Tax planning for businesses in a troubled economy

While the tax law cannot exactly make lemonade out of the lemons produced by a bad economy, it can help many businesses prevent a bad situation from becoming worse. This article suggests several tax strategies that can help businesses better deal with an economic downturn.

We generally take for granted that tax deductions are always advantageous by improving cash flow, that any business operating losses are temporary, and that bills will be paid, investments will pan out, and loans and mortgages will be repaid.

But as we have discovered in the last year, the economy may turn expectations upside down. No matter how well run, a business may be “distressed.” What does a company do when it has losses or when customers can’t pay bills? Knowing how to use tax losses more effectively can be an important tactic.

The first order of business in getting a handle on business losses is to measure them properly and most advantageously. One item on any business’ short list should be to evaluate whether the business is using the right tax year, both to conform to Internal Revenue Service guidelines and to consistently produce the lowest tax liability.

Care should be taken, however, in not electing a tax year that may produce a lower tax during hard times or a start-up period, but then may box the business into a disadvantageous position later. While many initial accounting periods do not require IRS consent to adopt, changing periods later may not be so easy, requiring justification that does not necessarily speak to tax savings.

Another issue that goes directly toward measurement of losses is determining what method of accounting is required and, if there are options, which method cash or accrual, or a special variation is most advantageous to a particular business. Depending on the method used, the business’ reported income (or loss) will vary. The cash method looks at actual payments and receipts. The accrual method looks at the time when property was bought or sold and the time when services were performed.

A loss, therefore, is deductible in the year paid or incurred, depending on the method of accounting. Since a tax loss is a component of both taxable income and deductions, a bad economy in which payments are made late can cut both ways: The cash basis allows a business not to recognize income until a customer actually pays, while it also means delaying expense deductions until the business pays its own bills.

A trade or business has a net operating loss when its deductions exceed its taxable income. The NOL is derived from the normal income tax deductions that the business takes. It is not a freestanding deduction; it cannot be used to justify a deduction that is not otherwise allowed by the Tax Code.

The treatment of the NOL depends on whether the business is operated through a regular corporation (which is entitled to deduct its own NOLs) or a “flow-through” such as an S corp, partnership, or a non-tax entity. The latter includes a disregarded entity such as single-owner limited liability company that elects not to be a corporation. It also includes an individual who operates the trade or business as an unincorporated proprietorship.

Generally, an NOL can be carried back two years and carries forward 20 years the carryover period whether owned on the corporation-entity level or by its owners via pass-through status. The first year of the carryover period is the year after the year of the NOL. The period is determined based on the year the NOL arises; thus, it becomes important to determine the correct year in which gross income is recognized and deductions are taken.

For NOLs from the years ending in 2001 and 2002, the carryback period was five years. While proponents of a second Economic Recovery Tax Act are pressing Congress for a three-to-five year carryback to allow a quick cash infusion into many businesses through refunds for the 2003-2005 boom years, the fate of that proposal remains uncertain at press time.

A handful of special extended carryback periods apply, however, and it is worthwhile to check whether a business qualifies. For example, a 10-year carryback is available for certain classes of liability losses: product liability, workplace liabilities and environmental remediation. For presidentially declared disasters and losses from fire, storm, shipwreck, other casualty and theft, the carryback period is three years if taken by a corporation that is a small business ($5 million or less in gross receipts) or engaged in farming.

In all cases, the carryback and carryover periods cannot be extended. However, it may be possible to use an expiring NOL by accelerating the recognition of income. Dragging out the entire back of tricks used to accelerate income and postpone deductions, or vice versa, for year-end tax purposes often works just as well for timing NOL recognition. Tax techniques both traditional ones and those unique to 2008 are among those most valuable to many businesses in economic distress.

Regardless of the tax year and the method of accounting chosen, the taxpayers will have some discretion in connection with when to recognize income or deductions, gains or losses. This flexibility can be enhanced through techniques of deferral and acceleration. These techniques can alter tax liability for several years, without affecting overall tax liability for the long term.

For example, the use of accelerated depreciation will reduce income in an earlier year but increase income in a subsequent year as a consequence of later depreciation not being as large. However, the overall depreciation that can be taken does not change.

The use of deferral and acceleration depends on whether the taxpayers want to modify the amount of income or loss shown on the return for a particular year. If the taxpayer is likely to have losses for the year anyway, accelerating a deduction may not be helpful. On the other hand, the deduction may create or increase an NOL. If this can be carried back to an earlier, profitable tax year, it can result in an immediate refund. Likewise, income can be deferred or accelerated. A seller, for example, may use the installment method of accounting to defer income and recognize it only as payments are made over the term of the installment obligation.

- **2008 bonus depreciation.** Bonus depreciation is an additional first-year depreciation deduction above the amount allowed under the general methods approved in the Tax Code. Bonus depreciation is computed before regular depreciation is taken, but after any Code Sec. 179 expensing.

The Economic Stimulus Act of 2008 re-instituted 50 percent bonus depreciation, previously available for the two years immediately following the 9/11 attacks. Current bonus depreciation is available solely for qualifying property place in service for the 2008 calendar year. Taxpayers can elect to take bonus depreciation, and then apply one of the conventional depreciation methods to the remaining basis of the property.

Unlike first-year expensing, bonus depreciation is not phased out as investment in qualifying property increases. Thus, bonus depreciation is particularly valuable to larger companies operating at a profit. (The places-in-service date is extended through 2009 for property with a recovery period of 10 years or longer, transportation property and certain aircraft.)

- **2008 first-year expensing.** Under Code Sec. 179, many businesses can initially write off a substantial portion of the cost of property, regardless of what the depreciation rules require.

Initially the write-off was set at $25,000. Congress then raised the ceiling to $100,000. Indexed for inflation, this rose to $128,000 for 2008. The Economic Stimulus Act of 2008 raised the ceiling to $250,000, but only for 2008. After 2008, the ceiling drops to $125,000 for 2009 and 2010, indexed for inflation, and $25,000 for subsequent years, with no inflation adjustment.

Unlike 2008 bonus depreciation, enhanced expensing under the act applies, “in case of any taxable year beginning in 2008,” which includes fiscal tax years that run over to 2009.

- **Interaction of depreciation and expensing.** To maximize deductions, it is recommended that taxpayers apply first-year expensing to the asset(s) with the longest write-off period, and apply other expensing or depreciation to assets with shorter write-off periods. Also, as a general rule of thumb, taxpayers should apply bonus depreciation after taking Code Sec. 179 expensing but before taking regular depreciation.

In making its selections, a business should also determine whether it is located in a state that follows the Stimulus Act or that has chosen not to allow increased expensing by decoupling from the federal law. It also should consider whether accelerating deductions through these provisions will generate presently useless NOLs that may well expire as carryforwards only many years in the future.

The recently enacted Housing and Economic Recovery Act of 2008 allows corporations to temporarily claim a limited amount of unused Alternative Minimum Tax and research credits attributable to tax years beginning before Jan. 1, 2006, in lieu of taking 50 percent bonus depreciation under the Economic Stimulus Act of 2008.

Unlike bonus depreciation, the amount of the accelerated AMT or research credit (called the “accelerated credit election”) is refundable. This can allow for an immediate cash infusion for those businesses that qualify, since it allows them to receive an immediately refundable credit in lieu of bonus depreciation that would give them no immediate cash benefit if NOL carrybacks otherwise created by taking bonus depreciation could not be fully used.

The election to forego bonus depreciation is made on an asset-by-asset basis. Not all property that may qualify for bonus depreciation, however, qualifies for the election. Bonus depreciation applies to all depreciable property acquired hand placed in service in 2008, while the election only applies to property placed in service under a shorter period of time: after March 31, 2008, and before 2009.

Under Section. 53, a corporation required to pay AMT for one year can claim a minimum tax credit in any later year in which it has no AMT liability. This credit is limited to the excess of the corporation's regular tax liability over its tentative minimum tax liability. Under Code Section. 38(c), the limit on the research credit component of the general business credit is generally equal to regular tax exceeding tentative minimum tax.

The R&D credit or AMT credit limitation under the election is increased by an amount equal to 20 percent of the bonus depreciation amount for certain eligible qualified property that would be claimed if an election were not made. The actual calculation has several technical steps, and deciding whether the election is favorable comes down to doing the math to determine whether cash now is worth getting slightly more value out of depreciation deductions in the future.

The business must first carryback an NOL to the earliest year available. Any excess NOL can be used in the succeeding year. A single NOL may be carried to multiple years, if the entire NOL was not used in the first year. The taxpayer can elect to waive the carryback period and begin to carry the losses forward. This election is irrevocable and, therefore, takes a certain degree of optimism in the business. The special extended five and 10 year carryback periods can also be waived. If the NOL occurs in the corporation's first year, there is no carryback period.

Tax liability for the carryover year is calculated using the full NOL before any reductions. This rule may be particularly important to a business whose creditors forgive a portion of a debt over the course of the year. There, NOLs are fully usable in the year that a debt is discharged before being lowered under any Code Sec. 108 tax attribute reduction rule for forgiveness-of-indebtedness income.

The NOL deduction itself if not allowed when computing the year's NOL. A contrary rule would negate the limits on the carryover of the NOL and could allow NOLs to be counted twice. If a C corporation becomes an S corporation, NOLs from the C corporation years cannot carry over to the S corporation years.

Net income remains better than net losses; the tax law cannot change that result for any business. Nevertheless, business success is not necessarily measured by the artificially created periods within which net income or losses may be calculated. This realty is recognized at least in part by the tax law through the availability of depreciation schedules, accrual accounting, capital loss carryforwards and net operating loss carrybacks and carryforwards.

This recognition, however, is itself imperfect, creating definite timelines within which certain tax benefits including loss deductions must be taken. The businesses that are most adept at working with these rules clearly have an edge, in good times and bad.