they are still available.

Children can work for the family business. Placing the child on the business payroll enables the child to make deductible IRA contributions or to make contributions to a Roth IRA. Putting children to work may also help avoid the kiddie tax, which has now been restored back to the parent's individual marginal income tax rate. The TCJA had previously changed the kiddie tax rules to use the trust and estate tax income tax rates. The kiddie tax only applies to children whose earned income does not exceed one-half the amount of their support. Adding children on the family payroll may increase their earned income to an amount more than one-half their total support – exempting their unearned income from the kiddie tax.

10. Consider what the Inflation Reduction Act means for business owners

The Inflation Reduction Act will reduce costs for small business by maintaining lower health care costs, supporting energy-saving investments, and bolstering supply-chain resiliency. The extension of the American Rescue plan's premium tax credit should help the self-employed maintain health insurance coverage. With the clean energy incentives, some business owners will see an increase in demand for their services and products as a result of this legislation (for example, small businesses that install HVAC systems or heat pumps, certain energy efficient home improvements etc.) Your business may be considering turning to clean commercial vehicles for savings via tax credits, as well as being better for the environment. There are also provisions for improving the energy efficiency of commercial buildings. The Research & Development tax credit for small businesses has also been expanded. Business owners should start thinking about how any of these provisions could benefit them and begin planning to take advantage of these incentives.

Year-end is a busy time of year for business owners for many reasons. Despite the hustle and bustle, it is important to consider the year-end tax planning strategies mentioned above to protect and preserve your business and personal assets. Your Key Bank Advisor can work with you and your legal and tax advisors to take decisive actions that best fit you, your business, and your family.

If you have any questions or need more information, please contact your advisor.

The Key Wealth Institute is comprised of financial professionals representing Key entities including Key Private Bank, KeyBank Institutional Advisors, and Key Investment Services. Any opinions, projections, or recommendations contained herein are subject to change without notice and are not intended as individual investment advice. This material is presented for informational purposes only and should not be construed as individual tax or financial advice.

Bank and trust products are provided by KeyBank National Association (KeyBank), Member FDIC and Equal Housing Lender. Key Private Bank and KeyBank Institutional Advisors are part of KeyBank. Investment products, brokerage and investment advisory services are offered through Key Investment Services LLC (KIS), member FINRA/SIPC and SEC-registered investment advisor. Insurance products are offered through KeyCorp Insurance Agency USA, Inc. (KIA). KIS and KIA are affiliated with KeyBank.

Investment and insurance products are:

NOT FDIC INSURED • NOT BANK GUARANTEED • MAY LOSE VALUE • NOT A DEPOSIT • NOT INSURED BY ANY FEDERAL OR STATE GOVERNMENT AGENCY

KeyBank and its affiliates do not provide legal advice. Individuals should consult their personal tax advisor before making any tax-related investment decisions. ©2022 KeyCorp.

221116-1811466