CORDASCO
& COMPANY P.C.

Certified Public Accountants

**2018**

# YEAR-END INCOME TAX PLANNING FOR CORPORATE AND NON-CORPORATE BUSINESSES

***Detailed Overview***

**UPDATED November 5, 2018**

**www.cordascocpa.com**

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# 2018 YEAR-END INCOME TAX PLANNING FOR BUSINESSES

## INTRODUCTION

It's that time of year when businesses should start developing year-end planning strategies. Late in 2017, Congress passed the **"Tax Cuts and Jobs Act" (TCJA)** which represents the most substantial tax reform legislation in over 30 years. Since the vast majority of its provisions **are first effective in 2018,** we have an array of new provisions that must be considered for this year's year- end planning. For example, 2018 will be the first year we must consider changes under TCJA that: Reduce tax rates for C corporations; Eliminate the corporate AMT; Allow a 20% Deduction for individual owners of certain proprietorships, partnerships and S corporations; and, allow accelerated up-front write-off for an ever-expanding group of business assets.

Despite this backdrop of significant tax changes, many businesses should still benefit from traditional year-end tax planning strategies that include deferring *"income"* to a later year and accelerating *"deductions"* into the current year. Consequently, this letter is intended to remind you of the time-honored year-end tax planning techniques you should be considering for your business. We also identify new wrinkles that the recent tax changes may bring to these strategies.

**Caution!** Over the last few months, the IRS has been releasing guidance on various TCJA provisions. However, as we complete this overview, we are still waiting for further IRS clarifications on several important provisions. We closely monitor these IRS releases on an ongoing basis. Please call our Firm for the latest IRS notifications and announcements regarding any TCJA provision that we do not address in this overview.

**Be careful!** Although this overview contains many planning ideas, you cannot properly evaluate a particular planning strategy without calculating the overall tax liability for the business and its owners (including the alternative minimum tax) with and without the strategy. In addition, this overview contains ideas for Federal income tax planning only. **State income tax issues are not addressed.** However, you should consider the state income tax impact of a particular planning strategy. We recommend that **you call our Firm before implementing any tax planning technique** discussed in this analysis, or if you need more information.

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## KEEP AN EYE ON CERTAIN PREVIOUSLY-EXPIRED BUSINESS TAX BREAKS

For well over a decade, we have been faced with the potential expiration of a long list of popular tax breaks for businesses. Although several years ago Congress removed the sunset date for several of these tax breaks, some expiring tax provisions remain. Unfortunately, several of the tax breaks that apply to businesses **expired at the end of 2017,** including: Deductions for Energy-Efficient Commercial Buildings; 7-Year Depreciation Period for Certain Motor Sports Racetrack Property; a Host of Business Credits for Qualified Energy-Related Expenditures; Temporary Suspension of the Fee on Health Insurance Providers; and 3-Year Depreciation Period for Certain Race Horses. Historically, Congress has temporarily extended most of these provisions every few years. As we send this letter, legislation is being considered that would extend these expired tax breaks if enacted. Please call our Firm if you want a status report.

- Planning Alert! The 30% business energy tax credit for **Qualified Solar Energy Property, Fiber-Optic Solar Property, Qualified Fuel Cell Property, and Qualified Small Wind Energy Property** doesn't begin phasing out until **after 2019.** "Qualified Solar Energy Property" is qualifying solar equipment installed to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat.

## PAY SPECIAL ATTENTION TO THE NEW 20% DEDUCTION FOR CERTAIN QUALIFIED INCOME

Background. One of the most significant and far-reaching provisions under TCJA is the ability of qualified taxpayers to take a 20% Deduction with respect to **"Qualified Business Income," "Qualified REIT Dividends,"** and **"Publicly-Traded Partnership Income."** Of these three types of qualifying income, **"Qualified Business Income" (QBI)** is expected to have the biggest impact on the greatest number of taxpayers. In fact, this new 20% Deduction for QBI is already having a significant impact on a broad range of owners of pass-through businesses (i.e., S Corporations, Partnerships, Sole Proprietors). Consequently, the remainder of this discussion on the new 20% Deduction focuses **primarily on "Qualified Business Income" (QBI).**

Planning Alert! The rules for determining the 20% Deduction for Qualified REIT Dividends and Publicly-Traded Partnership Income are relatively straight forward. Please call our Firm if would like additional information.

Highlights of the 20% Deduction For "Qualified Business Income" (QBI). In certain situations, the rules for determining whether a taxpayer qualifies for the new 20% Deduction with respect to **Qualified Business Income (QBI)** can be quite complicated. Consequently, the discussion below provides only an "overview" of the primary requirements a taxpayer must satisfy to be eligible to take the 20% Deduction as it applies to QBI.

Caution! If you need additional information on any matter we discuss below, please call our Firm and we will be glad to review your specific situation and help you determine whether you will qualify for this new 20% Deduction.

- Who Could Qualify for the 20% Deduction with Respect To "Qualified Business Income" (QBI)? Taxpayers who may qualify for the 20% Deduction for "Qualified Business Income" (QBI) generally include taxpayers who report certain types of business income as: Individual owners of S corporations or partnerships; Sole Proprietors; Trusts and Estates; and Certain beneficiaries of trusts and estates.
  Planning Alert! The 20% Deduction is generally taken on the owner's individual income tax return. The 20% Deduction does not reduce the individual owner's adjusted gross income (AGI) or impact the calculation of the owner's self-employment tax. Instead, the deduction simply reduces the individual owner's Taxable Income (regardless of whether the owner itemizes deductions or claims the standard deduction). In other words, the 20% Deduction is allowed **in addition to** individual owner's itemized deductions or standard deduction.

- Rules For 20% Deduction for QBI Much Simpler for Taxpayers With "Taxable Income" Of $157,500 Or Below ($315,000 Or Below If Filing Joint Return). Computing the 20% Deduction for QBI for some taxpayers can be extremely tricky. However, as you read the following discussion, you will discover that the rules for determining (and qualifying for) the 20% Deduction for QBI are far simpler and easier for individuals with 2018 "Taxable Income" (excluding the 20% Deduction) of **$157,500 or below** (**$315,000** or below if married filing jointly).
- "Qualified Business Income." **"Qualified Business Income" (QBI)** that is generally eligible for the 20% 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."**

  Caution! W-2 wages you receive as an employee do not qualify for the 20% Deduction. Moreover, the IRS says that income you earn as an independent contractor (e.g., sole proprietor) will not qualify if it is ultimately determined that you should have been classified as a "common law" employee. Determining whether a person should be classified as a "common law" employee requires the weighing of multiple factors and is exceedingly fact specific. If you are operating as an independent contractor and would like us to assist you in determining whether you could possibly be re-classified by the IRS as a "common law" employee, please call our Firm.

  **QBI Generally Does Not Include: 1)** Dividends, 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 a qualified trade of business to a service provider; 3)** Any **"guaranteed payment"** paid to a partner by the partnership; or **4)** Any amount allocated or distributed by a partnership **to a partner** where it is ultimately determined that the partner was **acting other than in** his or her capacity as a partner for services rendered to a partnership.

- Basic Formula for Determining the Amount of the 20% Deduction Where the Only Income Qualifying for the 20% Deduction Is "Qualified Business Income."

  Step 1 – **Calculate The "Initial 20% Deduction Amount" For Each, Separate "Qualified Trade or Business" Interest of The Taxpayer.** The **"Initial 20% Deduction Amount"** for each owner's "Qualified Trade or Business" interests is the lesser of: **1) 20%** of the owner's share of **QBI** (which can be a business "loss") from the owner's interest in each **"Qualified Trade or Business,"** or **2)** The **owner's share** of the **W-2 Wage and Capital Limitation** (if applicable) for each such trade or business interest.

  Planning Alert! As discussed in more detail below, if your "Taxable Income" (excluding the 20% Deduction) is **$157,500 or below** (**$315,000 or below** if married filing jointly), you are not subject to the **W-2 Wage and Capital Limitation.**

  Step 2 –**Total Your "Initial Deduction Amounts" From Each "Qualified Trade or Business" Interest.** Add the **"Initial Deduction Amounts"** in **Step 1** for each "Qualified Trade or Business" interest. This is Your **"Tentative 20% Deduction Amount."**

  Step 3 – **Apply Overall Limitation.** The aggregate **"Tentative Deduction Amounts"** computed in Step 2 **cannot exceed 20%** of the **excess** of your "Taxable Income" (before your 20% Deduction) over your "Net Capital Gains" (if you have any).
  Caution! This overall limitation in Step 3 ensures that your **20% Deduction Amount** can never exceed 20% of your Taxable Income (before your 20% Deduction) less your amount (if any) of Net Capital Gains.

- W-2 Wage and Capital Limitation. For taxpayers subject to the "W-2 Wage and Capital Limitation" mentioned in step 1 above, this limitation is <u>**the greater of:**</u> **1)** 50% of the taxpayer's allocable share of the business's W-2 wages allocated to the QBI of each "Qualified Trade or Business," or **2)** The sum of 25% of the taxpayer's allocable share of W-2 wages with respect to each "Qualified Trade or Business" plus 2.5% of the taxpayer's allocable share of unadjusted basis of tangible depreciable property held by the business at the close of the taxable year and which is used for the production of QBI.

<u>**Observation.**</u> This limitation, to the extent it applies to a taxpayer, is generally designed to ensure that the maximum 20% Deduction amount is available only to qualified businesses that have sufficient W-2 wages, sufficient tangible depreciable business property, or both.

<u>**Owners with Taxable Income Below Certain Thresholds Are Exempt from the W-2 Wage and Capital Limitation!**</u> As previously noted, otherwise qualifying taxpayers **are entirely exempt** from the **W-2 Wage and Capital Limitation** if the Taxpayer's **"Taxable Income"** for 2018 (computed without regard to the 20% Deduction) does **not exceed $157,500 ($315,000** if filing jointly).

<u>**Caution!**</u> The Wage and Capital Limitation phases in ratably as a taxpayer's Taxable Income **goes from more than $157,500 to $207,500 or from more than $315,000 to $415,000** (if filing jointly).

<u>**Planning Alert!**</u> This "Taxable Income" threshold applies separately to each individual owner of a qualifying business. For instance, assume **Owner A** and **Owner B** each **own 50%** of an S corporation that generates QBI and each files a joint return. If Owner A has "Taxable Income" of **$315,000** or less (before the 20% Deduction), she would be **fully exempt** from the W-2 Wage and Capital Limitation with respect to her share of the S corporation's QBI. However, if Owner B's "Taxable Income" equals or **exceeds $415,000,** he would be **fully subject to** the W-2 Wage and Capital Limitation.

- <u>**Business Income From "Specified Service Trade or Businesses" (SSTB) Generally Does Not Qualify for the 20% Deduction for Owners Who Have "Taxable Income" Above Certain Thresholds.**</u> Based on your "Taxable Income" (before the 20% Deduction), all or a portion of your business income from a so-called "Specified Service Trade or Business" (i.e., certain service-type operations listed below) **may not qualify** for the 20% Deduction. More specifically: **1)** If your **"Taxable Income"** (before the 20% Deduction) is **$157,500 or below ($315,000 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% Deduction; **2)** If your **"Taxable Income"** is **between $157,500 and $207,500** (between **$315,000 and $415,000** if married **filing jointly**), only **"<u>a pro rata portion</u>"** of your SSTB income will be eligible for the 20% Deduction, and **3)** If your **"Taxable Income"** is **$207,500 or more ($415,000 or more** if married **filing jointly), "<u>none</u>"** of your SSTB income qualifies for the 20% Deduction.

  <u>**Planning Alert!**</u> As the following example illustrates, a taxpayer with Taxable Income of **$157,500 or less ($315,000 or less** if married **filing jointly)** is provided two major benefits with respect to the 20% Deduction for Qualified Business Income (QBI): **1)** The taxpayer's SSTB income (if any) is fully eligible for the 20% Deduction, <u>**and**</u> **2)** The taxpayer is completely exempt from the W-2 Wage and Capital Limitation.

  <u>**Example.**</u> Assume the taxpayer is a physician who owns 50% of an S Corporation (that operates the physician's medical practice which is an SSTB) and the S corporation has $700,000 of QBI. The taxpayer has $315,000 of "Taxable Income" (before the 20% Deduction), $15,000 of "Net Capital Gain," and files a joint return. Since the physician's **"Taxable Income" is not over $315,000: 1)** Her pass-through business income from her S Corporation's medical practice (an SSTB) is **fully eligible** for the 20% Deduction and, **in addition 2)** She **is not subject to** the **W-2 Wage and Capital Limitation.** Therefore, her 20% Deduction Amount is computed as follows: **The lesser of: 1) $70,000** (20% of $350,000 - the owner's 50% share of the S corporation's QBI of $700,000), or **2)** The owner's share of the W-2 Wage and Capital Limitation for the trade or business (which does not apply because owner's Taxable Income does not exceed $315,000). However, the deduction may not exceed 20% of the Owner's "Taxable Income" ($315,000) less her "Net Capital Gains" ($15,000) which equals $300,000. Therefore, the amount of the owner's 20% Deduction **is $60,000** ($300,000 x 20%).

**Caution!** If this physician (who is filing a joint return) had "Taxable Income" **of $415,000 or more,** then **"none"** of her business income from the medical practice (which is an SSTB) would be eligible for the 20% Deduction. Moreover, if this S corporation had generated qualifying non-SSTB income, with Taxable Income on a joint return of $415,000 or more, the owner would be fully subject to the W-2 Wage and Capital Limitation.

- **What Is A "Specified Service Trade or Business" (SSTB)?** An SSTB is generally defined as a trade or business 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.
  **Note!** An "SSTB" **does not include** the performance of **architectural** or **engineering** services.

  **IRS Provides Additional Guidance on SSTBs.** In early August, the IRS released significant guidance on the 20% Deduction, which included 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. However, here are a **few notable examples** from that IRS guidance designed to illustrate the types of businesses that **would be included** (or **would not be included**) in the following selected **Fields of Service** that are included in the SSTB definition: **1) Health: Includes -** Physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists; **Does Not Include -** Operation of health clubs or health spas, research, testing, and manufacture and/or sales of pharmaceuticals or medical devices; **2) Law: Includes -** Performance of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals; **Does Not Include -** Services by printers, delivery services, or stenography services; **3) Accounting: Includes -** Accountants, enrolled agents, return preparers, financial auditors, and similar professionals; **Does Not Include -** Payment processing and billing analysis; **4) Performing Arts: Includes -** Actors, singers, musicians, entertainers, directors; **Does Not Include -** Services by persons who broadcast or otherwise disseminate video or audio of performing arts; **5) Consulting: Includes -** Professional advice and counsel to clients to assist the client in achieving goals and solving problems and providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency; **Does Not Include -** Services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses; **6) Financial Services: Includes -** Managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans; **Does Not Include -** Taking deposits or making loans; **7) Brokerage Services: Includes -** Person who arranges transactions between a buyer and a seller with respect to securities for a commission or fee; **Does Not Include -** Real estate agents and brokers, or insurance agents and brokers; **8) Investment Management: Includes -** Receipt of fees for providing investing, asset management, or investment management services; **Does Not Include -** Directly managing real property; and **9) Principal Asset Is Reputation/Skill Of Employees Or Owners: Includes -** Fees for celebrity endorsements, appearance fees, and fees for use of celebrity images. **Does Not Include -** Operating business income even if generated to a large degree by the good business reputation of the owners and/or employees.

  **Caution!** Although this IRS guidance is certainly helpful, it does not address all potential SSTB situations. If you own a service-related business that is not addressed by the IRS guidance summarized above, please call our Firm. We will be glad to review your specific situation.

- **In Certain Situations - Keeping Your "Taxable Income" From Exceeding $157,500 ($315,000 If Filing Jointly) May Allow You to Maximize Your 20% Deduction Amount.** It's worth repeating that, if for 2018 you are expecting your "Taxable Income" (before the 20% Deduction) to be **$157,500 or below ($315,000 or below** if filing a **joint return),** you will have two significant advantages when it comes to qualifying for the maximum 20% Deduction with respect to Qualified Business Income (QBI): **1)** Your 20% Deduction amount will not be subject to the W-2 Wage and Capital limitation, and **2)** Your business income that is generated by a "Specified Service Trade or Business" (SSTB) will be fully eligible for the 20% Deduction. Consequently, owners whose expected 20% Deduction would otherwise be significantly reduced by either of these limitations, will generally have an additional tax incentive to defer taxable income and/or increase deductions that cause their **Taxable Income** for 2018 to not exceed the **$157,500** or **$315,000 thresholds.**

<u>**Planning Alert!**</u> There are many time-tested strategies for taxpayers to defer taxable income or increase deductions. For example, a taxpayer could significantly increase deductions before year-end by: Bunching into the current tax year the charitable deductions the taxpayer was planning to make over the next several years; or, Accelerating into the current tax year planned purchases of business equipment, vehicles, etc. that would qualify for the 100% 168(k) Bonus Depreciation or the 179 Deduction (both of which are discussed in more detail below). Please call our Firm if you would like additional information on this planning technique.

- <u>Evaluating Reasonable W-2 Compensation Levels Paid to S Corp Owners/Employees Is More Important Than Ever!</u> Even before the 20% Deduction provision was enacted, S corporation shareholder/employees have had an incentive to pay themselves W-2 wages as low as possible because only the shareholder's W-2 income from the S corporation is subject to FICA taxes. Other income of the shareholder from the S corporation is generally not subject to FICA or Self-Employment (S/E) taxes. Traditionally, where the IRS has determined that an S corporation shareholder/employee has taken unreasonably **"low"** compensation from the S corporation, the IRS has argued that other amounts the shareholder has received from the S corporation (e.g., distributions) are disguised **"compensation"** and should be subject to FICA taxes. In light of the new 20% Deduction, in certain situations, reviewing the W-2 wage level for Shareholder/Employees of S Corporations becomes even more important as we illustrate below: For example, for S Corporation shareholder/employees who expect to have Taxable Income (before the 20% Deduction) of **$157,500 or less** (**$315,000 or less** if married filing jointly), in order to maximize their potential 20% Deduction **there is a tax incentive** to keep the shareholders' **W-2 wages as "low" as possible,** because: **1)** The W-2 Wages paid to shareholders **do not qualify** for the new 20% Deduction but the W-2 Wages **do reduce** a shareholder's pass-through Qualified Business Income, **2)** The shareholder will be exempt from the W-2 Wage and Capital Limitation (so lower W-2 wages will not limit the shareholder's potential 20% deduction amount), and **3)** The shareholder's pass-through SSTB income (if any) will be fully eligible for the 20% Deduction, while W-2 wages paid to the shareholder/employee will not qualify.

  <u>**Caution!**</u> The IRS has a long history of attacking S Corporations that it believes are paying shareholder/employees unreasonably low W-2 wages.

  By contrast, for S Corporation shareholder/employees who expect to have Taxable Income (before the 20% Deduction) of **$207,500 or more** (**$415,000 or more** if married filing jointly), there **may be** a **tax incentive** to **"increase"** the shareholder's W-2 wages if: **1)** The S corporation is generating pass-through Qualified Business Income (QBI), and **2)** The W-2 Wage and Capital Limitation will significantly limit the amount of the Shareholder/employee's 20% Deduction unless the S corporation significantly increases the W-2 wages paid to the shareholder/employee.

  <u>**Planning Alert!**</u> If you want our Firm to review the W-2 wages that your S corporation is currently paying to its shareholders in light of this new 20% Deduction for Qualified Business Income, please contact us as soon as possible. We will be glad to evaluate your specific situation and make recommendations.

- <u>Payments by A Partnership to A Partner for Services.</u> A partner's pass-through share of **QBI** generally **"is eligible"** for the 20% Deduction. Moreover, payments by the partnership to the partner that are properly classified as "distributions" neither reduce or increase the partnership's QBI that passes through to its partners. However, the following types of payments to a partner by a partnership **do reduce** the **amount of QBI** otherwise generated by a partnership, and are also **"not eligible"** for the 20% Deduction: **1)** Any amount that is a **"guaranteed payment"** paid by the partnership to the partner, or **2)** Any amount allocated or distributed by a partnership **to a partner** where it is ultimately determined that the partner was **acting other than in** his or her capacity as a partner for services rendered to a partnership.

  <u>**Caution!**</u> It is not always clear whether specific payments to a partner will be classified as "distributions" (that generally do not reduce the amount of your 20% Deduction), or alternatively fall into one of the two above-listed

categories that are not eligible for the 20% Deduction. In light of these potential limitations as applied to the 20% Deduction for QBI, please call our Firm if you want us to review your partnership's current payment arrangement with its partners.

## TCJA REDUCES THE CORPORATE TAX RATE TO 21% AND ELIMINATES CORPORATE AMT

Reduction in Corporate Tax Rate. For tax years **beginning after 2017,** TCJA provides for 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.**

Planning Alert! The IRS has confirmed that a fiscal-year C corporation essentially uses a blended tax rate for the fiscal year that includes January 1, 2018. Please call our Firm if you have a fiscal-year C corporation and you need information on determining this blended tax rate for your corporation.

Corporate Tax Rate on Certain S Corporations That Previously Converted From "C" Corporation Status Is Also 21%! Before TCJA, a C corporation that converted to an S corporation (converted S Corporation) was potentially subject to a flat 35% corporate built-in gains tax or passive investment income tax. After TCJA, the tax rate on both of these corporate taxes potentially imposed on converted S corporations **is reduced to a flat rate of 21%.**

Repeal Of "Corporate" Alternative Minimum Tax (AMT). TCJA **repeals** the **corporate AMT** for **tax years beginning after 2017.** A corporation will be allowed a **refundable credit** for each of the **tax years beginning in 2018, 2019, and 2020** equal to **50%** of unused AMT credit carryovers to those respective years in excess of the regular tax for those years. Any **AMT credit carryover amount** that remains unused after applying it to the **2021** regular tax is 100% refundable. Consequently, the **entire corporate AMT credit** that carries over beyond 2017 will be recouped either as a reduction in post-2017 corporate income tax and/or a refundable credit **no later than 2021.**

Planning Alert! The IRS has confirmed that a fiscal-year C corporation essentially uses a blended AMT rate for the fiscal year that includes January 1, 2018.

Impact of TCJA Changes To Choice Of Business Entity Analysis. 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.

<u>Practice Alert!</u> **The Tax Cuts and Jobs Act did not eliminate these advantages!**

However, 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 Democratic leaders 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.

<u>Caution!</u> 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 **$694,587 of taxable income** (before the 20% §199A deduction) in 2018, would have an overall effective individual income tax rate on the $694,587 of 21%, if the entire $694,587 qualified for the 20% §199A deduction.

<u>Planning Alert!</u> If your business is currently operating as a pass-through entity, we will be glad to review your specific situation and determine whether we believe there is a strong "tax" reason to convert to a "C" corporation.

## <u>TRADITIONAL YEAR-END TAX PLANNING TECHNIQUES BEFORE AND AFTER TCJA</u>

A traditional year-end tax planning strategy for businesses that should generally apply even 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 save taxes where the income tax rate on the business's income in the following year will be the same or greater than the current-year tax rates. This strategy could be even more important if the deferral of business income or acceleration of business deductions will maximize the business owner's 20% Deduction by causing the owner's "Taxable Income" to drop to **$157,500 or less ($315,000 or less** if filing a **joint return).** Traditionally, a popular way for businesses to maximize current-year deductions has been to take advantage of the **First-Year 168(k) Bonus Depreciation deduction** and the **179 Deduction.**

<u>Planning Alert!</u> TCJA has significantly enhanced and expanded the deductions for qualifying 168(k) Property and 179 Property.

## <u>PLANNING WITH THE FIRST-YEAR 168(k) BONUS DEPRECIATION DEDUCTION AFTER TCJA</u>

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 **<u>after September 27, 2017</u>** and **before January 1, 2023.** TCJA also made the following changes to the 168(k) Bonus Depreciation deduction:

- <u>"Used" Property Now Qualifies For 168(k) Bonus Depreciation.</u> Previously, 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,** TCJA allows the 168(k) Bonus Depreciation to be taken on **"new" or "used"** property. Therefore, under TCJA, 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!** Even after TCJA, used property will not qualify if the property was previously used by the taxpayer (or by certain parties related to the taxpayer).

**Planning Alert!** The expansion of the 168(k) Bonus Depreciation to "used" property creates new planning opportunities, including: **1)** A lessee that currently leases qualifying 168(k) property (e.g., leased equipment) from an unrelated lessor, could later purchase the property from the lessor and qualify for the 100% 168(k) Bonus Depreciation; **2)** Taxpayers that purchase the operating assets of another operating business will be able to deduct 100% of the purchase price that is properly allocated to 168(k) assets of the target business; **3)** Otherwise qualifying 168(k) property purchased new or used for personal use (e.g., a truck or passenger vehicle) which is later converted primarily to business use by the same owner can qualify for the 100% 168(k) Bonus Depreciation deduction in the year of the conversion, if the asset was acquired after September 27, 2017

(**Caution!** For a car, truck, or SUV, the business mileage for the year of conversion would generally have to be greater than the personal mileage); and **4)** The IRS says that a person who buys a partnership interest from an unrelated selling partner may be entitled to the 100% 168(k) Bonus Depreciation deduction with respect to a certain portion of the purchase price of the partnership interest, if the partnership owns existing qualifying 168(k) property. **Planning Alert!** Please call our Firm if you need additional information regarding the rules for determining whether a portion of the cost incurred by a purchaser of a partnership interest might qualify for the 168(k) Bonus Depreciation.

- **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.** More specifically, these vehicles **acquired and placed-in-service in 2017** and used 100% for business were generally allowed **maximum depreciation of $3,160** ($3,560 for trucks and vans). Also, these caps were increased by $8,000 if the vehicle otherwise qualified for the 168(k) Bonus Depreciation.

  For qualifying vehicles placed-in-service **after 2017** and used 100% for business, TCJA increases the annual depreciation caps (without regard to the $8,000 increase) as follows: **1st year - $10,000** (up from $3,160 if placed-in-service in 2017); **2nd year - $16,000** (up from $5,100); **3rd year - $9,600** (up from $3,050); **fourth and subsequent years - $5,760** (up from $1,875). Moreover, if the vehicle (new or used) otherwise qualifies for the 168(k) Bonus Depreciation, the first-year depreciation cap is increased by $8,000 (i.e., from $10,000 to $18,000).

  **Planning Alert!** 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 2018** would be entitled to a **depreciation deduction for 2018 of up to $18,000,** whether purchased new or used. 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 2018** as a **168(k) Bonus Depreciation deduction.**

- **100% 168(k) Bonus Depreciation Expanded to Production Costs Related to Certain Qualified Film, TV, And Live Theatrical Productions.** Effective for productions **acquired and placed-in-service after September 27, 2017 and before 2027,** the 100% 168(k) Bonus Depreciation deduction is available for the production costs of certain qualified film, television and live theatrical productions. To qualify, generally 75% or more of the compensation must be paid to actors, production personnel, directors and producers for services performed in the United States.

<u>Planning Alert!</u> Before TCJA, generally a taxpayer could elect to deduct immediately only up to $15 million (and in some cases up to $20 million) of these productions' costs. There is no dollar limit with regard to the 100% 168(k) Bonus Depreciation deduction.

## <u>PLANNING WITH THE SECTION 179 DEDUCTION</u>

Another popular and frequently-used business tax break is the up-front Section 179 Deduction ("179 Deduction"). For 179 Property placed-in-service **in tax years beginning after 2017,** TCJA made several taxpayer-friendly enhancements to the 179 Deduction which include: **1)** Increasing the 179 Deduction limitation to $1,000,000 (up from $510,000 for 2017), **2)** Increasing the phase-out threshold to $2,500,000 (up from $2,030,000 for 2017), and **3)** Expanding the types of business property that qualify for the 179 Deduction.

<u>Planning Alert!</u> To maximize your 179 Deductions for 2018, it is important for your business to determine which depreciable property acquired during the year qualifies as 179 Property. The following is a list of the expanded types of business property that qualify for the 179 Deduction **afterTCJA:**

- <u>TCJA Expands the General Definition Of 179 Property.</u> Generally, "depreciable" property qualifies for the **179 Deduction** if: **1)** It is purchased **new or used, 2)** It is "tangible personal" property, **and 3)** It is used primarily for business purposes (e.g., machinery and equipment, furniture and fixtures, business computers, etc.). Off-the-shelf business software also qualifies.

  <u>Planning Alert!</u> **Before TCJA,** the 179 Deduction was not allowed for property used in **connection with lodging** (other than hotels, motels, etc.). **Effective for property placed-in-service in tax years beginning after 2017,** TCJA removes this restriction, so the 179 Deduction **is now allowed** for otherwise qualifying property used in connection with lodging (e.g., the cost of furnishing a home that the owner is renting to others would now qualify).

- <u>New Definition Of "Qualified Real Property."</u> **Before TCJA,** property that qualified for the 179 Deduction also included **"Qualified Real Property"** (i.e., certain leasehold improvements to existing commercial buildings; certain costs of acquiring and/or improving restaurant buildings; and, certain costs of improving the interior of existing buildings used for retail sales). **Effective for property placed-in- service in tax years beginning after 2017,** TCJA changed the definition of **"Qualified Real Property"** (which qualifies for the 179 Deduction) to mean any of the following **"improvements" to an existing commercial** (i.e., nonresidential) building that are **placed-in-service after** the **commercial building was first placed-in-service: 1) "Qualified Improvement Property"** (defined below), **2) Roofs, 3) Heating, Ventilation, and Air-Conditioning Property, 4) Fire Protection and Alarm Systems,** and **5) Security Systems.**

  <u>Tax Tip!</u> Determining whether a major repair to a building's roof should be capitalized or deducted immediately as a repair under the voluminous capitalization regulations, is not always an easy task. Since new roofs with respect to an existing commercial building may now qualify for the 179 Deduction after 2017, in many situations the "capitalization vs. repair" issue relating to the replacement of roofs should largely be eliminated where the 179 limitation caps for the year are not exceeded.

  <u>Definition Of "Qualified Improvement Property."</u> The first category of "Qualified Real Property" (listed above) qualifying for the 179 Deduction is "Qualified Improvement Property." **"Qualified Improvement Property"** is generally defined as: **1)** an **Improvement, 2)** to the **Interior Portion** of a nonresidential **Commercial Building** (provided the improvement is not attributable to an enlargement of the building, elevators or escalators, or the internal structural framework of the building), and **3)** provided the **Improvement** is **placed-in-service** <u>**after**</u> the building was first placed-in-service.

  <u>Caution!</u> The Committee Reports to TCJA make it clear that Congress intended to enact statutory language that would ensure that **"Qualified Improvement Property"** would also qualify for the 100% 168(k) Bonus Depreciation

deduction if placed-in-service after 2017. However, that intended statutory language was omitted (presumably inadvertently) from the final TCJA legislation. Consequently, the IRS in recently- released proposed regulations is taking the position that **"Qualified Improvement Property"** placed-in- service after 2017 has a 39-year depreciable life and <u>does not qualify</u> for **the 168(k) Bonus Depreciation deduction,** unless and until Congress enacts legislation correcting its statutory mistake.

<u>Good News!</u> Under the existing provisions of TCJA, it is clear that **"Qualified Improvement Property"** placed-in-service in tax years beginning after 2017 <u>does qualify</u> for the **179 Deduction** (subject to the dollar cap limitations).

<u>Planning Alert!</u> Qualified Real Property is subject to the **overall 179 Cap** of **$1,000,000** (for 2018) and the **overall phase-out threshold** of **$2,500,000** (for 2018).

<u>Caution!</u> These caps apply to **all** 179 Property (including QRP) **in the aggregate.**

- <u>Business Vehicles.</u> New or used business vehicles generally qualify for the 179 Deduction, provided the vehicle is **used more-than-50% in your business.**

  <u>Planning Alert!</u> As discussed previously in the 168(k) Bonus Depreciation segment, there is a dollar cap imposed on business cars and trucks that have a **loaded vehicle weight of 6,000 lbs or less.** If applicable, this dollar cap applies to both the 168(k) Bonus Depreciation and the 179 Deduction taken with respect to the vehicle.

  <u>So-Called "Heavy Vehicles" Exempt from Dollar Caps.</u> As also previously discussed, Trucks and SUVs that **weigh over 6,000 lbs** are exempt from the annual depreciation caps. In addition, new or used "heavy vehicles", if used more-than-50% in business, will also generally qualify for a **179 Deduction of up to $25,000** (which will be indexed for inflation after 2018).
  <u>Tax Tip!</u> Pickup trucks with loaded vehicle weights over 6,000 lbs are exempt from the $25,000 limit to the 179 Deduction if the truck bed is at least six feet long.

  <u>Planning Alert!</u> The $25,000 cap applies only for purposes of the 179 Deduction. This $25,000 cap **does not apply** with respect to the 100% 168(k) Bonus Depreciation deduction taken on vehicles weighing over 6,000 lbs.

  **Example.** Let's assume that before the end of 2018 you purchase and place-in-service a **new** or **used** *"over-6,000 lb"* SUV for $50,000 **used entirely for business.** If you elected to take the 179 Deduction for the SUV, your deduction would be capped at $25,000. However, you could forego the 179 Deduction and simply deduct the entire $50,000 cost under 168(k) in 2018, provided you **placed the SUV in service no later than December 31, 2018.** Generally, you will be considered to have placed the SUV in service in 2018 if you have purchased the vehicle and made it **ready and available** for use **no later than December 31, 2018.**

  <u>Caution!</u> Whether you take the 179 Deduction or 168(k) Bonus Depreciation on your business vehicle (whether or not it weighs more than 6,000 lbs), if your business-use percentage later **drops to 50% or below,** you will generally be required to bring into income a portion of the deductions taken in previous years.

  <u>Tax Tip.</u> 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 Deduction** (as well as the 168(k) Bonus Depreciation deduction, if applicable) for 2018 purchases, even if the qualifying property **was placed-in-service as late as December 31, 2018!**

<u>The Section 179 Taxable Income Limitation Becomes Less Important After TCJA.</u> The 179 Deduction is limited to a taxpayer's "trade or business" taxable income (determined without the 179 Deduction) for the tax year. Any excess 179 Deduction over the "taxable income limitation," is carried forward to later years until the taxpayer generates enough

business taxable income to fully deduct it. This generally means that this "taxable income limitation" will not limit the taxpayer's Section 179 Deduction for a specific tax year so long as the taxpayer has aggregate net income from all trades or businesses at least equal to the 179 Deduction for that tax year. For this purpose, a taxpayer's trade or business income includes W-2 wages reported by the taxpayer or the taxpayer's spouse (if filing a joint return).

**For example,** assume that in 2017 (before TCJA) Bob was employed as an accountant with a salary of $75,000. On the side, Bob also operated a one-person consulting business (operating as a sole proprietorship that is not considered a "hobby") and expected to earn $5,000 of gross revenue in 2017 (his first year of operation). Assume further that Bob purchased an SUV (weighing over 6,000 lbs) for $55,000 before the end of 2017, which he used entirely in his consulting business. Since his $75,000 salary counted for purposes of the "taxable income limitation," if he bought the $55,000 SUV and placed it in service by December 31, 2017, he would have been allowed a Section 179 Deduction of $25,000 for 2017, and he could have depreciated the remaining cost of $30,000.

<u>Planning Alert!</u> There is no "taxable income limitation" or $25,000 cap with respect to the 168(k) Bonus Depreciation deduction. Therefore, assuming these same facts occurred in 2018 (after TCJA), Bob **could deduct 100% of the $55,000 cost** of the SUV as a **168(k) Bonus Depreciation deduction** (whether he purchased the SUV new or used), and regardless of his taxable income.

<u>Make Sure Newly-Acquired Property Is "Placed-In-Service" By Year End.</u> In order to take the 168(k) Bonus Depreciation deduction and/or the 179 Deduction in 2018 (assuming a calendar-year taxpayer), any newly-acquired asset must actually be **"Placed-In-Service"** no later than **December 31, 2018.** 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 2018.** 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.

<u>The 100% 168(k) Bonus Depreciation Deduction For "Used" Property Generally Makes Cost Segregation Studies More Valuable.</u> Depreciable components of a building that are properly classified as depreciable personal property under a **cost segregation study** are generally depreciated over 5 to 7 years. **Before TCJA,** these depreciable building components for a purchaser of a used building generally qualified for the 179 Deduction (subject to the dollar caps) but did not qualify for a 168(k) Bonus Depreciation deduction because it only applied to "new" property. However, **after TCJA,** the depreciable components of a building that are properly classified as "personal property" (as opposed to "real property") will qualify for the 100% 168(k) Bonus Depreciation (whether new or used).

**Example.** Assume a taxpayer acquired an existing shopping center on **January 1, 2017 (before TCJA)** for $5,000,000. Also, assume the taxpayer had no qualifying 179 Property acquisitions during 2017 other than the 179 Property identified in the cost segregation study for the $5,000,000 acquisition. Pursuant to a cost segregation study, assume the taxpayer allocated the $5,000,000 purchase price to the various asset components as follows: **1)** $1,000,000 to land (non-depreciable), **2)** $750,000 to land improvements (15-year recovery period), **3)** $600,000 to equipment (five-year recovery period), and **4)** $2,650,000 to the building (39-year recovery period). **For 2017 (before TCJA),** by employing a cost segregation study, the taxpayer's **first-year depreciation deduction** would have been **<u>$630,618</u>** (i.e., $37,500 for land improvements, $528,000 for the equipment including $510,000 of 179 Deduction, and $65,118 for the building).

By contrast, assume the facts are the same, except the shopping center was **acquired on January 1, 2018 (after TCJA).** The land improvements and the equipment identified in the cost segregation study would now be eligible for a 100-percent 168(k) Bonus Depreciation deduction since **used property qualifies as long as the taxpayer is not a "previous user"** of the property. Therefore, the **depreciation deduction for 2018** (including the 100% §168(k) deduction) **would be <u>$1,415,118</u>** ($750,000 for land improvements, $600,000 for equipment and $65,118 for the building). Therefore, **the first-year depreciation deduction for this taxpayer** would be <u>increased by $784,500</u> due to the changes to the 168(k) Bonus Depreciation deduction under TCJA.

## BE CAREFUL WITH EMPLOYEE BUSINESS EXPENSES AFTER TCJA

Un-Reimbursed Employee Business Expenses No Longer Deductible! **Starting in 2018 and through 2025,** "un-reimbursed" employee business expenses are not deductible at all. For example, you **will not be able to deduct** any of the following business expenses **you incur as an "employee"** if you are not properly reimbursed by your employer: **Automobile expenses** (including auto mileage, vehicle depreciation); **Costs of travel, transportation, lodging, and meals** related to the employee's work; **Union dues** and expenses; **Work clothes and uniforms;** Otherwise qualifying **employee's home office expenses; Dues** to a chamber of commerce for employment-related purposes; **Professional dues; Work-Related education expenses; Job search expenses** in the employee's present occupation; **Licenses and regulatory fees; Malpractice insurance premiums; Subscriptions** to professional journals and trade magazines related to the employee's work; and **Tools and supplies** used in the employee's work.

Good News - An Employer's Qualified Reimbursement of An Employee's Business Expenses Remains Deductible! Generally, employee business expenses that are reimbursed under the employer's qualified **Accountable Reimbursement Arrangement are 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.

Planning Alert! Generally, in order for an employer to have qualified **"Accountable Reimbursement Arrangement" - 1)** The employer must maintain a reimbursement arrangement that requires the employee to substantiate covered expenses, **2)** The reimbursement arrangement must require the return of amounts paid to the employee that are in excess of the amounts substantiated, and **3)** There must be a business connection between the reimbursement (or advance) and anticipated business expenses. **Please call our Firm if you need assistance.** We can help you establish a qualifying **Accountable Reimbursement Arrangement** with your employer.

## OTHER SELECTED TAX CHANGES UNDER TCJA IMPACTING BUSINESS

TCJA Provides New Simplified Accounting Methods for Certain Small Businesses. **Generally effective for tax years beginning after 2017,** TCJA provides the following accounting method relief for businesses with **Average Gross Receipts (AGRs)** for the **Preceding Three Tax Years** of **$25 Million or Less: 1)** Generally allows businesses to use the cash method of accounting even if the business has inventories, **2)** Allows simplified methods for accounting for inventories, **3)** Exempts businesses from applying UNICAP, and
**4)** Liberalizes the availability of the completed-contract method.

Planning Alert! The IRS has released detailed procedures to follow for taxpayers who qualify and wish to change their accounting methods in light of these new relief provisions. Please call our Firm if you think you may qualify, and we will provide you with additional details.

TCJA Imposes New Limits on Business Interest. **Effective for tax years beginning after 2017,** TCJA provides that businesses may not deduct interest expense for a taxable year in excess of: **1)** Interest income, plus **2)** 30% of the business's adjusted taxable income, plus **3)** Floor plan financing interest. Any excess is carried over to subsequent years for an unlimited number of years.

Planning Alert! Businesses with **Average Gross Receipts** for the preceding three tax years **of $25 million or less** are generally **"exempt"** from this new limitation on the interest expense deduction. In addition, certain **Real Property Trades or Businesses** and **Farming Businesses** with average receipts exceeding $25 million may "elect out" of the limitation on the business interest deduction. However, this election will generally require the business to use slower depreciation rates on certain depreciable assets and may restrict its ability to claim the 100% 168(k) Bonus Depreciation deduction.

**Caution!** When applicable, these interest limitation rules can be extremely complex particularly where pass-through entities (partnerships and S corporations) are involved. If you think your business exceeds the $25 million Average Gross Receipts safe harbor and you want more detailed information on these rules, please contact our Firm.

**TCJA Imposes New Restrictions on The NOL Deduction.** TCJA generally makes the following changes to the Net Operating Loss (NOL) deduction: **1)** For **NOLs arising in tax years "ending" after 2017, repeals** the prior law 20-year limitation on the number of years to which an NOL could be carried forward (i.e., the carryover period is not limited), and also **repeals** the ability to carry back the NOL to previous years (except TCJA allows NOLs attributable to certain farming businesses and certain property and casualty insurance companies to be carried back to the 2 prior tax years); and **2)** For **NOLs arising in tax years "beginning" after 2017** and carried to future years, the NOL carryforward will not be allowed to offset more than 80% of taxable income (as determined before the NOL deduction).

## SELECTED TRADITIONAL YEAR-END PLANNING CONSIDERATIONS FOR BUSINESSES

**Salaries for S Corporation Shareholder/Employees.** For 2018, an employer generally must pay FICA taxes of 7.65% on an employee's wages up to $128,400 and FICA taxes of 1.45% on wages in excess of $128,400. In addition, an employer must withhold FICA taxes from an employee's wages of 7.65% on wages up to $128,400 and 1.45% of wages in excess of $128,400. 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.

- **Compensation Must Be "Reasonable."** 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. Determining "reasonable compensation" for S corporation shareholder/employees continues to be a hot audit issue, and the IRS has a winning record in the Courts. Over the years, the IRS has been particularly successful in reclassifying distributions as wages where S corporation owners pay themselves **no wages** even though they provided significant services to the corporation. However, more recently, there have been several cases where the S corporation owners paid themselves **more than de minimis wages,** but the Court still held that an additional portion of their cash "distributions" should be reclassified as "wages" (subject to payroll taxes).

  **Caution!** Determining "reasonable" compensation for an S corporation shareholder is a case-by-case determination, and there are no rules of thumb for determining whether the compensation is "reasonable." However, recent Court decisions make it clear that the compensation of S corporation shareholders should be supported by independent data (e.g., comparable industry compensation studies), and should be properly documented and approved by the corporation.

  **Planning Alert!** Keeping wages low and minimizing your FICA tax could also reduce your Social Security benefits when you retire. Furthermore, if your S corporation has a qualified retirement plan, reducing your wages may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based upon your "wages."

**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. It also may be possible to restructure (with timely and proper documentation) an existing outside loan directly to an S corporation in a way that will give the shareholder debt basis, however, the loan must be restructured before the S corporation's year ends.

Caution! A shareholder cannot get debt basis by merely guaranteeing a third-party loan to the S corporation. **Please do not attempt to restructure your loans without contacting us first.**

Making Payments on S Corporation Shareholder Loans May Trigger Income. Let's assume you have previously loaned funds to your S corporation which, in turn, created basis that you have used to deduct pass- through losses from prior years. If all or a portion of the loan is paid back after the loan's basis has been reduced by pass-through losses, you will recognize a gain on the repayment. The amount, character, and timing of the gain is dependent on several factors, including: **1)** When during the tax year the payment is made, **2)** Whether the loan is an "open account" advance, or evidenced by a written promissory note, and **3)** The amount of the unpaid balance on an "open account" advance as of the end of the tax year. For example, if the loan is an "open account" (i.e., not evidenced by a written promissory note), any gain triggered by a payment on the loan will generally be taxed at ordinary income tax rates. However, if the loan is evidenced by a written promissory note and has been outstanding for over one year, any gain triggered on the payback may qualify for favorable long-term capital gains treatment.

Tax Tip. It may save you taxes in the long run if you postpone principal payments on the depleted-basis loan until the loan's basis has been restored by subsequent S corporation profits. **Please consult with us before your S corporation repays a shareholder loan.** We will help you structure the loans and any loan repayments to your maximum tax advantage.

Strategies for Business Owners to Avoid The 3.8% Net Investment Income Tax. A 3.8% tax is imposed on the **net investment income** (3.8% NIIT) of **higher-income** individuals. With limited exceptions, **"net investment income"** generally includes the following types of income (less applicable expenses): interest, dividends, annuities, royalties, rents, "passive" income (as defined under the traditional "passive activity" loss rules), long-term and short-term capital gains, and income from the business of trading in financial securities and commodities.

Planning Alert! Income **is not** "net investment income" (and is therefore exempt from this new 3.8% NIIT), **if the income is "self-employment income"** subject to the 2.9% Medicare tax. The 3.8% NIIT only applies to individuals with modified adjusted gross income (MAGI) exceeding the following **"thresholds": $250,000** if **married filing jointly; $200,000** if **single;** and **$125,000** if **married filing separately.**

- Passive Owners Should Consider Taking Steps to Avoid The 3.8% Net Investment Income Tax (3.8% NIIT). For purposes of this 3.8% NIIT, net investment income includes operating business income that is taxed to a **"passive"** owner (unless the operating income constitutes self-employment income to the owner that is subject to the 2.9% Medicare tax). For this purpose, an owner is considered "passive" in a business activity if the owner is "passive" under the passive loss limitation rules that have been around for years. For example, you are deemed to materially participate (i.e., you're not "passive") if you spend **more than 500 hours** during the year working in the business.

  Observation. Traditionally, business owners have focused on the passive activity rules largely in the context of **avoiding** the rigid passive **"loss"** restrictions. Now that passive **"income"** can be subject to the **3.8% NIIT,** business owners are seeking ways to **avoid** passive **"income"** classification.

- <u>"Passive" S Corporation Shareholders Should Take Steps To "Materially Participate."</u> If you are an **S corporation shareholder,** and you **materially participate** in the business, your pass-through business income will generally be **exempt** from the 3.8% NIIT. **Note!** The pass-through income to an S corporation shareholder is also generally exempt from Social Security and Medicare taxes on earned income. However, if you are currently a **"passive"** S corporation shareholder and your MAGI exceeds the thresholds for the 3.8% NIIT (e.g., exceeds $250,000 if married filing jointly; $200,000 if single), you could possibly avoid the tax by taking steps **before the end of 2018** to establish that you "materially participate" in the business. For example, one way to materially participate in the business would be to devote over 500 hours during the year working in the business.

  <u>Tax Tip.</u> There may be other ways you can show that you "materially participate" in the business without working more than 500 hours. **Please call our Firm** if you need additional details.

  <u>Planning Alert!</u> If you have other "passive" activities generating losses, you may prefer to remain passive as to an activity producing income so that the activity's income may be used to absorb the passive losses.

  <u>Caution!</u> These rules are complicated and require a thorough review of your particular situation to develop the most tax-wise strategy.

- <u>Planning Alert!</u> We have recently seen a significant uptick in the number of cases the IRS is taking to Court contesting whether an owner has materially participated in the activities of his or her business operation. In these cases, IRS commonly argues that the owner's activities were passive because the owner could not properly document that he or she met one of the "material participation" tests. These cases typically involve an owner who is not working for the business full-time (e.g., retired owners, a side business, remote owners). Although the Courts generally did not strictly require these individuals to produce daily logs of time spent on the activity, the Courts rarely accepted "after-the-fact ballpark estimates" of the time spent. To minimize exposure to IRS attacks, where "material participation" could be an issue, owners should contemporaneously document their hours worked in their business activities (e.g., by recording their hours in a daily or weekly calendar).

<u>Deductions for Business Expenses Paid by Partners and Shareholders May Be Limited.</u> Historically, the IRS has ruled that a partner may deduct business expenses **paid on behalf** of the partnership **only if** there is an agreement (preferably in writing) between the partner and the partnership providing that those expenses are to be paid by the partner, and that the expenses will not be reimbursed by the partnership.

<u>Tax</u> <u>Tip.</u> If you are a partner paying unreimbursed expenses on behalf of your partnership, to be safe, you should have a written agreement with the partnership providing that those expenses are to be paid by you, and that the expenses will not be reimbursed by the partnership.

<u>Planning Alert!</u> The Courts continue to hold that a corporate shareholder may not deduct expenses the shareholder pays on behalf of the corporation **unless** the **shareholder is "employed" by the corporation,** the shareholder is required to incur the expenses as a part of his or her duties **"as an employee,"** and there is an agreement or understanding that the corporation will not reimburse the expenses. Even then, if the expenses incurred by the shareholder-employee are not reimbursed by the corporation, they would generally be classified as "miscellaneous itemized deductions." After TCJA, **miscellaneous itemized deductions are not deductible at all.**

<u>Tax Tip.</u> Even after TCJA, if business expenses paid by a shareholder/employee of an S corporation or C corporation are reimbursed to the shareholder under a qualified "accountable reimbursement arrangement," the corporation can generally take a deduction for the reimbursement (subject to the 50% limit on business meals), and the shareholder/employee will exclude the reimbursement from taxable income. Consequently, to preserve a deduction for a business expense a shareholder incurs on behalf of the corporation (whether an S corporation or C corporation), the corporation must reimburse the shareholder/employee under an "Accountable Reimbursement Arrangement."

**Please call our Firm** if you need assistance in establishing or maintaining an Accountable Reimbursement Arrangement.

**Establishing A New Retirement Plan For 2018.** Calendar-year taxpayers wishing to establish a qualified retirement plan for 2018 (e.g. profit-sharing, 401(k), or defined benefit plan) generally must adopt the plan **no later than December 31, 2018.** 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, 2018.**

**Year-End Accruals to Employees.** Generally, if an accrual-basis business accrues year-end compensation to its rank-in-file employees (non-shareholder employees), the accrual must be paid no later than the 15th day of the third month after year-end to be deductible for the year of the accrual. Otherwise, the accrual is not deductible until paid.

**Planning Alert!** These rules also apply to accrued vacation pay, and to accruals for services provided by independent contractors (e.g., accountants, attorneys, etc.).

**Accruals To "Related Parties."** Year-end accruals to certain cash-basis recipients must satisfy the following rules in order for an accrual-basis business to deduct the accruals. **These rules apply to fiscal year as well as calendar year businesses:**

- **Regular "C" Corporations.** If a C corporation accrues an expense (e.g., compensation, interest, etc.) to a cash basis stockholder owning **more than 50%** (directly or indirectly) of the company's stock, the accrual is not deductible by the corporation until the **"day"** it is includable in the stockholder's income.

- **S Corporations and Personal Service Corporations.** If your S corporation or personal service C corporation accrues an expense to any shareholder (regardless of the amount of stock owned), the accrual is not deductible until the **day** it is includable in the shareholder's income.

- **Partnerships, LLCs, LLPs.** If your business is taxed as a partnership, its accrual of an expense to **any owner** will not be deductible until the **day** it is includable in the owner's income.

- **Other Related Entities.** Generally, an expense accrued by one related partnership or corporation to another **cash-basis** related partnership or corporation is not deductible until the **day** it is includable in the cash-basis entity's income.

**Planning for C Corporation Estimated Taxes.** If your C corporation had less than $1 million of taxable income for **each** of the past three tax years, it qualifies for the **"small corporation safe harbor"** for estimated taxes. This allows the qualifying corporation to base its current year quarterly estimated tax payments on 100% of its **"prior" year** tax liability. If your corporation does not qualify for this safe harbor (i.e., it had $1 million or more of taxable income in any of the prior three tax years), it must generally base its quarterly estimated tax payment (after the first installment) on 100% of its "current" year tax liability, or 100% of its annualized tax liability.

**Planning Alert!** Even if your corporation otherwise qualifies for the small corporation safe harbor, but it had no income tax liability in the prior tax year (e.g., it incurred a tax loss for the prior year or was not in existence last year), it must pay 100% of the "current" year tax or 100% of the annualized tax to avoid an estimated tax underpayment penalty.

**Tax Tip.** If your corporation currently qualifies for the "small corporation safe harbor" and anticipates showing a small tax loss in 2018, you may want to accelerate income (or defer expenses) in order to generate a **small income tax liability in 2018.** This will preserve the corporation's ability to use the "100% of last year's tax" safe harbor for 2019 estimates.

**Planning Alert!** If your corporation expects taxable income of more than $1 million for the first time in 2018, consider **deferring income into 2019** or **accelerating deductions into 2018** to ensure the corporation's 2018 taxable income does not exceed $1 million, so that it retains the small business safe harbor for 2019.

## FINAL COMMENTS

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our Firm closely monitors these changes. In addition, please call us before implementing any planning ideas discussed in this letter, or if you need additional information.

**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.

**Disclaimer:** Any tax advice contained in the body of this material was not intended or written to be used, and cannot be used, by the recipient for the purpose of promoting, marketing, or recommending to another party any transaction or matter addressed herein. The preceding information is intended as a general discussion of the subject addressed and is not intended as a formal tax opinion. The recipient should not rely on any information contained herein without performing his or her own research verifying the conclusions reached. The conclusions reached should not be relied upon without an independent, professional analysis of the facts and law applicable to the situation.