TAXTALK

2021 YEAR END TAX PLANNING FOR CANADIAN BUSINESSES AND INDIVIDUALS WITH OPERATIONS AND FILINGS IN THE U.S.

This year proved to be challenging in the U.S. as practitioners continue to work through the various stimulus programs and changes in the tax rules and tax deadlines for federal and state returns. Highlighted below are the key U.S. federal tax considerations for 2021 year end planning for Canadian businesses with operations in the U.S.

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. If you own a small business, the bonus tax depreciation and expensing of capital asset purchases (Section 179 - see below) are the most important tax deductions you need to be familiar with in 2021. These deductions allow you to deduct all or part of the cost of equipment and other qualified assets that are purchased or financed and put into place before December 31, 2021.

Section 179 Expensing

For 2021, businesses can elect to expense (deduct immediately) the entire cost of new and used assets, such as equipment and furniture (Qualified Property – see below) up to a maximum of U.S. $1,050,000 for the first $2,620,000 of property placed in service by December 31, 2021. Note that the Section 179 deduction cannot exceed net taxable business income and create a tax loss for the year. The deduction is phased out dollar for dollar on amounts exceeding the $2,620,000 threshold and eliminated above amounts exceeding $3,670,000 for tax years beginning in 2021.

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 and 0 rate will apply in 2027 and later years.

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.

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 new and used property.

Control the Timing of Income and Deductions to your Tax Advantage

Business taxpayers may face potential tax rate increases in 2022 under the Biden administration's tax proposals. Under these proposals, the top corporate income tax rate will increase from the current 21% to 26.5% in 2022. If the rate increase becomes law in 2022, a taxpayer can realize permanent cash tax savings of 5.5% by accelerating income into the lower taxed 2021 year or, conversely, by deferring deductions until 2022 to offset higher taxed income in that year.

Based on the above, smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it. Also 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 in the loss year, which is usually beneficial. For example, there will be no cash tax in the current year by virtue of the tax loss and your company will get a tax benefit when those losses are carried forward to offset taxable income in future year(s).

Net Operating Losses (NOL)

The changes to the NOL over the last few years have been numerous. The 2017 Tax Cuts and Jobs Act (TCJA) made significant changes to the treatment of NOLs effective as of January 1, 2018. The changes were generally unfavourable for taxpayers by removing the two-year carryback option and allowing NOLs to offset only 80% of taxable income when carried forward. TCJA removed the 20-year limit on NOL carryovers to make them indefinite.

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) that was enacted in March 2020 in response to the pandemic, altered the NOL rules to help affected taxpayers. Under the CARES Act, NOLs arising in years beginning after December 31, 2017 and before January 1, 2021 (i.e. NOLs incurred in 2018, 2019 and 2020 taxation years) could have been carried back to each of the five years preceding the year of the loss to claim refunds of taxes in those years.(100% of taxable in the carryback years).

In 2021 and all subsequent years, we revert to the TCJA treatment of NOLs for tax years beginning after December 31, 2021, businesses that incur an NOL will only be allowed to carry the loss forward indefinitely to be used in future years. While these losses can be carried indefinitely, they can only be used to offset 80% of taxable income of the business.

Business Interest Expense Limitation

The TCJA applicable for tax years beginning after December 31, 2017, created a new provision for the potential business interest disallowance limitation. For each tax year, businesses are required to compute their adjusted taxable income to determine their eligibility to deduct business interest expense paid during the year. The deductible business expense was limited to 30% of the computed adjusted taxable income, and the computation for adjusted taxable income included an addback for tax depreciation and amortization. For tax years beginning after December 31, 2021, the addback for depreciation and amortization will no longer be included in the computation of adjusted taxable income. This change in the computation of adjusted taxable income may result in businesses having more interest disallowed for tax purposes.

Research and Development (R & D)

For tax years beginning after December 31, 2021, R & D costs must be capitalized and amortized. R & D costs incurred in the U.S. will have an amortization period of five years, while those costs incurred outside the U.S. will have an amortization period of 15 years. This tax treatment is different from the way businesses currently account for these costs, as businesses can either deduct these costs or choose to capitalize and amortize these costs.

Note, that there is a provision in the budget reconciliation bill before the U.S. House and Senate that would delay the effective date of the R & D capitalization and amortization requirement to taxable years beginning after December 31, 2025.

Employee Retention Credit (ERC)

The ERC was enacted with the passage of the CARES Act in 2020. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 extended the ERC to apply to wages paid from January 1, 2021, through June 30, 2021, and the American Rescue Plan Act of 2021 further extended the ERC to apply to wages paid from July 1, 2021, through December 31, 2021. There were a number of modifications to the ERC that will apply to wages paid in 2021, including which businesses are eligible for credit as well as the amount of the credit.

To qualify for the credit for 2021 tax year, you must meet the definition of an eligible employer. Eligible employers can claim a credit equal to 70% of qualified wages up to a maximum of $10,000 per employee per quarter. This means that the maximum credit for one employee could total $28,000 for calendar year 2021.

The credit is claimed on your payroll remittances (Form 941).

Full Deduction for Business Meals

The “Consolidated Appropriations Act, 2021” (CAA 2021), provides for a 100% deduction for business meals provided by a restaurant and is applicable for 2021 and 2022. This is an increase from the 50% deduction limit for taxation years before 2021. In order to get the 100 % deduction the expenses must be paid or incurred during calendar year 2021 or 2022 for food and beverages provided by a restaurant. It appears that this expanded deduction is intended to benefit the restaurant industry which suffered significant loss of revenues during the pandemic lock downs in 2020 and 2021.

Summary

Year end tax planning is more important in 2021 because of the potential increase in the corporate income tax rates in 2022 and subsequent years. Smart timing of income and deductions could result in cash savings in 2021.

We Can Help

Your MG advisor can help you review your personal or business tax situation and help you decide which steps you can take before the year end to help you with the taxes you will pay for 2021.

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.

Offices: First Canadian Place
100 King Street West, Suite 5700
Toronto, Ontario M5X 1C7
Phone: 416-362-0515

1900 Minnesota Court, Suite 116
Mississauga, Ontario L5N 3C9
Phone: 905-451-4788
Fax: 905-451-3299

TaxTalk is prepared by our Tax Group (taxtalk@mgca.com). Please visit our web site at www.mgca.com.

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