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Certified Public Accountants

2019

**YEAR-END INCOME TAX PLANNING  
FOR CORPORATE AND NON-CORPORATE BUSINESSES**  
*Detailed Overview*

UPDATED November 21, 2019

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## **2019 YEAR-END INCOME TAX PLANNING FOR BUSINESSES**

### **INTRODUCTION**

It's that time of year when businesses should start developing year-end planning strategies. 2018 was the first year businesses and their owners filed tax returns reflecting major tax changes under the "**Tax Cuts and Jobs Act**" (TCJA). Having experienced the impact of TCJA on 2018 returns, the possible impact of the TCJA provisions on year-end planning for 2019 is even more evident.

We are sending this letter not only to remind you of the time-honored, year-end tax planning techniques for businesses that survived the tax changes under TCJA, but also to stress the importance of new year-end planning strategies that TCJA provides.

**Previously-Expired Tax Breaks.** For well over a decade, we have been faced with the off-and-on expiration of a long list of popular tax breaks for businesses. Historically, Congress has temporarily extended the majority of these tax breaks every few years. However, several popular tax breaks designed primarily for business taxpayers **expired at the end of 2017**, and Congress has yet to extend them. Some of the more popular tax breaks that **expired after 2017 include:** 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; and, 3-Year Depreciation Period for Certain Race Horses. As we send this letter, it has been reported that some members of Congress are still pushing for these tax breaks to be extended through 2019. However, many believe the chances of such an extension are diminishing.

**Caution!** The IRS continues releasing guidance on various important tax provisions (particularly on matters involving the tax changes under TCJA). However, as we complete this letter, 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 if you want a status report on the latest IRS guidance.

**Be careful!** Although this letter contains 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 letter 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 letter, **or if you need more information concerning anything discussed.**

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## **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**.

**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 **repealed** the **corporate AMT** imposed on C corporations for **tax years beginning after 2017**. A corporation is 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** carried over from tax years beginning before 2018 will be recouped either as a reduction in post-2017 corporate income tax and/or a refundable credit **no later than 2021**.

**New 20% 199A Deduction Not Available To “C” Corporations.** As discussed in much more detail below, one of the most significant and far-reaching provisions under TCJA is the new 20% Deduction under new Section 199A (***“20% 199A Deduction”***) with respect to ***“Qualified Business Income.”*** Although the 20% 199A Deduction is also available for ***“Qualified REIT Dividends”*** and ***“Publicly-Traded Partnership Income,”*** the 20% 199A Deduction

for **“Qualified Business Income” (QBI)** is having the biggest impact on the greatest number of business owners because of the broad range of businesses that can generate QBI. **Caution!** **“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.

**Planning Alert!** 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.

#### **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 much 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.

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**. **Planning Alert!** TCJA significantly enhanced and expanded the deductions for qualifying 168(k) Property and 179 Property.

#### **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). However, if a business leases property from an unrelated party and the business does not capitalize the lease and take depreciation on the property, the lessee could purchase the property from the lessor and take 168(k) depreciation on the purchase price.

- **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, as discussed above; **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**. 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. If the vehicle continues to be used exclusively for business during the **second year** (i.e., during 2020), it would be entitled to a second-year depreciation deduction of **up to \$16,100**. **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.

### **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. **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. The following is a list of the types of business property that qualify for the 179 Deduction (as expanded by TCJA):

**General Definition Of 179 Property.** 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. **Planning Alert! Before TCJA**, the 179 Deduction was not allowed for property used in **connection with lodging** (other than hotels, motels, etc.). TCJA removed 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).

**Expanded Definition Of “Qualified Real Property.” 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**. **Tax Tip!** 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, 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.

**Definition Of “Qualified Improvement Property.”** 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 after** the building was first placed in service. **Caution!** 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. Unfortunately, the IRS in recently-released final regulations takes the position that “Qualified Improvement Property” placed in service after 2017 has a 39-year depreciable life and **does not qualify** for the **168(k) Bonus Depreciation**

**deduction**, unless and until Congress enacts legislation correcting its statutory mistake. **Good News!** It is clear, however, that **“Qualified Improvement Property” does qualify** for the **179 Deduction** (subject to the dollar cap limitations). **Planning Alert!** Qualified Real Property is subject to the **overall 179 Cap** of **\$1,020,000** (for 2019) and the **overall phase-out threshold** of **\$2,550,000** (for 2019). **Caution!** These caps apply to **all 179 Property** (including Qualified Real Property) **in the aggregate**.

**Business Vehicles.** New or used business vehicles generally qualify for the 179 Deduction, provided the vehicle is **used more-than-50% in your business**. **Planning Alert!** 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.

- **So-Called “Heavy Vehicles” Exempt From Dollar Caps.** As 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 \$25,500** (if placed in service in 2019). **Tax Tip!** Pickup trucks with loaded vehicle weights over 6,000 lbs are exempt from the \$25,500 limit to the 179 Deduction if the truck bed is at least six feet long. **Planning Alert!** The \$25,500 cap applies only for purposes of the 179 Deduction. This \$25,500 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 2019 you purchase and place in service a **new or used “over-6,000 lb” SUV** for \$60,000 **used entirely for business**. If you elected to take the 179 Deduction for the SUV, your deduction would be capped at \$25,500. However, you could forego the 179 Deduction and simply deduct the entire \$60,000 cost under 168(k) in 2019, provided you **placed the SUV in service no later than December 31, 2019**. Generally, you will be considered to have placed the SUV in service in 2019 if you have purchased the vehicle and made it **ready and available** for use **no later than December 31, 2019**. **Caution!** Whether you take the 179 Deduction or 168(k) Bonus Depreciation on your business vehicle (and 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.
- **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!**

**The Section 179 Taxable Income Limitation Becomes Less Important After TCJA.** 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 (before the 179 Deduction) 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). **Planning Alert!** There is no “taxable

income limitation” or \$25,500 cap with respect to the 168(k) Bonus Depreciation deduction. Therefore, for example, a taxpayer could deduct the full cost of an SUV weighing over 6,000 lbs purchased in 2019 and used entirely in business as a **168(k) Bonus Depreciation deduction** without being limited by the \$25,500 cap and regardless of the amount of the taxpayer’s taxable income.

**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.

**The 100% 168(k) Bonus Depreciation Deduction For “Used” Property Generally Makes Cost Segregation Studies More Valuable.** 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 the 168(k) depreciation deduction 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 your S corporation acquired an existing shopping center during 2019 for \$5,000,000. 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 2019**, 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 did not** depreciate the property prior to its acquisition. Therefore, the **depreciation deduction for 2019 would be \$1,415,118** (\$750,000 for land improvements, \$600,000 for equipment and \$65,118 for the building).

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

**Background.** First effective in 2018, the new 20% 199A Deduction is one of the most significant and far-reaching provisions of TCJA. This provision allows qualified taxpayers to take a 20% 199A Deduction with respect to **“Qualified Business Income,” “Qualified REIT Dividends,”** and **“Publicly-Traded Partnership Income.”** As expected, the just completed filing season for the 2018 tax year confirms that, of these three types of qualifying income, **“Qualified Business Income” (QBI)** had the biggest impact by far on the greatest number of taxpayers. Consequently, this discussion of the 20% 199A Deduction focuses **primarily on “Qualified Business Income” (QBI).** **Planning Alert!** The rules for determining the 20% 199A Deduction for Qualified REIT Dividends and Publicly-Traded Partnership Income are relatively straight forward.

**Highlights Of The 20% 199A Deduction For “Qualified Business Income” (QBI).** In certain situations, the rules for determining whether a taxpayer qualifies for the 20% 199A 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% 199A Deduction as it applies to QBI.

**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 is available **for tax years beginning after 2017 through 2025**, and is generally taken on the owner’s individual income tax return. The 20% 199A 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% 199A Deduction 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 rules that could otherwise limit the amount of the 20% 199A Deduction do not apply to taxpayers with Taxable Income below certain levels. Consequently, the technical rules for determining (and qualifying for) the 20% 199A Deduction for QBI are far simpler and easier for individuals 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, the 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”** (e.g. W-2 wages). **Caution!** QBI also generally **does not include** certain items of income, such as: **1) Dividends, investment interest income, short-term capital gains, long-term capital gains, income from annuities, commodities gains, foreign currency gains, etc.;** **2) Any “guaranteed payment”** paid to a partner by the partnership; **3) reasonable compensation paid by an S corporation to a shareholder;** or **4) Income you report as an independent contractor (e.g., sole proprietor) where it is ultimately determined that you should have been classified as a “common law” employee.**

- **“Depreciation Recapture Income” May Be Treated As QBI.** As noted above, a capital gain or loss (long-term or short-term) is excluded from the determination of QBI. However, on the sale of depreciable “personal” business property, the gain is generally treated as “ordinary” gain (not “capital” gain) to the extent the selling taxpayer previously took either depreciation or the 179 Deduction with respect to that property. This is commonly referred to as *“Depreciation Recapture Gain.”* Final 199A Regulations released this year indicate that *“Depreciation Recapture Gain”* (i.e., treated as “ordinary” gain) with respect to a qualifying business is included in the calculation of QBI. **Planning Alert!** *Depreciation Recapture Gain* most commonly occurs when a taxpayer sells depreciable **“personal”** property (e.g., business equipment, furniture and fixtures, certain business vehicles, etc.). However, as discussed previously, the sale of depreciable **“real”** property (e.g., depreciable buildings used in a commercial business) in certain situations can also generate *“Depreciation Recapture Gain.”* For example, if a taxpayer takes the 179 Deduction with respect to *qualifying improvements* to a commercial building and later sells the building, the sale can trigger *Depreciation Recapture Gain* to the extent of the previous 179 Deduction. If, at the time of the sale, the building had been used in a business that was otherwise generating QBI, the *Depreciation Recapture Gain* on

the sale of the building would likewise be included in QBI.

- **“Ordinary Gain” On The Sale Of A Partnership Interest Could Generate QBI.** Generally, the gain on the sale of a partnership interest is classified as a “capital” gain which is excluded from the computation of QBI. However, §751 requires a partner to treat income from the sale of the partner’s partnership interest as “ordinary” gain (not “capital” gain) to the extent of the partner’s share of the partnership’s “*Unrealized Receivables*” (e.g., zero-basis receivables held by a cash-basis partnership; *Depreciation Recapture Gain* reflected in the partnership’s depreciable property) and substantially appreciated inventory. Final 199A Regulations issued this year say that any gain on the sale of a partnership interest to the extent it is treated as “ordinary” gain under §751(a) is considered attributable to the trades or businesses conducted by the partnership. Therefore, if the partnership is generating QBI at the date of the sale of the partnership interest, the “ordinary” gain triggered to the selling partner under §751 should also be included in the partner’s QBI. **Caution!** Since Subchapter S has no counterpart to §751, no portion of the gain or loss on the sale of S corporation stock will be included in the determination of QBI.

**W-2 Wage And Capital Limitation On The Amount Of The 20% Of QBI Deduction.** Generally, the amount of your 20% of QBI Deduction with respect to each Qualified Trade or Business may not exceed **the greater of: 1)** 50% of the your 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 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. **Observation.** This limitation, to the extent it applies, is generally designed to ensure that the full 20% of QBI Deduction is available only from qualified businesses that have sufficient W-2 wages, sufficient tangible depreciable business property, or both.

- **Owners With Taxable Income Below Certain Thresholds Are Exempt From The W-2 Wage And Capital Limitation!** For 2019, an otherwise qualifying taxpayer is **entirely exempt** from the **W-2 Wage And Capital Limitation** if the Taxpayer’s “**Taxable Income**” (computed without regard to the 20% 199A Deduction) is **\$160,700 or below (\$321,400 or below if married filing jointly)**. **Caution!** 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).

**Business Income From “Specified Service Trade Or Businesses” (SSTBs) Does Not Qualify For The 20% 199A Deduction For Owners Who Have “Taxable Income” Above Certain Thresholds.** Based on your “Taxable Income” (before the 20% 199A Deduction), all or a portion of your qualified 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)**, **“all”** of the qualified 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)**, **“none”** of your SSTB income qualifies for the 20% 199A Deduction. **Caution!** 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 prorate portion”** of your SSTB income will be eligible for the 20% 199A Deduction.

- **Planning Alert!** A taxpayer with Taxable Income for 2019 of **\$160,700 or less (\$321,400 or less if married filing jointly)** is provided two major benefits with respect to the 20% 199A Deduction for Qualified Business Income (QBI): **1)** The taxpayer’s SSTB income (if any) is fully eligible for the 20% 199A deduction, **and 2)** The

taxpayer is completely exempt from the W-2 Wage and Capital Limitation. Consequently, if you are in a situation where your 20% 199A deduction for QBI would otherwise be significantly reduced (or even eliminated altogether) due to either or both of these limitations, it is even more important that you review the year-end strategies (discussed below) that could help you reduce your 2019 taxable income (before the 20% 199A Deduction) to or below the \$160,700/\$321,400 thresholds.

- **What Is A “Specified Service Trade Or Business” (SSTB)?** A *Specified Service Trade or Business (“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!** Final 199A Regulations issued this year 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. However, one notable clarification in the Final regulations involves the SSTB activity described as *“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.”* The Final regulations clarify that this classification **only includes** the following types of business income: Fees for celebrity-type endorsements, appearance fees, and fees for using a person’s image, likeness, name, etc. The Final regulations also clarify this type of activity **does not include** the income of a business, other than the three types of income listed above, even if the income is generated to a large degree by the good business reputation of the owners and/or employees.

**Evaluating Reasonable W-2 Compensation Levels Paid To S Corp Owners/Employees Is More Important Than Ever!** Even before the 20% 199A 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 20% 199A 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 2019 Taxable Income (before the 20% 199A Deduction) of **\$160,700 or less (\$321,400 or less** if married filing jointly), in order to maximize their potential 20% 199A 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 20% 199A 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% 199A Deduction amount), and **3)** The shareholder’s pass-through SSTB income (if any) will be fully eligible for the 20% 199A Deduction, while W-2 wages paid to the shareholder/employee will not qualify. **Caution!** 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% 199A Deduction) of **\$210,700 or more (\$421,400 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% 199A Deduction unless the S corporation significantly increases the W-2 wages paid to the shareholder/employee.

- **Planning Alert!** 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 20% 199A Deduction for Qualified Business Income, please contact us as soon as possible. We will be glad to evaluate your specific situation and make recommendations. **Caution!** The quicker you contact us on this issue, the better chance we may be able to suggest steps that can be implemented before the end of 2019.

**Payments By A Partnership To A Partner For Services.** A partner’s pass-through share of **QBI** generally “is eligible” for the 20% 199A 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% 199A 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 for services provided to the partnership where it is ultimately determined that the partner was **acting other than in** his or her capacity as a partner. **Caution!** 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% 199A Deduction), or alternatively fall into one of the two above-listed categories that are not eligible for the 20% 199A Deduction. Often partnerships call distributions to partners “guaranteed payments” when they are not technically guaranteed payments. Generally, guaranteed payments are payments made to partners without regard to the partnership’s income. If payments to partners are merely distributions of profits or advance distributions of profits, they are probably not guaranteed payments and should not reduce the QBI of the partnership.

**IRS Provides 250-Hour Safe Harbor For Rental Real Estate.** In order for any business activity to generate “Qualified Business Income” (QBI), it must first 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 recently 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. **Caution!** This 250-hour safe harbor contains several rules and requirements that are too lengthy to address in detail in this letter. If you own rental real estate that is generating net rental income, feel free to call our Firm and we will gladly review your specific situation and determine if your rental real estate activity is a trade or business qualifying for the 20% 199A Deduction using the 250-hour safe harbor or one of the other trade or business tests.

## **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 **may not deduct** on your income tax return any of the following business expenses **you incur as an “employee”** - **Automobile expenses** (including auto mileage, vehicle depreciation); **Costs of travel, transportation, lodging, and meals** related to your work as an employee; **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 your present occupation; **Licenses and regulatory fees**; **Malpractice insurance premiums**; **Subscriptions** to professional journals and trade magazines related to your work as an employee; and **Tools and supplies** used in your work.

**Good News! - An Employer’s Qualified Reimbursement Of An Employee’s Business Expenses Remains Deductible By The Employer And Tax-Free To The Employee.** Generally, employee business expenses that are reimbursed under the 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. **Planning Alert!** Generally, in order for an employer to have a 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.

**Deducting Entertainment Expenses Much More Restricted.** Effective for amounts paid or incurred after 2017, TCJA generally repealed business deductions with respect to an entertainment, amusement or recreation activity. **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. 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 (from 2018 through 2025).

## **OTHER SELECTED TAX CHANGES UNDER TCJA IMPACTING BUSINESSES**

**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 \$26 Million or Less for 2019:** **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.

**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 **\$26 Million or Less for 2019** 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 \$26 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.

**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**, TCJA **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**

**The 30% Business Credit For Certain Qualified Energy-Efficient Property Begins Dropping After 2019.** The 30% tax credit for **qualified solar energy property, fiber-optic solar property, qualified fuel cell property and qualified small wind energy property** is **reduced to 26%** for qualified property where the construction of the property **begins after 2019 and before 2021**, and to **22%** for qualified property where the **construction** of the property **begins after 2020 and before 2022**. "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. **Planning Alert!** Consequently, to qualify for the full **30% credit**, construction of the qualifying energy-efficient property must begin no later than **December 31, 2019**.

**Salaries For S Corporation Shareholder/Employees.** As discussed briefly above, 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.

- **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 in 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.
- **“Passive” S Corporation Shareholders Should Take Steps To “Materially Participate.”** 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 2019** 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. **Tax Tip.** 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. **Planning Alert!** 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. **Caution!** These rules are complicated and require a thorough review of your particular situation to develop the most tax-wise strategy.
- **Planning Alert!** 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).

**Deductions For Business Expenses Paid By Partners And Shareholders May Be Limited.** 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. **Tax Tip.** 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. **Planning Alert!** 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.** **Tax Tip.** 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 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.**

**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 by accrual-basis businesses 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.

### **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 idea discussed in this letter, or if you need additional information concerning any item mentioned in this letter.** We will gladly assist you. **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.