

# TAX TALK

## 2020 YEAR END TAX PLANNING FOR CANADIAN BUSINESSES WITH OPERATIONS AND FILINGS IN THE U.S.

Tax planning is probably the last thing on most business owners' mind as they deal with the financial and operational challenges of the COVID-19 crisis. However, businesses cannot afford to neglect tax planning this year. To take advantage of all available tax breaks, you need to be aware of some major changes under this year's Coronavirus Aid, Relief and Economic Security (CARES) Act and the massive Tax Cuts and Jobs Act (TCJA) that went into effect two years ago but still impacts tax planning.

This summary addresses key federal tax considerations for 2020 year end planning for Canadian businesses with U.S. operations.

Highlighted below are tax planning strategies you can use to minimize your tax burden for 2020-2021.

### **Business Structure**

Income taxation and owner's legal liability are the main factors that differentiate one business structure from another. Also the TCJA significantly changed the tax consequences of business structure.

The now-flat corporate rate (21%) is significantly lower than the top individual rate (37%), providing significant tax benefits to C corporations and helping to mitigate the impact of double taxation for their owners.

For tax and other reasons, a structure change may be beneficial in certain situations depending on your specific facts and circumstances.

### **Section 199A Deduction for Pass-through Businesses**

TCJA provides the Section 199A deduction for sole proprietorships and owners of pass-through entities, such as, sole proprietorships, partnerships and S corporations. The deduction generally equals 20% of

qualified business income ("QBI"). This deduction coupled with the reduction of the corporate tax rate to a flat 21% from a top rate of 35%, makes it worthwhile for businesses to re-evaluate whether their current entity type is the most tax efficient.

The QBI deduction effectively reduces the top individual income tax rate applicable to ordinary business income from 37% to 29.6%. Note that the QBI deduction is slated to end after 2025. At the end of the day, your business's individual circumstances will determine the optimal structure.

### **Control the Timing of Income and Deductions to your Tax Advantage**

Smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it. When you are expecting a loss in the current year, deferring income to next year and accelerating deductible expenses into the current year may be a good idea. Why? Because it will defer tax, which is usually beneficial. Also you may be able to carry back the tax losses in the current year to prior years when the tax rate was higher (see NOLs and NOLs carrybacks below).

### **Deferring Income/Accelerating Expenses**

This technique has long been employed by businesses that do not expect to be in a higher tax bracket in the following year. For example, if your business uses the cash method of accounting, you might defer income into 2021 by sending December 2020 invoices toward the end of the month (note TCJA allows businesses with three-year average annual gross receipts of \$25 million or less to use cash-basis accounting). Businesses using the accrual method can defer income by postponing delivery of goods or services until January 2021.

Likewise, businesses can accelerate deductible expenses into 2020 by putting them on a credit card in late December and paying it off in 2021.

### **Capital Asset Purchases and Tax Depreciation**

Purchasing equipment and other qualified assets has been a valuable tool for reducing taxable income for businesses for years, but TCJA further enhanced these opportunities by expanding bonus depreciation and expensing of qualified capital assets (Section 179 expensing where you can deduct the entire cost of the asset in the current year subject to certain limits below).

#### **Section 179 Expensing**

Businesses should take advantage of Section 179 expensing for a couple of reasons.

First, is that in 2020 businesses can elect to expense (deduct immediately) the entire cost of new and used assets, such as equipment and furniture (see Qualified Property below) up to a maximum of U.S. \$1,040,000 for the first \$2,590,000 of property placed in service by December 31, 2020. Note that the Section 179 deduction cannot exceed net taxable business income and create a tax loss. The deduction is phased out dollar for dollar on amounts exceeding the \$2,590,000 threshold and eliminated above amounts exceeding \$3,630,000 for tax years beginning in 2020.

Second, TCJA also expanded the definition of Section 179 property to allow businesses to elect to include certain improvements made to non-residential real property after the date when the property was first placed in service.

These changes apply to property placed in service in taxable years beginning after December 31, 2017.

1. Qualified improvement property, which means any improvement to a building interior. However, improvements do not qualify if they are attributable to:

- \* the enlargement of the building,
- \* any elevator or escalator, or
- \* the internal structural framework of the building.

2. Roofs, HVAC, fire protection systems, alarm systems, and security systems.

### **Vehicle-related Depreciation**

Purchases of new and used vehicles may be eligible for Section 179 expensing, and buying a large truck or SUV can maximize the deduction. The normal Section 179 expensing limit generally applies to vehicles with a gross vehicle weight rating of more than 14,000 pounds. A \$25,900 limit applies to vehicles (typically SUVs) rated at more than 6,000 pounds, but no more than 14,000 pounds.

Note that if you use a vehicle for business and personal purposes, the associated expenses, including depreciation, must be allocated between deductible business use and non-deductible personal use. If business use is 50% or less, you won't be able to use Section 179 expensing.

#### **Section 179 and COVID-19**

Note that tangible business equipment purchased to modify business processes and/or to conform to COVID-19 restrictions and measures will generally qualify for the Section 179 deduction. This includes sanitizing stations, temperature check stations, dividers/plexiglass shielding, new printed signage, and similar business equipment purchased to modify the workspace for employees and/or the public.

#### **Bonus Depreciation**

Under bonus depreciation, businesses are allowed to immediately deduct 100% of the cost of eligible property placed in service after September 27, 2017, and before January 1, 2023, after which it will be phased downward over a four-year period: 80% in 2023, 60% in 2024, 40% in 2025, and 20% in 2026.

The immediate expensing and bonus depreciation provisions are intended to increase business expansion in the U.S. These changes will also provide an incentive to Canadian businesses that want to expand their activities in the U.S. via a U.S. structure, or enter the U.S. market for the first time (see Retroactive Refund for Bonus Depreciation below).

It is important to note that when both 100% bonus depreciation and the Section 179 deduction are available for the same asset, it's generally more advantageous to claim 100% bonus depreciation, because there are no limits on it.

### **Qualified Property**

Qualified property for Section 179 and bonus tax depreciation is defined as property that you placed in service during the tax year and used predominantly (more than 50%) in your U.S. trade or business. Property that is defined as property that you placed in service during the tax year and then disposed in the same year does not qualify, nor does property converted to personal use in the same tax year it is acquired.

Qualified property includes computer systems, computer software, vehicles, machinery, equipment, and office furniture.

Note that the above U.S. tax depreciation rules are applicable to both U.S. domestic and foreign-owned entities.

### **CARES ACT**

Enacted in response to COVID-19 pandemic in March 2020, the CARES Act provides relief to corporate taxpayers, including corporations seeking sources of liquidity through net operating loss (NOL) carryback claims and expedited income tax refunds.

#### **NOLs and NOLs Carrybacks**

##### **Use Current Losses for Quick Refunds**

The CARES Act resurrected a provision allowing businesses to use current losses against past income for immediate refunds.

Under the CARES Act, NOLs arising in tax years beginning after December 31, 2017 and before January 1, 2021 (e.g., NOLs incurred in 2018, 2019 and 2020 taxation years) can be carried back to each of the five tax years preceding the tax year of such loss for refunds against prior taxes. These losses can even offset income at the higher 35% tax rates that was in place before TCJA (21% flat rate) that came into effect on January 1, 2018. As indicated above, companies should consider opportunities to accelerate deductions into a loss year to benefit from the rate arbitrage and obtain a larger refund.

The fastest way to obtain a tax refund is generally by filing a tentative refund claim on IRS Form 1139-Corporation Application for Tentative Refund. Note that these forms must be filed by December 31, 2020 for the 2019 calendar year. If you are expecting losses in 2020, you should start preparing to file your corporate income tax return early, because you cannot claim an NOL carryback refund until you file your return for the year.

##### **Accelerate Alternative Minimum Tax (AMT) Refunds**

When the TCJA repealed the AMT, it allowed corporations to claim refunds for all their unused AMT credits (before TCJA) in the tax years beginning in 2018, 2019, 2020, and 2021. The CARES Act accelerated this timeline for claiming these refunds, by allowing corporations to claim all remaining refunds in full in either 2018 or 2019 tax years. This gives companies several options to file for quick refunds. The fastest method for many companies will be filing a tentative refund claim on Form 1139, but as indicated above, this form must be filed by December 31, 2020 to claim the credit this way.

The other option is to file an amended income tax return for 2018 or 2019 to claim the credit but this option generally takes longer for you to get the refund.

##### **Retroactive Refund for Bonus Depreciation**

The CARES Act fixed a technical problem with bonus depreciation. The legislation expands bonus depreciation to a generous category of qualified improvement property (QIP). QIP is commonly thought of as a retail and restaurant issue, but it is much broader and applies to almost any improvement to the interior of a building that is either owned or leased. This fix is retroactive, so businesses can fully deduct qualified improvements dating back to January 1, 2018, which may offer relatively quick refunds.

Taxpayers who filed 2018 and 2019 income tax returns before the law changed can choose whether to reflect the additional retroactive deduction entirely in the 2020 tax year with an accounting method change, or amend both the 2018 and 2019 returns to apply bonus depreciation for QIP in each of those years.

### Claim Quick COVID-19 Disaster Loss Refunds

U.S. Tax rules allows businesses to claim losses attributable to a disaster on a prior year return. This is meant to provide quicker refunds.

President Trump's COVID-19 disaster declaration was unprecedented in scope, designating all 50 states, the District of Columbia and five territories as disaster areas. This means essentially every U.S. business is in the covered disaster area and may be eligible for refunds from certain types of losses. Under this provision, a business could claim a COVID-19 related disaster occurring in 2020 on a 2019 amended return for a quicker refund. The provision may potentially affect losses arising from a variety of circumstances, including loss of inventory or supplies or the closure of offices, stores or plants. Note to qualify, the loss must actually be attributable to or caused by COVID-19 and satisfy several other requirements.

### Other COVID-19 Credits for employers

To help employers retain their workforce and provide paid leave during the COVID-19 crisis, legislation signed into law in March has offered some tax relief.

### Payroll Tax Credit

Under the CARES Act, this credit is generally available to employers whose operations have been fully or partially suspended because of COVID-19 related governmental shutdown orders or whose gross receipts fell below 50% for the same quarter in 2019.

Employers whose workforce exceed 100 employees (based on the average number of full-time employees in 2019) may claim the credit for employees who have been furloughed or had their hours reduced because of the reasons noted. If an employer has 100 or fewer employees, it can qualify for the credit regardless of whether there have been furloughs or hour reductions.

The credit equals 50% of up to \$10,000 in compensation, including health care benefits, paid to an eligible employee after March 12, 2020, through December 31, 2020.

### Paid Leave Credit

The Families First Coronavirus Response Act generally requires employers with fewer than 500 employees to provide paid leave in certain COVID-19 situations. Covered employers generally can take a federal payroll tax credit for 100% of the family leave wages they pay in each quarter, up to \$511 per day for leave taken for the employee's own illness or quarantine and \$200 for leaves taken to care for others.

### Payroll Deferral

The CARES Act enables employers to delay payment of their share (6.2% of wages) of Social Security payroll tax. Businesses can now pay the tax over the next two years, with the first half due by December 31, 2021, and the second half due by December 31, 2022.

### Summary

Year end tax planning is more important than ever this year as quick actions are required to claim generous tax refund under the CARES Act.

If you need more information, please contact Basil Punit, Partner, U.S. Taxation for more information.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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