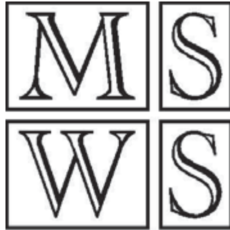

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NOVEMBER 2019
YEAR END INCOME TAX PLANNING NEWSLETTER

With year-end approaching, this is the time of year we suggest possible year-end tax strategies for our clients. 2018 was the first year individuals and business owners filed tax returns reflecting the major changes under the **"Tax Cuts and Jobs Act" (TCJA).** Now that we have 2018 under our belt, we have a better understanding of the practical applications of the tax law changes. In many cases, it is crucial for taxpayers to plan ahead in order to maximize tax savings under the TCJA, specifically the 20% Section 199A QBI (qualified business income) tax deduction. We are sending this letter not only to remind you of the time-honored, year-end tax planning techniques that survived the tax changes under TCJA, but also to stress the importance of new year-end planning strategies that TCJA provides. The letter is broken down in three sections:

●Planning Ideas for Individual Taxpayers●

●Planning Ideas for Businesses●

●Planning and Overview of the TCJA 20% Section 199A (QBI) Deduction●

Caution! The IRS continues to issue regulatory guidance interpreting the TCJA, and with nearly two years since its passage, substantial guidance in certain areas has yet to be issued. We closely monitor these IRS releases on an ongoing basis. Please call our firm if you want an update on the latest IRS notifications, announcements, and guidance or **if you need additional information concerning any item discussed in this letter.**

Be Careful! We suggest you call our firm before implementing any tax planning technique discussed in this letter. You cannot properly evaluate a particular planning strategy without calculating your overall tax liability with and without that strategy. This letter contains ideas for Federal income tax planning only. **State income tax issues are not addressed.**

SELECTED TCJA PROVISIONS PRIMARILY IMPACTING INDIVIDUALS

PLEASE NOTE - Each of the changes below **impacting "Individual"** taxpayers **is first effective in 2018** and will **sunset after 2025** (unless we indicate otherwise)!

Changes In The Individual Income Tax Rates. Before TCJA, there were seven regular income tax rate brackets as follows: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. **Starting in 2018 and through 2025,** TCJA changes the seven tax rate brackets to: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. As compared to prior law, TCJA's regular income tax rates generally reduce the tax rate on comparable levels of taxable income. **Caution!** TCJA **did not change** the **3.8% Net Investment Income Tax** on investment income (e.g., capital gains, dividends, passive income) which will continue to apply once the modified adjusted gross income of married taxpayers filing jointly exceeds $250,000 (exceeds $200,000 if single). **Observation.** Although TCJA lowers the actual tax rates at most income levels (regardless of filing status), the overall tax impact on a particular individual or family as compared to prior law will vary due to other changes in TCJA, such as: an increase in the standard deduction, loss of personal and dependency exemptions, the elimination or limitation of certain itemized deductions, increases in the child tax credit, higher income phase-outs for the child credit, and a new credit for certain qualifying dependents.

Minor Changes In The Tax Rates For Long-Term Capital Gains And Qualified Dividends. Starting in 2018 and through 2025, TCJA retains the same 0%, 15%, and 20% rates that applied before 2018 to long-term capital gains and qualified dividends. Under TCJA, the 0%, 15%, and 20% rates apply at income levels similar to prior law.

Increased Standard Deduction. In an attempt to help simplify the income tax rules for individuals, TCJA substantially increases the standard deduction **starting in 2018 and through 2025.** It is expected that far fewer people will benefit from itemizing their deductions, and therefore their record-keeping will be simplified. TCJA increases the Standard Deduction to the following levels for 2019: Joint Return - $24,400 ($27,000 if both taxpayers age 65 or older); Single - $12,200; and Head-of-Household - $18,350 (Single and HOH increases by $1,650 for taxpayers age 65 or older).

Reduction Of Personal Exemption Deduction Amount To Zero. Starting in 2018 and through 2025, TCJA **reduces the personal exemption deduction** for taxpayers and their dependents **to zero.**

Enhanced Child Tax Credit. The TCJA doubles the maximum Child Tax Credit for each **"Qualifying Child"** to **$2,000,** and also significantly increases the income level where the credit begins phasing out. Under TCJA, the Child Tax Credit begins phasing out as the individual's modified adjusted gross income (MAGI) **exceeds $400,000** on a **Joint Return** (up from the previous $110,000), or **exceeds $200,000 if Single** (up from the previous $75,000).

<u>New $500 Family Tax Credit.</u> TCJA creates a **new non-refundable "Family Tax Credit" of up to $500** for each person the taxpayer could have claimed as a dependent under prior law but who does not qualify for the $2,000 Child Tax Credit. This $500 Family Tax Credit will generally be available for a: **1)** "Qualifying Child" who does not qualify for the $2,000 Child Tax Credit because the child is 17 or older, and **2)** "Qualifying Relative." Generally, **a "Qualifying Relative"** is a person who is not a Qualifying Child but who meets certain residency, gross income, and relationship tests. This $500 Family Tax Credit is added to any other child tax credits and the total credits begin phasing out once a taxpayer's MAGI exceeds $400,000 on a joint return or $200,000 for singles.

<u>Impact Of TCJA On Certain "Above-The-Line" Deductions.</u> So-called **"above-the-line"** deductions reduce both your "adjusted gross income" (AGI) and your "modified adjusted gross income" (MAGI), while **"itemized"** deductions (i.e., below-the-line deductions) do **not** reduce either AGI or MAGI. Deductions that reduce your AGI (or MAGI) can potentially generate multiple tax benefits by: **1)** Reducing your taxable income and allowing you to be taxed in a lower tax bracket; **2)** Freeing up deductions (and tax credits) that phase out as your AGI (or MAGI) increases (e.g., Child Tax Credit; Family Tax Credit; certain IRA contributions; certain education credits; adoption credit, etc.); **or 3)** Reducing your MAGI below the income thresholds for the 3.8% Net Investment Income Tax: or **4)** Potentially reducing your taxable income to a level that could maximize your 20% 199A (QBI) deduction – see further discussion at the end of this letter.

"Above-the-line" deductions include: Deductions for IRA or Health Savings Account (HSA) Contributions; Health Insurance Premiums for Self-Employed Individuals; Qualified Student Loan Interest; Qualifying Alimony Payments; and Business Expenses for a Self-Employed Individual.

<u>Be Careful With "Employee" Business Expenses After TCJA.</u> Starting in 2018 and through 2025, "un-reimbursed" employee business expenses are not deductible at all. Good News! Generally, employee business expenses that are reimbursed under an employer's qualified "Accountable Reimbursement Arrangement" continue to be deductible by the employer (subject to the 50% limit on business meals), and the reimbursements are not taxable to the employee. However, reimbursements under an arrangement that is not a qualified "Accountable Reimbursement Arrangement" generally must be treated as compensation and included in the employee's W-2, and the employee would get no offsetting deduction for the business expense. Please call our Firm if you need assistance with establishing a qualifying Accountable Reimbursement Arrangement with your employer.

<u>Deducting Entertainment Expenses Much More Restricted.</u> Effective for amounts paid or incurred after 2017, TCJA generally repealed business deductions with respect to entertainment, amusement or recreation activities. Planning Alert! Initially, some questioned whether this new provision also eliminated the 50% deduction for business meals with customers or clients. Fortunately, the IRS announced that taxpayers can still generally deduct 50% of the cost a taxpayer incurs for meals with a business associate (i.e., a current or potential business customer, client, consultant, or similar business contact). In addition, the IRS stated that a taxpayer could deduct 50% of the cost of food and beverages provided during a nondeductible entertainment activity with a business associate provided the food and

beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. Caution! If an employer reimburses an employee's deductible business meal and beverage expense under an Accountable Reimbursement Arrangement, the employer could deduct 50% of the reimbursement. This same rule applies if you are employed by your own S corporation. However, as discussed previously, an employee who is not reimbursed by the employer for the business meal would get no deduction because un-reimbursed employee business expenses are no longer deductible under TCJA.

New Limitations On Certain "Itemized Deductions." **"Itemized Deductions"** (i.e., below-the-line deductions) do **not** reduce your AGI or MAGI, but may still provide tax savings if they exceed in the aggregate your Standard Deduction. Since TCJA substantially increases the Standard Deduction, it will take a larger amount of itemized deductions to generate a tax benefit after 2017. However, TCJA not only increases the amount of the Standard Deduction, it also repeals or places new limits on several popular itemized deductions. It has been reported that the number of individuals who "itemized" deductions (instead of taking the Standard Deduction) dropped in 2018 by approximately two thirds as compared to prior years.

New Limits On The Home Mortgage Interest Deduction. Before TCJA, individuals were generally allowed an itemized deduction for home mortgage interest: **1)** Paid on up to $1,000,000 ($500,000 for married individuals filing separately) of **"Acquisition Indebtedness"** (i.e., funds borrowed to purchase, construct, or substantially improve your principal or second residence and secured by that residence), and **2)** Paid on up to $100,000 of **"Home Equity Indebtedness"** (i.e., funds borrowed that do not qualify as "Acquisition Indebtedness" but are secured by your principal or second residence - regardless of how the funds are used). TCJA makes the following changes:

- **Reduction In Cap For "Acquisition Indebtedness."** For **Acquisition Indebtedness incurred after December 15, 2017,** TCJA reduces the dollar cap for "Acquisition Indebtedness" **from $1,000,000 to $750,000** ($375,000 for married filing separately) for **2018 through 2025.** There are two **"grandfather"** rules that allow you to use the $1,000,000 cap for: **1)** Any "Acquisition Indebtedness" you **incurred on or before December 15, 2017,** or **2)** Any Acquisition Indebtedness that was incurred pursuant to a binding written contract entered into **before** **December 15, 2017** to close on the purchase of a **"principal residence"** before **January 1, 2018,** provided the individual purchased that residence **before April 1, 2018.** **Caution!** The $750,000 cap that generally applies to "Acquisition Indebtedness" incurred after December 15, 2017 is reduced by the outstanding balance of any grandfathered "Acquisition Indebtedness." **Planning Alert!** Subject to limited exceptions, if a taxpayer incurred Acquisition Indebtedness on or before December 15, 2017 (i.e., grandfathered Acquisition Indebtedness), the refinancing of that indebtedness after December 15, 2017 will still be entitled to the $1,000,000 cap (to the extent of the outstanding balance of the original Acquisition Indebtedness on the date of the refinancing).

<u>Suspension Of Interest Deduction For "Home Equity Indebtedness."</u> For 2018 through 2025, taxpayers may not deduct interest with respect to "Home Equity Indebtedness" (i.e., up to $100,000 of funds borrowed that do not qualify for "Acquisition Indebtedness" but are secured by your principal or second residence). **<u>Caution!</u>** Unlike the interest deduction for "Acquisition Indebtedness," TCJA **does not grandfather** any interest deduction for **"Home Equity Indebtedness"** that was **outstanding before 2018. <u>Planning Alert!</u>** Loans that have been labeled by your lender as a home equity loan, home equity line of credit (HELOC), or second mortgage on a Qualified Residence can be classified as "Acquisition Indebtedness" if the borrowed funds were used to **"substantially improve**" your Qualified Residence that secures the loan. Consequently, the interest on this type of home improvement loan continues to be deductible after 2017, subject to the $1,000,000 or $750,000 loan limitation, whichever applies.

<u>$10,000 Cap On The "State And Local" Tax Deduction.</u> From 2018 through 2025, the aggregate itemized deduction for state and local real property taxes, state and local personal property taxes, and state and local income taxes (or sales taxes if elected) is **limited to $10,000** ($5,000 for married filing separately).

<u>Charitable Contributions.</u> If you think your itemized deductions this year could likely exceed your Standard Deduction of $24,400 if filing jointly ($12,200 if single) and you want to accelerate your charitable deduction into 2019, please note that a charitable contribution deduction is allowed for 2019 if the check is "mailed" on or before December 31, 2019, or the contribution is made by a credit card charge in 2019. In addition, if you are considering a significant 2019 contribution to a qualified charity (e.g., church, synagogue, or college), it will generally save you taxes if you contribute appreciated long-term capital gain property, rather than selling the property and contributing the cash proceeds to the charity. By contributing capital gain property held more than one year (e.g., appreciated stock, real estate, etc.), a deduction is generally allowed for the full value of the property, but no tax is due on the appreciation. If instead you intend to use "loss" stocks to fund a charitable contribution, you should sell the stock first and then contribute the cash proceeds. This will allow you to deduct the capital loss from the sale, while preserving your charitable contribution deduction.

<u>Medical Expense Deductions</u>. For 2018, for both regular tax purposes and AMT purposes, a taxpayer could deduct medical expenses to the extent they exceeded 7.5% of his or her AGI. Planning Alert! **The 7.5% threshold reverted back to 10% for 2019 and after.** If you think your itemized deductions this year could likely exceed your standard deduction of $24,400 if filing jointly ($12,200 if single), but you do not expect your itemized deductions to exceed your Standard Deduction next year, you could save taxes in the long run by accelerating elective medical expenses (e.g., braces, new eye glasses, etc.) into 2019.

<u>POSTPONING TAXABLE INCOME MAY SAVE TAXES</u>

Generally, deferring taxable income from 2019 to 2020 may also reduce your income taxes, particularly if your effective income tax rate for 2020 will be lower than your effective income tax rate for 2019. Moreover, deferring income from 2019 to 2020 may provide you with the same possible tax benefits listed previously with respect to accelerating deductions into 2019 (i.e., Freeing up other deductions and tax credits that phase out as your AGI or MAGI increases;

Reducing your MAGI below the income thresholds for the 3.8% Net Investment Income Tax; Reducing your household income to a level that allows a "refundable" Premium Tax Credit; or, Reducing your taxable income to a level that could maximize your 20% 199A Deduction). **Planning Alert!** If, after considering all factors, you believe deferring taxable income into 2020 will save you taxes, consider the following:

Planning For Tax Rates. The deferral of income could cause your 2019 taxable income to fall below the thresholds for the highest 37% tax bracket (i.e., $612,350 for joint returns; $510,300 if single). In addition, if you have income subject to the 3.8% Net Investment Income Tax (3.8% NIIT) and the income deferral reduces your 2019 modified adjusted gross income (MAGI) below the thresholds for the 3.8% NIIT (i.e., $250,000 for joint returns; $200,000 if single), you may avoid this additional 3.8% tax on your investment income. **Planning Alert!** TCJA temporarily reduced the tax rates on virtually all levels of income, including reducing the "highest" income tax rate from 39.6% to 37%. These lower rates are not scheduled to expire until after 2025.

Deferring Self-Employment Income. If you are a self-employed individual using the cash method of accounting, consider delaying year-end billings to defer income until 2020. **Planning Alert!** If you have already received the check in 2019, deferring the deposit of the check does not defer the income. Also, you may not want to defer billing if you believe this will increase your risk of not getting paid.

TCJA Offers New Gain Deferral Opportunities By Investing In "Qualified Opportunity Funds." Generally, new section 1400Z as enacted under TCJA allows taxpayers to defer capital gains (long-term or short-term) to the extent the gains are re-invested in a QOF ***within 180 days*** of realizing the capital gain. In addition, if the investment in the QOF is held for at least 5 years - then 10% of the original deferred capital gain is essentially eliminated. If the QOF investment is held at least 7 years - then 15% of the original deferred capital gain is eliminated. Moreover, for qualified investments in a QOF held for at least 10 years, the taxpayer may elect to exclude any gain that arose after the taxpayer initially purchased the QOF investment. **Observation!** All remaining deferred gain reflected in the investment in a QOF must be fully recognized on the **earlier of 1)** The date the taxpayer sells the QOF investment, or **2)** December 31, 2026. Thus, the remaining deferred gain **must be fully recognized** no **later than December 31, 2026,** even if the taxpayer still holds the QOF investment on December 31, 2026. **Planning Alert!** Even in the best case scenario, 85% of the original deferred capital gain will be taxed ***no later than December 31, 2026*** at whatever capital gains rates exist in 2026. **Caution!** The requirements for satisfying this new gain deferral provision are far too technical and detailed to address in detail in this letter. If you would like additional details regarding this new provision, please call us.

Selected Planning Techniques For IRA Distributions. Generally, once you reach age 70½, you are required to begin taking "*Required Minimum Distributions*" (RMDs) from your IRA or qualified retirement plan account. A 50% penalty applies to the excess of the *"Required Minimum Distribution"* (RMD) over the amount actually distributed. Moreover, if you are a beneficiary of an IRA of a deceased owner, you are generally required to begin taking RMDs regardless of your age under the "inherited" IRA rules. If you decide that you could reduce your overall taxes by deferring your IRA distributions, please consider the following:

- **Individuals Making Charitable Contributions Who Are Age 70½ Or Older.** If you have reached **age 70½** and you are planning to make charitable contributions before the end of 2019, there is a special tax break that could apply to you. There is a popular rule that allows taxpayers, who **have reached age 70½,** to have their IRA trustee transfer **up to $100,000** from **their IRAs directly to a qualified charity,** and **exclude the IRA transfer from income.** The IRA transfer to the charity also counts toward the IRA owner's "Required Minimum Distributions" (RMDs) for the year. For those who wish to make charitable contributions, this tax break effectively allows a qualifying individual to exclude all or a portion of the individual's otherwise taxable RMDs from taxable income. This, in turn, could cause your 2019 modified adjusted gross income (MAGI) and/or taxable income to stay below the thresholds that qualify you for various tax benefits (previously listed) that are phased out as your MAGI or taxable income exceeds these thresholds. **Planning Alert!** In addition, since this tax break only applies to individuals who are at least 70½, this tax strategy could potentially reduce the portion of your social security payments that would otherwise be taxable, and could also reduce the amount of your Medicare Part B and Part D premiums for subsequent years which generally increase as your MAGI increases. Moreover, this planning technique could be even more valuable because TCJA substantially increased the standard deduction for individuals. For 2019, the standard deduction is $24,400 for Married filing jointly ($12,200 for singles). This is causing far fewer individuals to "itemize" their deductions. However, using this technique for a charitable contribution will provide an individual with this tax benefit **in addition to** the full benefit of the standard deduction.

  Caution! To qualify, the check from your IRA must be made out "directly" to your designated charity. In addition, if the **contribution is $250 or more,** you must get a **timely, qualifying receipt** from the charity for the charitable contribution. To take advantage of this exclusion for 2019, the **trustee** of your IRA **must write the check to the charity by December 31, 2019.** It may take the IRA custodian several days to complete all the necessary paper work to write the check. Consequently, you should alert the trustee that you want the check written to the charity **well before December 31, 2019.**

Selected Year-End Planning Strategies For Capital Gains And Losses. Generally, net capital gains (both short-term and long-term) are potentially subject to the 3.8% Net Investment Income Tax (3.8% NIIT). This could result in an individual filing a joint return with taxable income for 2019 of $488,850 or more ($434,550 or more if single) paying tax on his or her **net long-term capital gains** at a **23.8%** rate (i.e., the maximum capital gains tax rate of 20% plus the 3.8% NIIT). In addition, this individual's **net short-term capital gains** could be taxed as high as **40.8%** (i.e., 37% plus 3.8%). Consequently, traditional planning strategies involving the timing of your year-end sales of stocks, bonds, or other securities continue to be as important as ever. The following are a few time-tested, year-end tax planning ideas for sales of capital assets. **Planning Alert!** Always consider the **economics of a sale or exchange first!**

- **Planning With Zero Percent Tax Rate For Capital Gains And Dividends.** For individuals filing a **joint return** with 2019 Taxable Income of **less than $78,750 (less than $39,375 if single),** their long-term capital gains and qualified dividends are taxed at a zero percent rate. **Tax Tip.** Taxpayers who have historically been in higher tax brackets but now find themselves between jobs, recently retired, or expecting to report higher-than-normal business deductions in 2019, may temporarily have income low enough to take advantage of the

zero percent rate for 2019. **Planning Alert!** If you are experiencing any of these situations, please call our Firm as soon as possible and we will help you determine whether you can take advantage of this zero percent tax rate for long-term capital gains and qualified dividends.

- **Lower-Income Retirees.** The zero percent rate for long-term capital gains and qualified dividends is particularly important to lower-income retirees who rely largely on investment portfolios that generate dividends and long-term capital gains. Furthermore, gifts of appreciated securities to lower-income individuals who then sell the securities could reduce the tax on all or part of the gain from as high as 23.8% to as low as zero percent. **Caution!** If the lower-income individual is subject to the so-called kiddie tax, this planning technique will generally not work.

SELECTED MISCELLANEOUS YEAR-END PLANNING CONSIDERATIONS

Consider Increasing Withholding If Facing An Estimated Tax Underpayment Penalty. Starting with the 2018 tax year, TCJA reduced the overall tax liability for a significant number of individual taxpayers. However, it has been reported that some individual taxpayers were upset because their tax refund for the 2018 tax year was less than expected. Of course, if you reduced your withholdings or estimated tax payments for 2018 to reflect your anticipated tax savings under TCJA, it is entirely possible (and in fact probable) that you paid less overall tax in 2018 due to the TCJA tax cuts, even though your refund was smaller than in previous years. However, it is important that you continue to monitor your withholdings and estimated tax payments before the end of 2019 in order to avoid a potential tax underpayment penalty. **Planning Alert!** If you have failed to pay sufficient estimated taxes during 2019 potentially causing an estimated tax underpayment penalty, **increasing your withholdings before the end of 2019** may solve the problem. Any income tax withholding (including withholdings at the end of 2019 from a year-end bonus or an IRA distribution) is generally deemed paid in quarterly installments by each quarter's estimated tax payment due date (i.e., April 15, 2019; June 17, 2019; September 16, 2019; and January 15, 2020). Therefore, amounts **withheld on or before December 31, 2019** may reduce or eliminate your penalty for underpaying estimated taxes.

529 Plans Allowed To Pay K-12 Tuition. TCJA allows 529 plans to pay **up to $10,000 per beneficiary per year** of qualified tuition in connection with the enrollment or attendance of the designated beneficiary at **a public, private, or religious elementary or secondary school.** This provision has no sunset date!

Estate And Gift Tax Exemption Amount Increased. **Effective for individuals dying and gifts made after 2017 and before 2026,** TCJA increases the **Basic Unified Exclusion Amount** for estate and gift tax purposes **to $11,400,000 for 2019** (after indexing for inflation). The annual gift tax exclusion remains at $15,000.

2019 YEAR-END INCOME TAX PLANNING FOR BUSINESSES

TRADITIONAL YEAR-END TAX PLANNING TECHNIQUES BEFORE AND AFTER TCJA

A traditional year-end tax planning strategy for businesses that should generally apply before and after TCJA includes reducing current year taxable income by deferring taxable income into later years and accelerating deductions into the current year. This strategy can be particularly beneficial where the income tax rate on the business's income in the following year will be the same or lower than the current-year tax rates. Planning Alert! As discussed in more detail below, this strategy could be even more important if the deferral of business income or acceleration of business deductions causes the owner's 2019 "Taxable Income" to drop below certain safe harbor thresholds needed to maximize the owner's 20% 199A Deduction.

PLANNING WITH THE FIRST-YEAR 168(k) BONUS DEPRECIATION DEDUCTION AFTER TCJA

For the past several years, one of the most popular tax-favored business deductions has been the 168(k) Bonus Depreciation deduction. Before TCJA, the 168(k) Bonus Depreciation deduction was equal to 50% of the cost of qualifying "new" depreciable assets placed in service. TCJA generally increased the 168(k) Bonus Depreciation deduction to 100% for qualifying property acquired and placed in service after September 27, 2017 and before January 1, 2023. TCJA further enhanced the 168(k) Bonus Depreciation deduction by making the following changes:

"Used" Property Now Qualifies For 168(k) Bonus Depreciation. Before TCJA, only "new" qualifying property was eligible for the 168(k) Bonus Depreciation deduction. For qualifying property acquired and placed in service after September 27, 2017 and before 2027, the 168(k) Bonus Depreciation may be taken on "new" or "used" property. Therefore, property that generally qualifies for the 168(k) Bonus Depreciation includes "new" or "used" business property that has a depreciable life for tax purposes of 20 years or less (e.g., machinery and equipment, furniture and fixtures, sidewalks, roads, landscaping, computers, computer software, farm buildings, and qualified motor fuels facilities). Caution! "Used property" will not qualify if the property was previously depreciated by the taxpayer (or by certain parties related to the taxpayer).

Annual Depreciation Caps For Passenger Vehicles Increased. Vehicles used primarily in business generally qualify for the 168(k) Bonus Depreciation. However, there is a dollar cap imposed on business cars, and also on trucks, vans, and SUVs that have a loaded vehicle weight of 6,000 lbs or less. This dollar cap was increased significantly under TCJA. More specifically, for qualifying vehicles placed in service in 2019 and used 100% for business, the annual depreciation caps are as follows: 1st year - $10,100; 2nd year - $16,100; 3rd year - $9,700; fourth and subsequent years - $5,760. Moreover, if the vehicle (new or used) otherwise qualifies for the 168(k) Bonus Depreciation, the first year depreciation cap (assuming 100% business use) is increased by $8,000 (i.e., from $10,100 to $18,100 for 2019). Thus, a vehicle otherwise qualifying for the 168(k) Bonus Depreciation deduction with loaded Gross Vehicle Weight (GVW) of 6,000 lbs or

less used exclusively for business and placed in service in 2019 would be entitled to a depreciation deduction for 2019 of up to $18,100, whether purchased new or used. Planning Alert! Even better, if the same new or used business vehicle (which is used 100% for business) has a loaded GVW over 6,000 lbs, 100% of its cost (without a dollar cap) could be deducted in 2019 as a 168(k) Bonus Depreciation deduction. Caution! Whether you take 168(k) Bonus Depreciation or the 179 Deduction (discussed below) on your business vehicle (whether or not it weighs more than 6,000 lbs), if your business-use percentage drops to 50% or below in a later year, you will generally be required to bring into income a portion of the deductions taken in previous years.

PLANNING WITH THE SECTION 179 DEDUCTION

Another popular and frequently-used business tax break is the up-front Section 179 Deduction ("179 Deduction"). TCJA made several taxpayer-friendly enhancements to the 179 Deduction which include: 1) Substantially increasing the 179 Deduction limitation (up to $1,020,000 for 2019), 2) Increasing the phase-out threshold for total purchases of 179 property (to $2,550,000 for 2019), and 3) Expanding the types of business property that qualify for the 179 Deduction to include **Qualified Real Property and Qualified Improvement Property**. Planning Alert! To maximize your 179 Deductions for 2019, it is important for your business to determine which depreciable property acquired during the year qualifies as 179 Property.

Make Sure Newly-Acquired Property Is "Placed In Service" By Year End. In order to take the 168(k) Bonus Depreciation deduction and/or the 179 Deduction in 2019 (assuming a calendar-year taxpayer), any newly-acquired asset must be "Placed In Service" no later than December 31, 2019. Generally, if you are purchasing "personal property" (equipment, computer, vehicles, etc.), "placed in service" means the property is ready and available for use. To be safe, qualifying property should be set up and tested on or before the last day of 2019. If you are dealing with building improvements (e.g., "Qualified Improvement Property" for purposes of the 179 Deduction), a Certificate of Occupancy will generally constitute placing the building improvements in service. Tax Tip! Neither the 179 Deduction nor the 168(k) Bonus Depreciation deduction requires any proration based on the length of time that an asset is in service during the tax year. Therefore, your business would get the benefit of the entire 179 or 168(k) Deduction for 2019 purchases, even if the qualifying property was placed in service as late as December 31, 2019!

SELECTED TRADITIONAL YEAR-END PLANNING CONSIDERATIONS FOR BUSINESSES

Salaries For S Corporation Shareholder/Employees. For 2019, an employer generally must pay FICA taxes of 7.65% on an employee's wages up to $132,900 and FICA taxes of 1.45% on wages in excess of $132,900. In addition, an employer must withhold FICA taxes from an employee's wages of 7.65% on wages up to $132,900, and 1.45% of wages in excess of $132,900. Generally, the employer must also withhold an additional Medicare tax of .9% for wages paid to an employee in excess of $200,000. If you are a shareholder/employee of an S corporation, this

FICA tax is generally applied only to your W-2 income from your S corporation. Other income that passes through to you or is distributed with respect to your stock is generally not subject to FICA taxes or to self-employment taxes. Caution! If the IRS determines that you have taken unreasonably "low" compensation from your S corporation, the Service will generally argue that other amounts you have received from your S corporation (e.g., distributions) are disguised "compensation" and should be subject to FICA taxes.

S Corporation Shareholders Should Check Stock And Debt Basis Before Year-End. If you own S corporation stock and you think your S corporation will have a tax loss this year, you should contact us as soon as possible. These losses will not be deductible on your personal return unless and until you have adequate "basis" in your S corporation. Any pass-through loss that exceeds your "basis" in the S corporation will carry over to succeeding years. You have basis to the extent of the amounts paid for your stock (adjusted for net pass-through income, losses, and distributions), plus any amounts you have personally loaned to your S corporation. Planning Alert! If an S corporation anticipates financing losses through borrowing from an outside lender, the best way to ensure the shareholder gets debt basis is to: 1) Have the shareholder personally borrow the funds from the outside lender, and 2) Then have the shareholder formally (with proper and timely documentation) loan the borrowed funds to the S corporation.

Establishing A New Retirement Plan For 2019. Calendar-year taxpayers wishing to establish a qualified retirement plan for 2019 (e.g. profit-sharing, 401(k), or defined benefit plan) generally must adopt the plan no later than December 31, 2019. However, a SEP may be established by the due date of the tax return (including extensions), but a SIMPLE plan must have been established no later than October 1, 2019.

CHOICE OF BUSINESS ENTITY IN LIGHT OF CHANGES UNDER TCJA

Many have re-evaluated whether the tax changes impacting businesses under the ***"Tax Cuts and Jobs Act"*** or **"TCJA"** (first effective in 2018) encourage a new business form for operations. Over the past 30 years, pass-through entities (S corporations and partnerships) have been the entity of choice for most closely-held businesses. C corporations have been in disfavor largely due to the following advantages of pass-through entities: **1)** Single tax on pass-through business income allowing business income to be distributed to the owners without triggering a double tax, **2)** Ability to sell the assets of the business without triggering a double tax on the gain, **3)** Ability to take business losses on the owner's individual return, **4)** Inapplicability of the Accumulated Earnings Tax and the Personal Holding Company (PHC) penalty taxes, **5)** Expanded opportunities for owners of partnerships to transfer appreciated property into or out of a partnership without triggering an immediate taxable gain, **6)** Ability of partners who purchase or inherit a partnership interest to use the so-called 754 election to step-up their basis in partnership assets to equal the basis in their partnership interests, and **7)** Opportunities for S corporation shareholders to minimize their exposure to FICA and SECA taxes. **Practice Alert! TCJA did not eliminate these advantages!** However, it is worth reviewing the following key changes under TCJA that could warrant a business to re-visit its choice of business entity:

Reduction In Corporate Tax Rate. For tax years beginning after 2017, TCJA provides a flat tax rate of 21% (down from a top 35% rate) for regular "C" corporations. "Personal Service Corporations" (PSCs) are also subject to the flat 21% tax rate (down from a 35% flat tax rate). A PSC is generally a "C" corporation that is primarily in the business of providing services in the areas of health, law, accounting, engineering, architecture, actuarial sciences, performing arts, or consulting. Planning Alert! Before 2018, the tax on C corporations was calculated using graduated progressive tax rates ranging from 15% to 35% of corporate taxable income. However, using these previous progressive tax rate tables that existed before 2018, the overall "effective" tax rate for C corporations was below 21% if the corporation's taxable income was below $90,385. However, after TCJA, all taxable income (regardless of amount) of a C corporation is taxed at a flat rate of 21%. Consequently, assuming the corporation previously had no exposure to the corporate AMT, the flat regular corporate rate of 21% after TCJA is effectively an overall "effective" tax-rate increase for C corporations with taxable income under $90,385.

New 20% 199A Deduction Not Available To "C" Corporations. As discussed in more detail below, one of the most significant and far-reaching provisions under TCJA is the 20% Deduction under Section 199A. "C" corporations do not qualify for the 20% 199A Deduction.

Observation Regarding Choice Of Business Entity In Light Of The TCJA Changes. There is no question that the reduction of the top corporate tax rate of 35% to a fixed rate of 21% for C corporations has caused many owners of pass-through entities to re-evaluate whether they should convert their pass-through entity to a regular C corporation. Although changes in the effective tax rates on business income are important, there are additional tax provisions that should always be considered in determining whether operating as a C corporation or a pass-through entity is best for a particular business enterprise. There is no single recommendation that applies to all businesses. The impact of a variety of tax factors must be applied to each particular situation before an informed decision for a particular business can be made. And even then, the analysis is inevitably based, at least in part, on factors and assumptions that might occur in the future but are not necessarily reliable or quantifiable. We are in an ever-changing tax environment. With key national-level politicians calling for a roll back or repeal of several of the most significant tax breaks for businesses enacted under TCJA, the longevity of the business tax breaks under TCJA is uncertain. Consequently, Rules of Thumb are unreliable in deciding whether an S corporation, partnership, or proprietorship should become a C corporation. **Caution! It is worth noting that, where the owners of a pass-through business entity currently have an "overall" effective individual income tax rate (after considering the 20% §199A Deduction) of 21% or less, converting to a C corporation will not reduce the shareholders' overall effective Federal income tax rate. For example, a married couple with $709,000 of taxable income (before the 20% §199A deduction) in 2019, would have an overall effective Federal individual income tax rate on the $709,000 of approximately 21%, if the entire $709,000 qualified for the 20% §199A deduction.**

MAXIMIZE YOUR 20% 199A DEDUCTION FOR “QUALIFIED BUSINESS INCOME” (QBI)

Overview. One of the most significant and far-reaching provisions under TCJA that impacted 2018 tax returns for the first time is the **20% Deduction** under **Section 199A (“20% 199A Deduction”)** with respect to **“Qualified Business Income,” “Qualified REIT Dividends,”** and **“Publicly-Traded Partnership Income.”** The IRS has estimated that over 20 million taxpayers took this deduction on their 2018 tax returns! The 20% 199A deduction does not reduce your adjusted gross income (AGI) or impact your calculation of self-employment tax. Instead, the deduction simply reduces your Taxable Income (regardless of whether you itemize deductions or claim the standard deduction). In other words, the 20% 199A Deduction is allowed ***in addition to*** your itemized deductions or your standard deduction.

What Type Of Income Qualifies For The 20% 199A Deduction? Generally, the following types of income are eligible for the 20% 199A Deduction: Qualified REIT Dividends, Qualified Publicly-Traded Partnership Income, and Qualified Business Income. The rules for determining the 20% 199A Deduction for Qualified REIT Dividends and Publicly-Traded Partnership Income are relatively straightforward. However, the 20% 199A Deduction for “Qualified Business Income” (QBI) is by far having the biggest impact on the greatest number of individual and business taxpayers, and in certain situations can be complicated and tricky.

Who Qualifies For The 20% 199A Deduction With Respect To “Qualified Business Income” (QBI)? Taxpayers who may qualify for this 20% 199A Deduction are generally taxpayers that report “Qualified Business Income” (QBI) as: Individual owners of S corporations or partnerships; Sole Proprietors; Trusts and Estates; and Certain beneficiaries of trusts and estates. **Planning Alert!** The 20% 199A Deduction: **1)** Reduces an individual’s “taxable income,” **2)** Does not reduce the individual’s “adjusted gross income, and **3)** Is allowed **in addition to** an individual’s itemized deductions or standard deduction.

Rules For 20% 199A Deduction For QBI Are Much Simpler For Taxpayers With 2019 “Taxable Income” Of $160,700 Or Below ($321,400 Or Below If Filing Joint Return). Computing the 20% 199A Deduction for QBI for some taxpayers can be extremely tricky. However, as you read the following discussion, you will discover that certain provisions that could otherwise limit the amount of the 20% 199A Deduction, **do not apply** to taxpayers with 2019 “Taxable Income” (excluding the 20% 199A Deduction) of **$160,700 or below** (**$321,400** or below if married filing jointly). **Caution!** For married individuals filing separately, this Taxable Income threshold is $160,725 or below.

“Qualified Business Income.” **“Qualified Business Income” (QBI) -** that is generally eligible for the 20% 199A Deduction - is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to **“any”** trade or business **other than: 1)** Certain **personal service** businesses known as **“Specified Service Trades Or Businesses”** (described in more detail below), and **2)** The **Trade or Business** of performing services **“as an employee.”**

- **<u>QBI Generally Does Not Include:</u> 1)** Dividends (although Qualified REIT Dividends separately qualify for the 20% 199A Deduction), investment interest income, short-term capital gains, long-term capital gains, income from annuities, commodities gains, foreign currency gains, etc.; **2) Reasonable compensation** paid **by an S corporation to a shareholder; 3)** Any **"guaranteed payment"** paid to a partner by the partnership; or **4)** Any amount allocated or distributed by a partnership **to a partner** for services rendered to a partnership where it is ultimately determined that the partner was **acting other than in** his or her capacity as a partner.

<u>W-2 Wage And Capital Limitation On The Amount Of The 20% Of QBI Deduction.</u> Generally, the amount of your 20% of QBI Deduction with respect to each Qualified Trade or Business may not exceed **<u>the greater of:</u> 1)** 50% of your allocable share of W-2 wages allocated to the QBI of each "Qualified Trade or Business," or **2)** The sum of 25% of your allocable share of W-2 wages with respect to each "Qualified Trade or Business" plus 2.5% of your allocable share of unadjusted basis of tangible depreciable property held by the business at the close of the taxable year.

- **<u>Owners With Taxable Income Below Specified Thresholds Are Exempt From The W-2 Wage And Capital Limitation!</u>** For 2019, an otherwise qualifying taxpayer is **entirely exempt** from the **W-2 Wage And Capital Limitation** if **"Taxable Income"** (computed without regard to the 20% 199A Deduction) is **$160,700 or below** (**$321,400** or below if married filing jointly). **<u>Caution!</u>** For 2019, the Wage and Capital Limitation phases in ratably as a taxpayer's Taxable Income **goes from more than $160,700 to $210,700, or from more than $321,400 to $421,400** (if filing jointly).

<u>Business Income From "Specified Service Trade Or Businesses" (SSTBs) Generally Does Not Qualify For The 20% 199A Deduction For Owners Who Have "Taxable Income" Above Specified Thresholds.</u> Based on your "Taxable Income" (before the 20% 199A Deduction), all or a portion of your business income from a so-called *"Specified Service Trade or Business"* (i.e., certain service-type operations discussed in more detail below) **may not qualify** for the 20% 199A Deduction. More specifically, if your **"Taxable Income"** for 2019 (before the 20% 199A Deduction) is **$160,700 or below ($321,400 or below** if married **filing jointly), "<u>all</u>"** of the business income from your **"Specified Service Trade or Business" (SSTB)** is eligible for the 20% 199A deduction. However, if for 2019, your **"Taxable Income"** is **$210,700 or more ($421,400 or more** if married **filing jointly), "<u>none</u>"** of your SSTB income qualifies for the 20% 199A Deduction. **<u>Caution!</u>** If for 2019, your **"Taxable Income"** is **between $160,700 and $210,700** (between **$321,400 and $421,400** if married **filing jointly**), only **"a prorata portion"** of your SSTB income will be eligible for the 20% 199A Deduction. **<u>Planning Alert!</u>** If your Taxable Income for 2019 is **$160,700 or less ($321,400 or less** if married **filing jointly),** you are provided two major benefits with respect to the 20% 199A Deduction for Qualified Business Income (QBI): **1)** Your SSTB income (if any) is fully eligible for the 20% 199A deduction, ***and*** **2)** You are completely exempt from the W-2 Wage and Capital Limitation.

HIGHLIGHTS OF FINAL 199A REGS AND OTHER RECENT IRS GUIDANCE

With this overview in mind, the following is a summary of key highlights from the Final 199A Regs and other recent IRS guidance regarding the 20% 199A Deduction:

IRS Provides 250-Hour Safe Harbor For Rental Real Estate. In order for any business activity to generate "Qualified Business Income" (QBI), it first must be determined that the activity constitutes a *"trade or business."* For Federal income tax purposes, there has always been uncertainty whether and when a specific *"real estate rental"* activity would be considered a "trade or business." In response to that uncertainty, the IRS released guidance that presumes a rental real estate activity is a "trade or business" ***for purposes of the 20% 199A Deduction*** if the owner, employees, and independent contractors provide 250 or more hours of qualifying services with respect to the rental property during the tax year. **Planning Alert!** Failing to satisfy this 250-hour safe harbor only means the rental real estate activity will not be *"presumed"* to be a *"trade or business"* for purposes of the 20% 199A Deduction. For those who fail to satisfy this safe harbor, depending on the facts, it would still be possible that the owner could successfully argue that the rental real estate activity constitutes a "trade or business" under general common law principles or using another safe harbor (i.e., the self-rental safe harbor). **Caution!** This 250-hour safe harbor contains several rules and requirements, which are far too detailed to address in this letter.

Guidance On The Determination Of "Qualified Business Income" (QBI). "Qualified Business Income" (QBI) is commonly generated as pass-through income to an S corporation shareholder or a partner in a partnership, or as self-employed business income of a sole proprietor. The Final 199A Regs and other recent IRS guidance have provided additional information regarding the impact of selected items in the computation of QBI. The following items taken as a deduction against AGI will reduce QBI:

- **One-Half Of The Self-Employment Tax By A Self-Employed Taxpayer.**
- **Health Insurance Premiums By Self-Employed Taxpayers.**
- **Retirement Plan Contributions By Self-Employed Taxpayers And Partners.**
- **Deduction By A Partner Who Is Not Reimbursed For The Payment Of Partnership Expenses.**
- **Section 179 Deduction Taken By A Partnership Or S Corporation On The Owner's QBI.**

Clarification Of Selected SSTB Issues. As discussed previously, based on your "Taxable Income" (before the 20% 199A Deduction), all or a portion of your business income from a so-called ***"Specified Service Trade or Business" (SSTB)*** **may not qualify** for the 20% 199A Deduction. An SSTB is generally defined as a trade or business activity involved in the performance of services in the fields of: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, or any trade or business involving the services of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. An "SSTB" **does not include** the performance of **architectural** or **engineering** services. **Caution!** The Final 199A Regs provide significant guidance on SSTBs, including many examples of the types of businesses that **would** or **would not be classified as SSTBs.** This IRS guidance is far too lengthy to cover in detail in this letter.

FINAL COMMENTS

Please call us before implementing any planning ideas discussed in this letter, or if you need additional information. We are here to assist if you have questions and/or need to plan for maximizing your potential QBI deduction(s). Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our Firm closely monitors these changes. **Note!** The information contained in this material should not be relied upon without an independent, professional analysis of how any of the items discussed may apply to a specific situation.

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