TAXTALK

2023 YEAR-END TAX PLANNING FOR CANADIAN BUSINESSES AND INDIVIDUALS WITH OPERATIONS AND FILINGS IN THE U.S.

As the year-end approaches, it offers a strategic opportunity for businesses to review their tax planning strategies. Now is the time to review your company's and your personal situation to ensure that you have maximized your 2023 tax planning.

Summary

This summary addresses the key federal tax and state tax considerations for 2023 year-end tax planning for individuals and Canadian businesses conducting business in the U.S.

Highlighted below are tax planning strategies you can use to minimize your tax burden for 2023-2024.

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 current tax, which is usually beneficial. Also, it is not expected that tax laws will change in 2024. For this reason, the idea of accelerating expenses is still sound.

Depreciation Tax Planning

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 the Tax Cuts and Jobs Act (TCJA) that went into effect in 2018 (and still impacts current tax planning) further enhanced these opportunities by expanding bonus depreciation and expensing of qualified capital assets

Section 179 Expensing

If you are a small business, the Section 179 deduction is one of the most important tax codes you need to be familiar with in 2023. It lets you deduct all, or part of the cost of equipment that is purchased or financed and placed in service before the end of 2023.

For 2023, 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. $1,160,000 for the first $2,800,000 of property placed in service by December 31, 2023. 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 $2,800,000 threshold and eliminated above amounts exceeding $4,050,000 for tax years beginning in 2023.

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. Starting on January 1 of this year, bonus depreciation dropped 20 points to 80%, with 20-point drops scheduled every year after and ending on December 31, 2026 (60% in 2024, 40% in 2025, 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 the 80% bonus depreciation and the Section 179 deduction are available for the same asset, it is generally more advantageous to claim 100% bonus depreciation, because there are no limits on it.

Leasehold Improvements

As indicated below, leasehold improvements are qualified property. Note that you can take 80% bonus depreciation on leasehold asset additions if they are placed in service by December 31, 2023.

Goodwill

The cost of goodwill acquired in connection with the acquisition of assets that constitute a trade or business, generally is capitalized and amortized on a straight-line basis over 15 years, beginning in the month that the goodwill is acquired.

Qualified Property

Qualified property for Section 179 and bonus tax depreciation is defined as property that was placed in service during the tax year and used predominantly (more than 50%) in a U.S. trade or business. Property that was placed in service during the tax year and then disposed in the same year does not qualify for the deductions. Similarly, property converted to personal use in the same tax year that it was acquired, will not qualify for the deductions.

Qualified property includes computer systems, computer software, vehicles, machinery, equipment, and office furniture. Leasehold improvements are also qualified property.

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

Maximize Business Interest Expense Deduction

The TCJA is applicable for tax years beginning after December 31, 2017, imposes a limitation on business interest expense of many taxpayers, with exceptions for small businesses (those with three-year average annual gross receipts not exceeding $29 million in 2023). 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 is limited to 30% of the computed adjusted taxable income, and the computation for adjusted taxable income (ATI) included an addback for tax depreciation and amortization. Practically, ATI is roughly equivalent to earnings before interest, taxes, depreciation, and amortization (EBITDA) for tax years that began before January 1, 2022. For tax years beginning on or after that date, ATI is roughly equivalent to earnings before interest and taxes (EBIT).

The above changes in the computation of adjusted taxable income may result in businesses having more interest disallowed for tax purposes. However, that disallowed interest is carried forward indefinitely.

Maximize Business Net Operating Loss Deductions

A net operating loss exists if a company's deductions exceed taxable income. Net operating losses (NOL) are valuable deductions that can benefit a company by reducing taxable income in future years.

For tax years beginning in 2022, businesses that incur an NOL will only be allowed to carry the loss forward (as opposed to carrybacks for NOLs before 2021) to be used in future years. While these losses can be carried forward indefinitely, they can only be used to offset 80% of taxable income of the business in the carry forward years.

Research and Development

For tax years beginning with 2022, research and development costs must be capitalized and amortized. Research and Development (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 accounted for these costs prior to 2022, where businesses could either deduct these costs or choose to capitalize and amortize them.

Bad Debts and Worthless Stock Deductions

Bad debts resulting from a trade or business in the U.S. may be deducted in the year the debt becomes worthless.

For U.S. tax purposes, business bad debts can be wholly or partially written off. If a business bad debt is only partially worthless, and is recoverable in part, then the worthless portion is deductible to the extent it is written off during the tax year in the accounting records. A complete write-off requires that the debt is wholly uncollectible as of the end of the year.

Whether a debt is wholly or partially worthless is a question of fact, requiring consideration of all the relevant evidence, including the debtor's financial condition and the value of the collateral secured by the debt. A debt becomes worthless when there is no longer any chance the amount will be collected.

In addition, with signs of a possible recession looming, businesses should consider claiming losses in 2023 for investment in the shares of insolvent U.S. subsidiaries. In order to claim the losses the subsidiaries must be at least 80% owned.

Net Investment Income Tax (NIIT)

The NIIT rate is 3.8% on the investment income that typically applies only to high-income taxpayers (see below). The tax applies to individuals, estates and trusts, but certain income thresholds (depending on filing status) must be met before the tax takes effect. For example, the tax applies to all investment income reported on a U.S. return, but only if a single individual has modified gross income above $200,000 and above $250,000 for a married couple. Note that this tax is an additional tax to regular income tax liability.

Investment income includes dividends, interest and capital gains. It can also include income from rental properties, capital gain distributions from mutual funds and even royalty or annuity income.

Note that the NIIT does not include wages, self-employment income, unemployment compensation, social security benefits, or alimony.

State Nexus

Canadian companies with operations in the U.S. should determine if they have Nexus with any state. Nexus is defined as a presence or connection in a state that is sufficient to be subject to state tax and state tax filings. Nexus for income tax is different from Nexus for sales tax and the Nexus rules for each state are also different.

You should review your company's activities in each state in which the company is doing business to determine if you have any state tax exposures for income and/or sales tax. Note that state and local taxes imposed on businesses are deductible expenses for federal income tax purposes.

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 that you will pay in 2023.

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.

McCarney Group LLP is an independent member of Morison Global