2015 PATH Act: What all Taxpayers Need to Know

AUTHORS

Loree Dubois, CPA

Loree is the Chair of the Firm's Corporate Tax Group and Co-Chair of the Firms Healthcare Services Group. She has over 20 years of experience providing tax advisory services to closely held, medium sized and publicly held businesses.

Laura H. Yalanis, CPA,MST

Laura is the Chair of the Firm's Business & Individual Tax Group and Chair of the Firms Hospitality Services Group. She provides tax advisory services to closely held and medium sized businesses, and has extensive knowledge of hospitality related industries.

CONTENTS

INTRODUCTION

This e-book will cover the most significant tax law changes under the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act).

If, after reading this eBook, you would like more information or have questions about these tax law changes, please visit KahnLitwin.com or contact us at trustedadvisors@kahnlitwin.com.

OVERVIEW

Good News for Taxpayers

The PATH Act was signed into law on December 18, 2015. Without it, many valuable tax breaks for businesses and individuals would not have been available for 2015 and 2016.

But the act doesn't just extend breaks through 2016 — it makes many breaks permanent. This is good news for taxpayers because it provides both long-term, tax-saving opportunities and more certainty about the breaks that will be available in the future, which helps make planning easier.

That said, with tax reform continuing to be a popular topic in Washington and 2016 being an election year, taxpayers still need to be prepared for future tax law changes.

"Permanent" doesn't mean a break will be available forever; it just means that it doesn't have a set expiration date. Congress could repeal or change some of these breaks in the future.

In the meantime, it's important to factor the changes into your 2015 tax return filing and your tax planning for 2016 and beyond.

KLR

Part 1.

Business Breaks: Section 179 Expensing

The PATH Act makes permanent higher limits under Sec. 179 of the Internal Revenue Code. This section allows businesses to immediately expense the cost of qualified property (generally depreciable tangible personal property, whether new or used) in the year it's placed in service. So businesses can accelerate their tax deductions compared to recovering the costs over several years under the applicable depreciation schedule. (Be aware that this deduction can be taken only against net income. You can't use it to create or increase a net operating loss.)

The PATH Act allows a business to deduct up to $500,000 in qualified new or used property for 2015. However, a dollar-for-dollar phase-out applies to the extent that the cost of all qualified property placed in service during the tax year exceeds $2.01 million and is completely eliminated when the cost is above $2.51 million.

Additionally, the Sec. 179 cap will be indexed to inflation in $10,000 increments in future years.

Share:

Section 179 Expensing

Without the PATH Act, the expensing limits for 2015 and 2016 would have been only $25,000, with a $200,000 phaseout threshold.

The new law also permanently allows off-the-shelf computer software to be considered qualified property. In addition, beginning in 2016, air conditioning and heating equipment will be considered qualified property. Previously, they were specifically excluded from such treatment.

Finally, the PATH Act makes permanent the ability to apply Sec. 179 expensing to qualified leasehold-improvement, restaurant and retail-improvement property. The expensing limit for such property is $250,000 of the full $500,000 expensing limit for 2015 but the entire Sec. 179 expensing limit can be applied to such property beginning in 2016.

Planning Tips:

1. **When filing your 2015 tax return**, determine whether you purchased — and placed in service — **property that qualifies for Sec. 179 expensing** and the amount of the potential deduction. Then assess whether this break will be beneficial to you long-term. If your business is growing and you expect to be in a higher tax bracket in future years, opting out of the election and depreciating the property over the applicable depreciable life might ultimately provide greater tax savings.

2. **In 2016**, carefully consider Sec. 179 when planning purchases for the year. If you can qualify for this break and it will be beneficial to you, consider purchasing (and placing in service) just enough qualifying property during the year that you can enjoy the maximum benefit. That is, **don't allow your asset purchases to exceed the phaseout threshold.**

Part 2.

Business Breaks: Bonus Depreciation

The PATH Act extends 50% bonus depreciation through 2017. It then reduces it to 40% for 2018 and 30% for 2019. Under bonus depreciation, businesses can take an additional depreciation deduction in the year that qualified property is placed in service.

For 2015, qualified property includes *new* tangible property with a recovery period of 20 years or less, off-the-shelf computer software, water utility property and qualified leasehold-improvement property.

Beginning in 2016, the PATH Act allows bonus depreciation for qualified improvement property regardless of whether the property is leased.

The PATH Act also allows corporations to accelerate the use of alternative minimum tax (AMT) credits in lieu of bonus depreciation under special rules. Beginning in 2016, it increases the amount of AMT credits that can be used in lieu of bonus depreciation.

Planning Tips:

1

When filing your 2015 return, **assess whether Sec. 179 expensing or 50% bonus depreciation will provide you the greater benefit**:

If your property acquisition expenses are eligible for both breaks, Sec. 179 expensing will provide a greater current-year tax benefit because it allows you to **deduct 100%** of the expense.

If your property acquisitions for the year are **greater than** the Sec. 179 phaseout threshold or your acquisition expenses exceed your 2015 income, bonus depreciation may provide a larger tax benefit.

Planning Tips:

2 **If typically** your annual qualified property acquisitions exceed the Sec. 179 phaseout threshold, you may want to **accelerate purchases into 2016 and 2017** so you can take maximum advantage of 50% bonus depreciation before the bonus percentage drops to 40% in 2018.

3 **As with Sec. 179 expensing**, if your business is growing and you expect to be in a higher tax bracket in future years, **forgoing bonus depreciation and depreciating the property over the applicable depreciable life** might ultimately provide greater tax savings.

Part 3.

Business Breaks: Accelerated Depreciation

The PATH Act makes permanent the ability to apply a shortened recovery period of 15 years (rather than 39 years) to qualified leasehold-improvement, restaurant and retail-improvement property.

"Permanent" doesn't mean a break will be available forever; it just means that it doesn't have a set expiration date.

Planning Tip:

1

For property that qualifies for Sec. 179 expensing, bonus depreciation and accelerated depreciation, you can first apply Sec. 179 expensing up to the applicable limit, **then apply 50% bonus depreciation to any amount in excess of that limit**, and then apply the 15-year recovery period to the remaining amount.

Example: If in 2015 you had a $400,000 qualifying leasehold improvement, you can first deduct $250,000 of the expense under Sec. 179, then deduct $75,000 under bonus depreciation (50% of the difference between $400,000 and $250,000), and then apply the 15-year accelerated depreciation to the remaining $75,000, providing an additional $5,000 deduction in 2015. So **your total 2015 deduction for the property could be as much as $330,000**.

Part 4.

Business Breaks: R&D Credit

The research and development (R&D) credit rewards businesses that increase their investments in research. The credit has been around for decades, but it continually was allowed to expire and then would be temporarily extended. As a result of this uncertainty, businesses couldn't rely on the tax benefits of the credit when planning for their research investments. Thanks to the PATH Act, they now can. The PATH Act makes the credit permanent.

The PATH Act also enhances the credit beginning in 2016. For example, businesses with $50 million or less in gross receipts can claim the credit against alternative minimum tax (AMT) liability. In addition, certain start-ups (in general, those with less than $5 million in gross receipts) that haven't yet incurred any income tax liability can use the credit against their payroll tax. These two provisions mean that a lot more businesses will be able to benefit from the credit when they **file their 2016 returns in 2017**.

R&D Credit

To be eligible for the credit, your business must have engaged in “qualified” research activities during the tax year. These are activities that meet the following four-factor test:

1. The activities’ purpose must be to create new — or improve existing — functionality, performance, reliability or quality of a product, process, technique, invention, formula or computer software that will be sold or used in your trade or business.
2. The intention must be to eliminate uncertainty.
3. There must be an experimentation process.
4. The experimentation process must rely on principles of physical or biological science, engineering or computer science.

R&D Credit

The research must be performed within the United States or its territories and possessions. Certain activities are specifically excluded from the credit, such as reverse engineering, software development for internal use and research related to social sciences, arts or humanities. You also can't claim a credit for research funded or reimbursed by a third party via a contract, grant or other arrangement.

Expenses that qualify for the credit include wages for time spent supporting, supervising or performing qualified research, supplies used in the experimentation process, and 65% of any contracted outside research expenses.

Planning Tip:

1

There are three options for computing research credits: **the traditional method, the alternative simplified credit method and the start-up calculation method**. Regardless of the method, the calculation is complicated, requiring businesses to not only calculate the current year's qualified research expenses but also factor in certain financial information from previous years.

So professional advice is essential — whether you're determining if you qualify for the credit on your 2015 return or are deciding if you'll increase your R&D spending in 2016.

Share:

Part 5.

Individual Breaks: Direct IRA Distributions to Charity

In recent years, charitably inclined taxpayers over age 70½ have been eligible for an attractive tax break: the ability to make direct distributions of up to $100,000 annually from their IRAs to qualified charities. However, this was a temporary break, which sometimes made taking advantage of it a challenge. For example, in both 2014 and 2015, the break had expired at the end of the previous year and wasn't revived for the current tax year until mid-December — leaving taxpayers little time to execute their distributions by the end of the tax year.

Now the PATH Act has made this break permanent. For eligible taxpayers, the amount of the direct distributions to charity up to the annual limit is excluded from taxable income. In addition, the distribution can help satisfy the taxpayer's IRA required minimum distribution (RMD) for the year. But the taxpayer can't take a charitable deduction for the contribution. Also be aware that donor-advised funds and supporting organizations aren't qualified charities for the purposes of this break.

Planning Tips:

1

You can benefit from the break on your 2015 tax return only if you had your IRA trustee make a direct transfer to an eligible charity by **December 31, 2015**.

2

If you're charitably inclined, meet the age requirement and have enough assets outside your traditional IRA so that you aren't planning to take more than your RMDs during your life, direct IRA distributions to charity — even beyond your RMDs (**as long as they don't exceed the $100,000 annual limit**) — may be right for you. **Why?** If you name a child or other loved one as beneficiary of your traditional IRA, he or she will have to pay income tax (at ordinary-income tax rates, not the more favorable long-term capital gains rates) on the distributions received.

Share:

Part 6.

Individual Breaks:
State and Local Tax Sales Deduction

For taxpayers in most states, the federal itemized deduction for state and local income taxes paid is a valuable tax break. But there are a handful of states that levy no income tax, or levy an income tax on only a limited basis (such as only on unearned income).

A temporary break allowing an itemized deduction for state and local *sales* taxes, instead of state and local *income* taxes, has been providing saving opportunities to taxpayers in these states for several years. But it was only temporary. **The PATH Act has made it permanent**. The sales tax deduction can also benefit taxpayers in other states who purchase major items, such as a car or boat.

Planning Tips:

1. **Don't worry if you don't have receipts** documenting all of the sales tax you paid in 2015. **You can still claim the break on your 2015 return**. All you need to do is use the IRS sales tax calculator. It determines the deduction based on your income and the sales tax rates in your locale. To that amount you can add the tax you actually paid on certain major purchases, such as a car or boat, **provided that you have proper substantiation.**

2. **Even if you live in a state that levies an income tax**, if you have a year when your taxable income is low and you've made a major purchase, you might save more tax from the sales tax deduction than from the income tax deduction. You could **also consider timing strategies where you "bunch" major purchases into alternating years**.

KLR

Part 7.

Individual Breaks: Small Business Stock Gains Exclusion

Investing in qualified small business (QSB) stock offers taxpayers multiple benefits, such as portfolio diversification and, under certain circumstances, tax-free gain rollovers.

If such stock is held for more than five years, a gain exclusion is available when the stock is sold. The amount of the exclusion depends on when the stock was acquired.

The PATH Act **makes permanent** the exclusion of 100% of any gain on the sale of QSB stock acquired after September 27, 2010. Without the legislation, QSB stock acquired after December 31, 2014, would have been eligible for only a 50% exclusion.

Also permanently extended by the PATH Act is the rule that eliminates QSB stock gain as a preference item for alternative minimum tax (AMT) purposes. In other words, such gain won't be a potential AMT trigger.

Share:

Planning Tip:

1

If you're considering investing in small-business stock because you want to take advantage of the 100% gain exclusion, make sure the small business you're considering is indeed qualified. It must be a domestic C corporation whose gross assets have **never exceeded $50 million**, and it must use **at least 80% of its assets** in an active trade or business.

2

In addition, you must acquire the stock at its original issue in exchange for money or property or as compensation for services. Keep in mind that **investment decisions shouldn't be made based only on potential tax benefits**. You also should consider your risk tolerance and investment goals, among other factors.

Share:

Part 8.

Individual Breaks: Child-and Education-Related Breaks

Taxpayers with children under age 17 at the end of the year may be eligible for a $1,000 child credit per qualifying child. If the child credit exceeds the taxpayer's tax liability for the year, the taxpayer may be eligible for a "refundable" credit equal to 15% of earned income in excess of the applicable threshold.

The PATH Act **makes permanent** the $3,000 threshold, which had been scheduled to increase to an inflation-adjusted $10,000 after 2017. The $3,000 threshold means that more taxpayers will be eligible for a refundable credit, and the dollar amount will generally be larger.

Child-and Education-Related Breaks

A tax credit that can be valuable to parents of older children is the American Opportunity credit. It can be **up to $2,500 for tuition and certain other expenses** for each of the first four years of postsecondary education.

The PATH Act makes the American Opportunity credit permanent. Without the legislation, the break would have reverted to the less-favorable “Hope” version of the credit after 2017. Under the Hope version, the credit **would have been only $1,800** and available for only the first two years of postsecondary education.

The PATH Act also addressed another **education-related break**: the above-the-line deduction for qualified tuition and related expenses for higher education. But rather than making the deduction permanent, the act only extends it through 2016. The maximum deduction is $4,000 for taxpayers whose adjusted gross income (AGI) doesn’t exceed $65,000 ($130,000 for joint filers) and $2,000 for taxpayers whose AGI exceeds those amounts but doesn’t exceed $80,000 ($160,000 for joint filers).

Share:

Planning Tips:

1 **Because credits reduce tax dollar-for-dollar**, it's especially important from a tax-saving standpoint to make sure you **claim every credit for which you're eligible**.

2 **You can't take both** the American Opportunity credit and the tuition deduction for the same student. If you're eligible for both breaks on your 2015 tax return, the **American Opportunity credit will likely provide more tax savings**.

Planning Tips:

3

Be aware that income-based phaseouts apply to the child credit and the American Opportunity credit. If such a phaseout prevents you from claiming the full American Opportunity credit, **consider having your child claim the credit**. You'll have to give up your personal exemption for the child, but family-wide there may be greater tax savings. If your personal exemption is eliminated due to the AMT or an income-based phaseout, you'll lose nothing by forgoing the exemption.

Part 9.

Individual Breaks: Mortgage-Related Breaks

The PATH Act extends two mortgage-related breaks, but only through December 31, 2016. The first break allows taxpayers to deduct qualified mortgage insurance premiums as if they were mortgage interest

The second break temporarily extended by the PATH Act is the exclusion from gross income for mortgage loan forgiveness on a principal residence. Under the act, the exclusion can also apply to mortgage forgiveness in 2017 as long as it's granted pursuant to a written agreement entered into in 2016. **The maximum exclusion is generally $2 million.**

Planning Tips:

1. **The deduction for qualified mortgage insurance** premiums phases out for taxpayers with AGI of $100,000 to $110,000. Generally it's best, if possible, to make additional principal payments as quickly as you can afford to in order to get your home equity to the level that your lender no longer requires you to maintain mortgage insurance. Even if you're eligible for the deduction, you'll save more by not having to pay the premiums at all.

2. **If you are considering a mortgage** workout that could include debt forgiveness, consider trying to enter into a written agreement in 2016 so you can take advantage of the forgiveness exclusion. Otherwise, you could end up owing substantial tax on what is considered "cancellation of debt" income. However, keep in mind that, if you keep the home, you must reduce your basis in the home by the amount of the excluded forgiveness — which could result in a larger tax bill when you sell the home.

SHARE THIS eBOOK

Share this eBook!

Visit our tax blog learn more about the 2015 Tax Extenders.

Find out why KLR is so much more than an accounting firm.

KLR is one of New England's premier accounting and business advisory firms. With 200+ team members and offices in Boston, Newport, Providence, Shanghai and Waltham, KLR provides a wide range of services to both individuals and businesses.

KahnLitwin.com