Contents
3 Introduction: Switch-hitting
4 Tax law changes: What's new this year?
6 Individual taxes on business income
9 Business taxes: The entity view
11 Incentives: Getting the credit you deserve
14 Buying and selling your business
16 Compensation and benefit plans
Introduction: Switch-hitting

The tax code is a double-edged sword for privately held businesses. On one hand, the code offers significant benefits to privately held businesses that public companies cannot enjoy. On the other, most privately held businesses have two levels of tax rules to worry about: their entity-level requirements and the tax burden on their individual owners.

Fortunately, it’s the ideal time for tax planning for privately held businesses. Congress finally made permanent some of the most beneficial temporary business provisions and extended many others for five years. You can now look well into the future and use long-term tax planning strategies without worrying if some of the most important business provisions will be re-enacted.

It’s time to start thinking further ahead. If you wait until your filing deadline to think about taxes, it’s too late. Our Year-End Tax Guide for Privately Held Businesses is your reference tool for understanding some of the most important tax issues facing privately held businesses. We’ve organized your planning considerations into easy-to-understand sections covering individual taxes applying to business owners, choosing an entity, credits and incentives, buying and selling your business, and benefit plans. To make tax planning easy, we’ve also included:

- Comprehensive tables that lay out important tax rules, limits and rates
- Explanations of many important new tax law changes
- Planning tips you can use right now

But remember, this guide can’t cover all possible strategies, and tax law changes are always possible after this guide is published. Check for the most up-to-date tax rules and regulations before making any tax decisions. Contact your local Grant Thornton LLP professional to discuss your situation or for an update on tax legislation.
Finally, some good news out of Washington. Lawmakers gave businesses a tremendous gift at the end of last year by making many of the tax code’s most popular business provisions permanent. The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) made 22 temporary tax incentives permanent, including the following popular business provisions:

- Research credit (with improvements!)
- Increased Section 179 expensing limits
- Reduced five-year holding period for S corporation built-in gains
- 15-year life for qualified leasehold, retail and restaurant improvements
- 100% exclusion from gain for qualified small business stock

In addition, the PATH Act extended the new markets tax credit and bonus depreciation for five years, though the bonus depreciation percentage is scheduled to decline. But it wasn’t all good news. Congress also enacted strict new partnership audit rules and adjusted several filing deadlines.

R&D credit boost
The PATH Act not only made the R&D credit permanent for the first time in its 30-year history, but it enhanced it in ways that make it even more valuable for entrepreneurial privately held businesses.

The R&D credit has historically provided little incentive for startup businesses because it provides no value until the company is turning a profit. Beginning this year, the credit is now partially refundable against payroll taxes. Businesses with less than $5 million in annual gross receipts, and no gross receipts outside of the last five years, can claim up to $250,000 in R&D credit against payroll taxes. Larger companies that are starting to become profitable may also be able to take advantage of the credit for the first time under a separate change. Many companies starting to generate income often have net operating losses from past years that push them into the alternative minimum tax (AMT), which limits their ability to benefit from the R&D credit. Privately held businesses with no more than $50 million in annual gross receipts can now claim the R&D credit against the AMT.
**Bonus depreciation**

Bonus depreciation has become a business staple during the economic recovery, allowing businesses to deduct half the cost of eligible equipment the year it is placed in service, with the rest depreciated using normal rules. The PATH Act extended this popular temporary provision, but with a big caveat. Property placed in service in 2016 and 2017 is still eligible for the full 50% bonus depreciation amount, but the depreciation rate is scheduled to decline to 40% in 2018 and 30% in 2019, before disappearing in 2020.

Congress has extended this popular provision many times in the past and will likely face intense pressure to increase the percentages in 2018 and 2019, and extend it to cover 2020 and beyond. Check with a Grant Thornton professional as 2018 nears to see if legislation has changed the outlook. In the meantime, Congress made a new kind of building improvement eligible for bonus depreciation in 2016: qualified improvement property. Previously, only qualified improvements made to leased property were eligible, and the improvements had to have been made more than three years after the building was placed in service. Congress dropped these requirements beginning this year, so you can deduct half the cost of qualified building improvements in 2016 even if you’re not leasing the space and the building is less than three years old.

**Section 179 expensing**

Section 179 provides an even more valuable depreciation incentive for privately held businesses that place less than $2,010,000 of new business equipment into service this year. Under Section 179, businesses can now expense up to $500,000 in new equipment. This limit has been made permanent and indexed to inflation. The $2 million phase-out limit was also made permanent and has already been adjusted to $2,010,000 for inflation. The $500,000 expensing limit is reduced on a dollar-for-dollar basis by the total amount by which eligible equipment placed in service exceeds $2,010,000. So if you’ve placed $2,510,000 in eligible property in service in 2016, you won’t benefit from Section 179.

**New filing deadlines**

C corporations and partnerships have had their filing deadlines essentially swapped beginning with 2016 returns (due in 2017). Partnership returns will be due three-and-a-half months after the close of the year, or March 15, instead of April 15, for calendar-year partnerships. C corporation deadlines are moving in the opposite direction and won’t be due until four-and-a-half months after the year close, or April 15, instead of March 15, for calendar-year C corporations. Congress enacted the deadline changes in an attempt to stagger the filing deadlines so that flow-through entities such as trusts, S corporations and partnerships are all due on March 15 while taxpaying entities like individuals and C corporations are due a month later, on April 15 (April 17 in 2017 because April 15 falls on a Saturday).

The deadlines are a little more complicated for extended returns. Generally, all returns except for those for trusts and some C corporations are now eligible for six-month extensions, meaning the extended deadline for partnership returns remains Sept. 15. Calendar year C corporations will receive only five-month extensions until 2026; so for now, their extended deadline also remains Sept. 15. There are special rules for C corporations with a fiscal year ending June 30. In addition, trusts are still permitted only a five-month extension.

**New partnership audit rules**

Lawmakers enacted legislation late last year that replaces the current partnership audit procedures with a new process that dramatically increases partnerships’ payment and reporting responsibilities. Many privately held businesses are organized as partnerships, and the new audit rules are designed to shift the burden for actually assessing tax after a partnership-level adjustment from the IRS to the taxpayer. Only partnerships with 100 or fewer partners can opt out of the new rules, and this can be done only if their partners are individuals, C corporations, estates of deceased partners or S corporations (with each shareholder counting toward the 100-partner limit). Partnerships that cannot elect out face new responsibilities after an adjustment made after an IRS exam. The partnership will generally be required to pay any tax resulting from the adjustment at the partnership level or issue statements to all partners, passing the adjustment on to them. The new rules also come with many other new restrictions on administrative proceedings and partner participation. The legislation is generally not effective until partnership tax years beginning in 2018 or later, but all affected partnerships should evaluate their partnership and operating agreements now. The partnership’s designated representative has sweeping authority to make decisions on behalf of the partnership, and many of the elections can shift the economic burden of adjustments to different partners in different ways. It’s particularly important to understand how adjustments can affect partners that have previously exited or been newly admitted to the partnership depending on the election.
Individual taxes on business income

Individual taxes have everything to do with privately held business planning. Privately held businesses are typically more sensitive than public companies to their owners’ tax burdens. In fact, privately held businesses such as S corporations and partnerships generally aren’t taxed at the entity level. Instead, the income, credits and deductions of these businesses are passed through the entity and taken only on the individual returns of their owners. Even private C corporation income, which is first taxed at the entity level, is eventually taxed a second time at the individual level when distributed to owners.

We’ll discuss entity choice in the next section, but the unique nature of privately held businesses means tax planning should start with understanding how the business income will be taxed at the individual-owner level. Most income is taxed as ordinary income. Ordinary income includes your salary and bonuses for working in your business, any self-employment income and almost all business income that flows through to you, including rent, royalties, interest and general business income on Line 1 of your business’s tax return. In general, only qualified dividends and capital gains from assets held more than one year are subject to special lower rates.

The top rate on ordinary income is 39.6%, while the top rate on long-term capital gains and qualifying dividends is 20%. These figures don’t include employment tax and net investment income (NII) tax. As our tables show, your income is subject to different rates as you climb the tax brackets. The top tax rate that applies to you is often called your marginal tax rate, or the rate you would pay on an additional dollar of income. We’ve included tables with the full tax brackets for investment and ordinary income.

### Individual ordinary income tax rates in 2016

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$1+</td>
<td>$1+</td>
<td>$1+</td>
<td>$1+</td>
<td>$1+</td>
<td>$1+</td>
<td>$1+</td>
<td>$1+</td>
</tr>
<tr>
<td>15%</td>
<td>$9,226+</td>
<td>$9,276+</td>
<td>$13,151+</td>
<td>$13,251+</td>
<td>$18,451+</td>
<td>$18,551+</td>
<td>$9,226+</td>
<td>$9,276+</td>
</tr>
<tr>
<td>25%</td>
<td>$37,451+</td>
<td>$37,651+</td>
<td>$50,201+</td>
<td>$50,401+</td>
<td>$74,901+</td>
<td>$75,301+</td>
<td>$37,451+</td>
<td>$37,651+</td>
</tr>
<tr>
<td>28%</td>
<td>$90,751+</td>
<td>$91,151+</td>
<td>$129,601+</td>
<td>$130,151+</td>
<td>$151,201+</td>
<td>$150,901+</td>
<td>$75,601+</td>
<td>$75,951+</td>
</tr>
<tr>
<td>33%</td>
<td>$189,301+</td>
<td>$190,151+</td>
<td>$209,851+</td>
<td>$210,801+</td>
<td>$230,451+</td>
<td>$231,451+</td>
<td>$115,226+</td>
<td>$115,726+</td>
</tr>
<tr>
<td>35%</td>
<td>$411,501+</td>
<td>$413,351+</td>
<td>$411,501+</td>
<td>$413,351+</td>
<td>$411,501+</td>
<td>$413,351+</td>
<td>$205,751+</td>
<td>$206,676+</td>
</tr>
<tr>
<td>39.6%</td>
<td>$413,201+</td>
<td>$415,051+</td>
<td>$439,001+</td>
<td>$441,001+</td>
<td>$464,851+</td>
<td>$466,951+</td>
<td>$232,426+</td>
<td>$233,476+</td>
</tr>
</tbody>
</table>
Hidden taxes

Unfortunately, the tax brackets for ordinary income don’t tell the whole story. Your effective marginal rate may differ significantly from the nominal rate in your top tax bracket. Many high-income taxpayers who own their own businesses can be stuck paying the alternative minimum tax (AMT) if they have common triggers like high state and local taxes, investment advisory fees, accelerated depreciation adjustments and related gain or loss differences on disposition. High-income individuals can also end up paying more tax for every additional dollar of additional income because of the personal exemption phaseout (PEP) and “Pease” phaseout of itemized deductions. Both of these phaseouts begin at an adjusted gross income level of $259,400 (single) or $311,300 (joint) in 2016.

Employment taxes

Business owners should give special consideration to employment and NII taxes. Understanding which tax, if either, applies to your business income can significantly affect your tax bill.

First look at employment taxes. The taxes on earned income that are used to fund Social Security and Medicare are called employment taxes because they apply to salaries, wages and bonuses. The Social Security tax on earned income is capped ($118,500 in income in 2016), but the Medicare tax has no limit. Both employees and employers pay Medicare tax at a 1.45% rate until earned income reaches $200,000 (single) or $250,000 (joint), and then the employee rate share increases to 2.35%.

The business income from sole proprietors and partners is generally self-employment income (there are exceptions), meaning they pay both the employee and employer share of Medicare tax. You take an above-the-line deduction for the employer portion of self-employment tax. Owners of C corporations and S corporations don’t pay employment or self-employment taxes on any business income unless it is salary (whether or not distributed), but the salary taken must be reasonable.

<table>
<thead>
<tr>
<th>Individual capital gains and dividends tax rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Your top ordinary income tax bracket</td>
</tr>
<tr>
<td>10% to 15%</td>
</tr>
<tr>
<td>15% to 35%</td>
</tr>
<tr>
<td>39.6%</td>
</tr>
</tbody>
</table>

Planning tip

Perform a reasonable compensation study

If you own a corporation and work in the business, consider your salary carefully. S corporation owners typically benefit from a low salary because income that isn't salary isn't generally subject to employment tax. This income typically won't be subject to NII tax either unless you are a passive owner. On the other hand, owners of a C corporation usually benefit from a higher salary and lower distributions. You will pay employment tax on the salary, but the salary is deductible at the corporate level so earnings paid out as salary are taxed only once. Earnings that are instead distributed as dividends are taxed twice, once at the corporate level and again at the individual level.

The IRS understands the benefits taxpayers can receive by adjusting their salaries and will challenge the salary amount if the IRS deems it unreasonable. You may want to consider using a reasonable compensation analysis to ensure your salary meets IRS standards. The factors courts use to determine reasonable compensation depends on the court jurisdiction, but the IRS will typically look to training and experience, duties and responsibilities, time and effort devoted to the business, dividend history, employee payments and bonuses, the amount comparable businesses pay for similar services, compensation agreements, and the use of a bonus formula to determine compensation.
Net investment income tax
The tax on NII was added in 2010 to expand the reach of the Medicare tax beyond earned income and create an equivalent tax of 3.8% on investment income. It applies to NII to the extent adjusted gross income (AGI) exceeds $200,000 (single) or $250,000 (joint). NII includes rent, royalties, interest, dividends and annuities. There is an exception if the income is derived in the ordinary course of a trade or business in which you are not passive. On the other hand, all income from businesses in which you are passive is NII regardless of the type of income. In addition, income from trading in financial instruments is always NII.

It can be tricky to figure out how employment and NII taxes fit. If you have to pay employment or self-employment tax on a stream of income, it is not included in NII. You never have to pay both taxes on the same income. The rules do not allow you to choose one or another, but in general, self-employment taxes are preferable because of the deduction on the employer share of tax.

Most income that isn’t subject to employment taxes is included in NII, but not all. There may be income that isn’t subject to employment or NII tax. An S corporation owner who is not passive in the business will typically pay employment taxes on salary only and will not owe self-employment tax or NII tax on the rest of the S corporation’s operating income. In some cases, a limited partner who participates in the partnership’s business may also escape both NII and employment tax on the partnership’s operating income. One key is to avoid passive characterization.

Planning tip
Group your business activities
Once you’ve exceeded the AGI threshold, the tax on NII applies to all passive trade or business income, regardless of its type. To avoid being passive, you must generally “materially participate” or “significantly participate” in the activity. These tests can be hard to satisfy if you’re involved in several different privately held entities.

Fortunately, if you have more than one business activity, you may be able to group these activities in order to meet the participation requirements and save yourself from NII tax. But there are limits. You generally cannot make a new grouping election unless you have a material change in facts, such as launching a new business activity or selling another off, or if you will be subject to the tax on NII for the first time.

If you are eligible for a new grouping election, there is considerable flexibility in the rules. Generally, the activities must represent an “appropriate economic unit,” and the regulations acknowledge there may be multiple acceptable ways to group a taxpayer’s activities. The regulations list five key factors the IRS will use to determine whether activities can be grouped:

• Similarities and differences in the trades or businesses
• Extent of common control
• Extent of common ownership
• Geographic location
• Interdependence between or among activities
Entrepreneurship comes with its own burden, especially on the tax side. But for privately held businesses, there are many benefits. You have opportunities for structuring and ownership that are unavailable to public companies. So the key to planning for and managing your business’s tax burden starts with understanding business tax structures.

Choosing an entity: Understanding business tax rates

Business structures generally fall into two categories: C corporations and pass-through entities. C corporations are taxed as separate entities from their shareholders and offer shareholders limited liability protection. Pass-through entities effectively “pass through” taxation to owners, so the business income is generally taxed only at the owner level. Some pass-through entities don’t provide limited liability protection, while S corporations, limited partnerships, limited liability partnerships and limited liability companies generally do.

There are many considerations in choosing a structure, but one of the biggest differences is that C corporations endure two levels of taxation. A C corporation’s income is taxed first at the corporate level and again at the shareholder level when it is distributed to shareholders as dividends. Generally, the income from pass-through entities is not taxed at the entity level and is taxed only at the owner level.

So how do the tax rates on pass-through entities and C corporations compare? Individual owners of pass-through businesses pay tax on all income, regardless of whether it is distributed, so the top rate on pass-through entities is 39.6% if you are not passive (excluding any self-employment taxes) and 43.4% if you are. That’s higher than the 35% corporate rate, but only if no corporate earnings are distributed. If all C corporation earnings are distributed, the combined rate of corporate and dividend tax is actually 50.5%. See our table for a comparison of the top rates of pass-through entities and C corporations, depending on how much of the earnings are distributed.

If you plan on reinvesting your earnings in the business without distributing it, the top C corporation rate of 35% can be very appealing. But remember, unless you plan to die without receiving a dividend or selling the stock, the earnings will eventually need to be distributed by the business. So the single level of tax enjoyed by pass-through entities still provides a distinct advantage, especially when you exit the business.

<table>
<thead>
<tr>
<th>Type of business income</th>
<th>Top rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pass-through: Active</td>
<td>39.6%</td>
</tr>
<tr>
<td>Pass-through: Passive</td>
<td>43.4%</td>
</tr>
<tr>
<td>C corporation: Distribute all earnings</td>
<td>50.5%</td>
</tr>
<tr>
<td>C corporation: Distribute half of earnings</td>
<td>42.7%</td>
</tr>
<tr>
<td>C corporation: Retain all earnings</td>
<td>35%</td>
</tr>
</tbody>
</table>

Rate comparison by entity

Includes 3.8% Medicare tax on investment income, but not Federal Insurance Contributions Act (FICA) or self-employment tax on earned income.
Reduced holding period after S corporation conversion made permanent

The benefit of a single level of taxation is so significant that any privately held corporation should at least consider the advantages of converting to or organizing as an S corporation if eligible. A conversion is made with a simple election for tax purposes and generally doesn’t affect the liability protection of a corporation.

One of the downsides of converting from a C corporation to an S corporation is that the corporation generally must pay a tax on the built-in gain (BIG) from any appreciated assets held at the time of conversion if it sells the assets within the BIG holding period. The good news is that Congress just made permanent a reduction in this holding period from 10 years to five years. A conversion now could save you in the long run and even allow the company’s assets to be sold without a double tax in as few as five years.

The corporation must satisfy many requirements to qualify for S corporation status. An S corporation can have no more than 100 shareholders, can have only a single class of stock issued and outstanding, and can be owned by only individuals and certain other eligible shareholders. The definition of an eligible shareholder has expanded over the years to include estates and certain trusts and tax-exempt organizations. Members of a family can also be considered a single shareholder.
Incentives: Getting the credit you deserve

Congress has loaded the tax code with incentives meant to encourage specific activities. These incentives can be a powerful source of funding, but many small or growing privately held business owners believe it’s too much trouble to apply all the rules to see if the business qualifies. This is a big mistake. Sometimes only minimal effort is needed to unlock significant tax savings.

**Tax law change alert**

**Business credits and incentives made permanent**

Congress finally gave businesses certainty on many of the most important business tax incentives. For years, Congress repeatedly extended scores of incentives on a temporary basis. Now, however, the PATH Act has made some of the most important incentives permanent, including the following:

- Research credit (with improvements)
- Increased Section 179 expensing limits
- Reduced five-year holding period for S corporation built-in gains
- 15-year life for qualified leasehold, retail and restaurant improvements
- 100% exclusion from gain for Section 1202 qualified small-business stock

You can now perform your business planning with more confidence and a better understanding of the tax treatment of future investments.

**R&D tax credit**

The R&D credit was first enacted as a temporary incentive in 1981 to encourage U.S. taxpayers to increase R&D activities and expenditures. It was then extended 16 times before finally being made permanent, all the while growing into one of the most widely used and generous tax incentives. Unfortunately, many privately held companies still believe it is too costly to analyze whether they can qualify for the credit and comply with the documentation rules. It is not. The following list outlines common misconceptions and explanations of why they don’t hold water.

- **It’s too complex to calculate and comply** — It’s true that the traditional research credit can come with burdensome record-keeping hurdles that require you to establish a decades-long historical baseline for research spending. But the alternative simplified credit rate is now up to 14%, and it offers a much easier calculation process that relies on only three years of data. Claiming the credit is likely easier than you think.

- **There’s no benefit if I’m suffering losses or paying AMT** — This is simply no longer true. Startups or loss companies no longer need to wait for profit to benefit from the R&D credit. Beginning in 2016, the credit is partially refundable against payroll taxes. Businesses with less than $5 million in annual gross receipts and no gross receipts outside of the last five years can claim up to $250,000 in R&D credit against payroll taxes. And if you’re just starting to turn a profit but past losses leave you paying AMT, there’s also new help. Beginning in 2016, privately held businesses with no more than $50 million in annual gross receipts can claim the R&D credit against the AMT.
• **My research isn’t innovative enough** — The Tax Court recently delivered an important opinion in *Suder v. Commissioner* (T.C. Memo 2014-201), offering guidance on what constitutes “qualified research.” The court rejected a common IRS argument and held that the R&D credit tests don’t necessarily require taxpayers to “reinvent the wheel” and that even “routine” research can qualify.

• **My research costs include executive pay** — Owners of many privately held companies are active as executives in the business but also contribute significantly to research. The Tax Court in *Suder* rejected another common IRS argument: that executive pay can never qualify. The court held that 75% of the CEO’s time spent on qualifying R&D was a reasonable allocation.

No matter what your size or industry, there is no excuse for failing to examine whether you qualify for an R&D credit. IRS statistics show that more than half of all credit claims come from companies with less than $10 million in gross receipts and the claims come from industries as diverse as manufacturing and technology to retail and professional services.

**Deduction for production**

The domestic production activities deduction (DPAD) under Section 199 was created in 2004 to encourage U.S. manufacturing. But the statute and guidance defining the type of production that qualifies are broad enough for the deduction to provide a healthy incentive to many different kinds of privately held businesses.

The deduction is generally 9% of your net profit from qualifying activities (except oil and gas production). It can also be limited by wages or by your total taxable income. Qualifying activities extend beyond traditional manufacturing to include:

- The manufacture, production, growth or extraction of tangible personal property, computer software, sound recordings, qualified films and television productions
- The production of electricity, natural gas or potable water
- Construction services, including related engineering and architectural services

There is work involved with allocating income and expenses between qualifying and nonqualifying activities, but it is not as daunting as many businesses fear.

---

**Depreciation appreciation**

Your investments in business equipment and property are big costs, so they also represent one of your biggest deductions. Business owners should always explore whether they are taking advantage of all the rules that provide for faster depreciation.

Most tangible personal property, including everything from computer equipment and office furniture to trucks and heavy machinery, is generally assigned to one of six recovery periods that range from three to 20 years. The recovery periods for real property like buildings are 27.5 years for residential property and 39 years for nonresidential. Separating items with shorter cost recovery lives from commercial building property can have a huge impact on your taxes. It is also important to differentiate repair and maintenance costs that are generally deductible as incurred from the costs of acquiring, producing or improving tangible property, which must be capitalized.

---

**Planning tip**

**Capital cost recovery review**

Commercial real estate is depreciated over nearly 40 years, so one of your biggest opportunities for tax savings might be identifying and reclassifying building assets that can be depreciated using shorter lives.

Many taxpayers assume all costs associated with constructing or substantially remodeling a building must be capitalized and depreciated over 39 years. This is not always true. A cost segregation study can often identify scores of building components that can be segregated and depreciated more quickly.

It is just as important to understand whether any of your business investments qualify as repair or maintenance costs that can be immediately deducted. If the costs are instead considered to be improvements, they must be capitalized. The IRS recently finalized new rules covering this issue, so you may be able to identify costs that can be deducted instead of capitalized. Consider a comprehensive review of your recent projects to determine if there are ways to accelerate your deductions.
Expensing options

The best cost recovery is the ability to deduct equipment in the same year you place it in service. Bonus depreciation allows you to deduct half of the cost of the qualified property you place in service before the end of the year, while the rest is depreciated using normal rules (certain long-production-period property like airplanes have later deadlines for placing property in service). To qualify for bonus depreciation, property must generally have a useful life of 20 or fewer years under the Modified Accelerated Cost Recovery System (MACRS). Property placed in service in 2016 and 2017 is still eligible for the full 50% bonus depreciation amount, but the depreciation rate is scheduled to decline to 40% in 2018 and 30% in 2019, before disappearing in 2020. Congress could amend this provision in the future, so be sure to check back in with a Grant Thornton professional before the end of 2017.

Lawmakers have done even better with Section 179, making permanent and indexing for inflation the higher limits on small business expensing. Under Section 179, you can expense up to $500,000 of equipment for your business in 2016, but this limit is reduced by the amount that all of your Section 179 property placed in service exceeds $2,010,000 million.
Many owners of privately held businesses invest much of their net worth in their business, making retirement a challenge. Others want to make sure their business — or at least the bulk of its value — will be passed to their loved ones without a significant loss to estate taxes. If you’re facing either situation, now is the time to start developing an exit strategy that will reduce the tax consequences.

An exit strategy is a plan for passing on responsibility for running the company, transferring ownership and extracting your money. To pass on your business within the family, you can give away or sell interests. But be sure to consider the gift, estate and generation-skipping transfer tax consequences.

A buy-sell agreement can be a powerful tool. It controls what happens to the business when a specified event occurs, such as an owner’s retirement, disability or death. Buy-sell agreements are complicated by the need to provide the buyer with a means of funding the purchase. Life or disability insurance can often help but can also give rise to several tax and nontax issues and opportunities.

One of the biggest advantages of life insurance as a funding method is that proceeds generally are excluded from the beneficiary’s taxable income. There are exceptions to this, however, so be sure to consult a Grant Thornton tax adviser.

You may also want to consider a management buyout or an employee stock ownership plan (ESOP). An ESOP is a qualified retirement plan created primarily so that employees can purchase your company’s stock. Whether you’re planning for liquidity, looking for a tax-favored loan or supplementing an employee benefit program, an ESOP can offer you many advantages.

**Tax law change alert**

**IRS threatening to curb FLP benefits**

For privately held business owners seeking to pass their business to heirs while still living, a family limited partnership (FLP) can provide for potential steep transfer tax valuation discounts. When you pass an interest in an FLP to a family member, the value of the partnership interest used to calculate the transfer tax implications may be discounted significantly because the underlying assets are subject to restrictions for marketability and control.

However, you can’t set up an FLP just for tax planning purposes, and the IRS has successfully challenged FLPs in which the donor retained the actual or implied right to enjoy the FLP assets or the donor retained the right to control the FLP. Even worse, the IRS has just proposed regulations that seek to gut your ability to take valuation discounts when transferring assets in a family controlled entity (FCE) such as an FLP. If finalized in their current form, the regulations may make it difficult for taxpayers to claim valuation discounts on any FCE or FLP interests at all in the future. The regulations are proposed to be effective on the day they are made final (with some rules effective 30 days after the regulations are final). If you own interests in an FCE or FLP and are considering this strategy, check with a Grant Thornton professional about making transfers before final regulations are issued.
Assess tax consequences when buying or selling

When you do decide to sell your business — or acquire another business — the tax consequences can greatly affect your transaction’s success.

Buyers will be looking for an asset sale so they can use future depreciation or amortization write-offs, assuming the assets have built-in gain. So C corporation owners typically have to either accept a potentially big tax bill on an asset sale or insist on a stock sale, which isn’t as valuable to the buyer and will often reduce the selling price. When selling a pass-through entity, an asset sale generally results in only one layer of tax.

Sellers should also consider whether they prefer a taxable sale or a tax-deferred transfer. The transfer of ownership of a corporation can be tax-deferred if made solely in exchange for stock or securities of the recipient corporation in a qualifying reorganization, but the transaction must comply with strict rules. Although it’s generally better to postpone tax, there are advantages to executing a taxable sale.

- The seller doesn’t have to worry about the quality of buyer stock or other business risks that might come with a tax-deferred sale.
- The buyer benefits by receiving a stepped-up basis in the acquisition’s assets and doesn’t have to deal with the seller as a continuing equity owner, as would happen in a tax-deferred transfer.
- The parties don’t have to meet the stringent technical requirements of a tax-deferred transaction.

A taxable sale may be structured as an installment sale if the buyer lacks sufficient cash or the seller wants to spread the gain over a number of years. Contingent sales prices that allow the seller to continue to benefit from the success of the business are common. But be careful: The installment sale rules create a trap for sellers if the contingency is unlikely to be fulfilled.

It’s essential to plan carefully while the sale is being negotiated. A Grant Thornton tax adviser can help you detect certain traps and find the exit strategy that best suits your needs.

Planning tip
Consider a transaction cost analysis

The fees involved with a complicated transaction can be substantial, so the tax treatment of the costs involved in the purchase and sale of a business is important.

IRS regulations generally require buyers to capitalize transaction costs like investment banking fees, attorneys, accountants, consultants and debt-related fees. The buyer in an asset sale generally adds these costs to the basis of the acquired assets and may be able to depreciate or amortize them. The buyer in a stock sale generally adds the capitalized transaction costs to the basis of the stock and cannot recover them except through another disposition. Fortunately, there are exceptions to capitalization treatment.

For many transactions, the regulations allow “investigatory” costs to be deducted if the acquisition is an expansion of the buyer’s business, or amortized over 15 years if not. A transaction cost analysis can determine which costs can be deducted and amortized based on a variety of factors.

Certain transaction fees are contingent on the success of the transaction, and the deduction of these “success based” fees hinge on complicated rules. Despite the administrative burden of complying with the rules, the tax savings are usually well worth the effort.
Compensation and benefit plans

Your compensation and benefit plans are critical for retaining the top talent needed to be successful. It can be especially difficult for privately held businesses to maintain competitive plans because they typically don’t offer stock-based incentives. Your business might also have too few employees to justify the large-scale retirement and health plans that are costly to administer.

Fortunately, lawmakers understand these challenges and have provided helpful incentives. There are simplified retirement plans that are cheaper to administer and compensation programs that can give your top employees the same benefits as stock incentives.

Planning tip

Consider a phantom stock or performance-based cash plan

There are options for privately held business owners who want to give key employees and managers the benefits of equity ownership without actually giving up any share of their ownership.

Consider a phantom stock plan or a performance-based cash payment plan. They offer opportunities for your employees to share the economic value of an equity interest without the equity itself. A typical phantom stock plan simply credits selected employees with stock units that represent a share of the firm’s stock. Essentially, it is a promise to pay the employee the equivalent of stock value in the future. Alternatively, a stock appreciation right (SAR) can be issued to provide an employee with a payment equal to only the appreciation in the stock value between the date the right is granted and some future date, rather than the full value of the stock.

You can value your stock by a formula or by formal valuation. The phantom stock or SAR can be awarded subject to a vesting schedule, which can be based on performance or time. A phantom stock plan must comply with restrictions on nonqualified deferred compensation (NQDC) plans unless the employee is paid for the value of the phantom stock shortly after vesting. The same holds true for SARs. But unlike phantom stock, SARs can meet certain other conditions that exempt them from the restrictions on NQDC.

Performance-based cash payment plans similarly promise employees a future cash bonus if performance goals are met.
Retirement plans
Because administering 401(k) plans can be so difficult and costly, lawmakers have given small businesses simplified ways to offer themselves and their employees the tax benefits of retirement accounts. A simplified employee pension (SEP) or a savings incentive match plan for employees (SIMPLE) may help if the costs of a more traditional plan are prohibitive based on how many people you employ.

A SIMPLE is limited to businesses with 100 or fewer employees, while a SEP is more broadly available. You adopt a SEP agreement and make contributions directly to traditional IRAs for you and each of your eligible employees. SEPs do not let employees make contributions, but have a high limit on employer contributions. The maximum 2016 contribution is the lesser of $53,000 or 25% of your eligible compensation. Your employees are always 100% vested, and you must typically contribute the same percentage of salary for everyone, including yourself.

SIMPLE plans come in two types: the SIMPLE IRA and the SIMPLE 401(k). Unlike a SEP, a SIMPLE plan allows employees to contribute to their SIMPLE accounts, but only up to $12,500 for 2016, plus a catch-up contribution of $3,000 for employees who are 50 or older. Like a SEP, a SIMPLE plan requires employers to contribute and provides that employee contributions are immediately 100% vested. Employers are required to contribute either dollar-for-dollar matching contributions up to 3% of an employee’s compensation or fixed contributions of 2% of compensation.

Classifying your workers
Many privately held businesses, especially startups or growing companies, rely heavily on independent contractors. The decision to hire a contractor rather than an employee is a business decision, but there may be tax benefits in some cases. For independent contractors, you don’t pay the employer share of payroll taxes, include them in benefit plans or face excise taxes for failure to offer health coverage. The IRS understands that these benefits can cause companies to misclassify employee-employer relationships as independent contractor relationships and has cracked down on the practice.

Misclassifying your workers can be costly. The IRS has an ongoing voluntary reclassification program that allows taxpayers to correct improper classification with greatly reduced back taxes and penalties. If the IRS discovers an issue outside of this program, it is unlikely to be lenient.

To prove the independent contractor relationship, documentation is imperative. You need to establish detailed policies, procedures and systems that employees responsible for hiring contractors can easily understand. To help establish a solid foundation for classifying workers as independent contractors, consider these suggestions:

- Develop a checklist that must be completed before hiring an independent contractor and that includes a mandatory questionnaire asking about factors that indicate the worker’s relationship to the company.
- Use a contract with specific language about the worker’s relationship to the organization.
- Avoid using contract language that establishes the “right of direction and control,” including noncompete agreements, restrictions on hiring subcontractors and payment of liability or workers’ compensation insurance.
- Create a formal internal policy document that clearly defines the required documentation and procedures, and lists the departments responsible for implementing the procedures.
Information reporting
This year-end is critical for preparing to meet all the information reporting deadlines in early 2017. Congress has added new health care reporting requirements and made the general filing rules and penalties more stringent. The IRS no longer allows automatic extensions for filing Form W-2, and its temporary regulations state that it will be reluctant to grant nonautomatic extensions. The penalties for information return failures have also increased over the past several years, sometimes doubling or even tripling. The due dates for many returns have also been moved up. See our table for the due dates in 2017.

Tax law change alert
New deadline for Forms 1099, W-2 and W-3
Congress enacted changes to some important filing deadlines in an effort to battle identity thieves, who often file fraudulent electronic refund claims early in the tax filing season before the IRS has enough datamatching information to reject the claims. Employee wage and tax statements on Forms W-2 and W-3 will all be due on Jan. 31 beginning in 2017. Previously they were due only to employees on Jan. 31, and not due to the Social Security Administration (SSA) until Feb. 28 if filed on paper, or March 31 if filed electronically. Form 1099-MISC will also be due on Jan. 31 if it includes nonemployee compensation. Similarly, under prior law these returns were not due to the IRS until Feb. 28 if on paper and March 31 if electronic.

Information return deadlines in 2017

<table>
<thead>
<tr>
<th>Return Type</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee wage and tax statement: Forms W-2 and W-3</td>
<td>Jan. 31</td>
</tr>
<tr>
<td>Form 1099-MISC for nonemployee compensation</td>
<td>Jan. 31</td>
</tr>
<tr>
<td>All other Forms 1099 and Forms 1096, 1098, 3921, 3922</td>
<td>Jan. 31, Feb. 28, March 31</td>
</tr>
</tbody>
</table>

Annual report of foreign financial account: FBAR

<table>
<thead>
<tr>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>File with Treasury</td>
</tr>
</tbody>
</table>

Calendar-year employee benefit plan report: Form 5500

<table>
<thead>
<tr>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original due date</td>
</tr>
<tr>
<td>Extended due date</td>
</tr>
</tbody>
</table>
Offices of Grant Thornton LLP
National Office
Grant Thornton Tower
171 N. Clark St., Suite 200
Chicago, IL 60601
+1 312 856 0200

Washington National Tax Office
1250 Connecticut Ave. NW, Suite 400
Washington, DC 20036
+1 202 296 7800

Alaska
Anchorage
+1 907 754 9200

Arizona
Phoenix
+1 602 474 3400

California
Irvine
+1 949 553 1600
Los Angeles
+1 213 627 1717
Sacramento
+1 916 449 3991
San Diego
+1 858 704 8000
San Francisco
+1 415 986 3900
San Jose
+1 408 275 9000

Colorado
Denver
+1 303 813 4000

Connecticut
Hartford
+1 860 781 6700
Stamford
+1 203 327 8300

Florida
Fort Lauderdale
+1 954 768 9900
Miami
+1 305 341 8040
Orlando
+1 407 481 5100
Tampa
+1 813 229 7201

Georgia
Atlanta
+1 404 330 2000

Illinois
Chicago
+1 312 856 0200
Oakbrook Terrace
+1 630 873 2500
Schaumburg
+1 847 884 0123

Kansas
Overland Park
+1 913 272 2700
Wichita
+1 316 265 3231

Maryland
Baltimore
+1 410 685 4000

Massachusetts
Boston
+1 617 723 7900
Westborough
+1 508 926 2200

Michigan
Détroit
+1 248 262 1950

Minnesota
Minneapolis
+1 612 332 0001

Missouri
Kansas City
+1 816 412 2400
St. Louis
+1 314 735 2200

Nebraska
Omaha
+1 402 462 5600

Nevada
Reno
+1 775 786 1520

New Jersey
MetroPark
+1 732 516 5500

New York
Albany
+1 518 427 7762
Long Island
+1 631 249 6001
Manhattan
+1 212 599 0100

North Carolina
Charlotte
+1 704 632 3500
Raleigh
+1 919 881 2700

Ohio
Cincinnati
+1 513 762 5000
Cleveland
+1 216 771 1400

Oklahoma
Oklahoma City
+1 405 218 2800
Tulsa
+1 918 877 0800

Oregon
Portland
+1 503 222 3562

Pennsylvania
Philadelphia
+1 215 561 4200
Pittsburgh
+1 412 586 3800

Rhode Island
Providence
+1 401 214 4242

South Carolina
Columbia
+1 803 231 3100

Texas
Austin
+1 512 692 1200
Dallas
+1 214 561 2300

Utah
Salt Lake City
+1 801 415 1000

Virginia
Alexandria
+1 703 837 4400
McLean
+1 703 847 7500

Washington
Seattle
+1 206 623 1121

Wisconsin
Appleton
+1 920 968 6700
Madison
+1 608 257 6761
Milwaukee
+1 414 289 8200
About Grant Thornton LLP
Founded in Chicago in 1924, Grant Thornton LLP (Grant Thornton) is the U.S. member firm of Grant Thornton International Ltd, one of the world’s leading organizations of independent audit, tax and advisory firms. Grant Thornton has revenue in excess of $1.6 billion and operates 60 offices with more than 570 partners and more than 8,500 personnel in the United States and at our Shared Services Center in Bangalore, India. Grant Thornton works with a broad range of dynamic publicly and privately held companies, government agencies, financial institutions, and civic and religious organizations.

Tax professional standards statement
This content supports Grant Thornton LLP’s marketing of professional services and is not written tax advice directed at the particular facts and circumstances of any person. If you are interested in the topics presented herein, we encourage you to contact us or an independent tax professional to discuss their potential application to your particular situation. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed herein. To the extent this content may be considered to contain written tax advice, any written advice contained in, forwarded with or attached to this content is not intended by Grant Thornton LLP to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

The information contained herein is general in nature and is based on authorities that are subject to change. It is not, and should not be construed as, accounting, legal or tax advice provided by Grant Thornton LLP to the reader. This material may not be applicable to, or suitable for, the reader’s specific circumstances or needs and may require consideration of tax and nontax factors not described herein. Contact Grant Thornton LLP or other tax professionals prior to taking any action based upon this information. Changes in tax laws or other factors could affect, on a prospective or retroactive basis, the information contained herein; Grant Thornton LLP assumes no obligation to inform the reader of any such changes. All references to “Section,” “Sec.,” or “§” refer to the Internal Revenue Code of 1986, as amended.

This content is not intended to answer specific questions or suggest suitability of action in a particular case. For additional information about the issues discussed, contact a Grant Thornton LLP professional.