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To Our Clients and Friends:

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.**

CHOICE OF BUSINESS ENTITY IN LIGHT OF CHANGES UNDER TCJA

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

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

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

TRADITIONAL YEAR-END TAX PLANNING TECHNIQUES BEFORE AND AFTER TCJA

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

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

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

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

- **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.

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

PLANNING WITH THE SECTION 179 DEDUCTION

Another popular and frequently-used business tax break is the up-front Section 179 Deduction ("179 Deduction"). TCJA made several taxpayer-friendly enhancements to the 179 Deduction which include: **1)** Substantially increasing the 179 Deduction limitation (up to $1,020,000 for 2019), **2)** Increasing the phase-out threshold for total purchases of 179 property (to $2,550,000 for 2019), and **3)** Expanding the types of business property that qualify for the 179 Deduction. **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.**

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

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

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 **"Publically-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. **Planning Alert!** As many of you discovered with your 2018 returns, if you own an interest in a business as a sole proprietor, an S corporation shareholder, or a partner in a partnership, you are a very good candidate for the 20% 199A Deduction with respect to QBI. Unfortunately, it is not feasible to provide a thorough discussion of the 20% 199A Deduction for **Qualified Business Income (QBI)** in this letter. However, the following are selected highlights that could be particularly helpful for year-end planning:

- **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 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. **Planning Alert!** 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).

- **<u>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.</u>** 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 in various professional fields such as law, medicine, accounting, consulting, etc.) **may not qualify** for the 20% 199A Deduction. More specifically, if your **"Taxable Income"** for 2019 (before the 20% 199A Deduction) is **$160,700 or below ($321,400 or below** if married **filing jointly), "<u>all</u>"** of the 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), "<u>none</u>"** of your SSTB income qualifies for the 20% 199A Deduction. **<u>Caution!</u>** If for 2019, your **"Taxable Income"** is **between $160,700 and $210,700** (between **$321,400 and $421,400** if married **filing jointly**), only **"a prorata portion"** of your SSTB income will be eligible for the 20% 199A Deduction.

- **<u>Rules For 20% 199A Deduction For QBI Are Much More Favorable For Taxpayers With 2019 "Taxable Income" Of $160,700 Or Below ($321,400 Or Below If Filing Joint Return).</u>** 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 consider strategies that could help you reduce your 2019 taxable income (before the 20% 199A Deduction) to or below the $160,700/$321,400 thresholds.

<u>Planning Alert!</u> If you need a more detailed explanation of the 20% 199A Deduction, please call our Firm and we will be glad to provide you with additional information.

<u>SELECTED TRADITIONAL YEAR-END PLANNING CONSIDERATIONS FOR BUSINESSES</u>

<u>Salaries For S Corporation Shareholder/Employees.</u> 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. **<u>Caution!</u>** 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. 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.

<u>S Corporation Shareholders Should Check Stock And Debt Basis Before Year-End.</u> 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. **<u>Planning Alert!</u>** If an S corporation anticipates financing losses through borrowing from an outside lender, the best way to ensure the shareholder gets **debt basis** is to: **1)** Have the shareholder personally borrow the funds from the outside lender, and **2)** Then have the shareholder formally (with proper

and timely documentation) loan the borrowed funds to the S corporation.

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

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.

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