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2018 Business Year-End Tax Planning Tips

The Tax Cuts and Jobs Act of 2017 will have a significant impact on many business owners. The following is a brief overview of many year-end tax saving strategies, incorporating the implications of the new tax law and how they will affect taxpayers with businesses. Some are straightforward, while others require more analysis and review to tailor them to your particular tax and financial situation. Please call on us to help you sort through the options and implement strategies that make sense for you and your situation.

NEW 20% DEDUCTION FOR QUALIFYING INCOME

Are you in a position to qualify for the new 20% deduction? You may need to take a closer look at your taxable income and business structure.

Effective for tax years beginning after 2017, the *New Law* creates a new 20% deduction that is generally provided to non-corporate taxpayers receiving certain qualifying income.

Planning Alert! Although not discussed in detail in this letter, a similar 20% deduction is allowed to certain agricultural and horticultural cooperatives that satisfy specific criteria.

Caution! While most new tax provisions primarily impacting businesses under the *New Law* do not have an expiration date, this 20% deduction does expire after 2025.

Income Qualifying For The 20% Deduction

The following types of income generated by partnerships, S corporations, sole proprietorships, trusts, and estates may qualify for the 20% deduction: "Qualified Business Income," "Qualified Cooperative Dividends," "Qualified REIT Dividends," and "Qualified Publically-Traded Partnership Income." Please note that, of these four types of qualifying income, the most common will, in all likelihood, be "Qualified Business Income" (QBI). Consequently, the remainder of this discussion focuses only on QBI.

"Qualified Business Income"

"Qualified Business Income" (QBI) is generally 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 Trade Or Businesses" (described in more detail below), and
2. The trade or business of performing services "as an employee." QBI does not include:
   a) Dividends, investment interest income, short term capital gains, long term capital gains, income from annuities, commodities gains, foreign currency gains, etc.,
   b) Reasonable compensation paid by a qualified trade of business for services rendered to the taxpayer claiming the 20% deduction
3. Any "guaranteed payment" paid to a partner for services actually rendered to or on behalf of the partnership, or
4. To the extent provided in regulations, any amount allocated or distributed by a partnership to a partner who is acting other than in his or her capacity as a partner for services rendered to a partnership.

The Amount Of The 20% Deduction

The amount of the 20% deduction with respect to Qualified Business Income is generally the lesser of:

1. 20% of the owner's share of "Qualified Business Income" (QBI) from the owner's interest in each "Qualified Trade or Business," or
2. The owner's share of the W-2 Wage and Capital Limitation (if applicable) for each such trade or business interest.

The aggregate 20% deduction for QBI also cannot exceed 20% of the excess of the taxpayer's "taxable income" over the taxpayer's "net capital gains."

Caution! Although we do not discuss the detailed workings of the "W-2 Wage and Capital Limitation" in this letter, this limitation

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is generally designed to ensure that the maximum 20% deduction is available only to qualified businesses that have sufficient W-2 wages, sufficient tangible depreciable business property, or both. Also, otherwise qualifying owners of pass-through entities are entirely exempt from the W-2 Wage And Capital Limitation if the owner's "taxable income" (computed without regard to the 20% deduction) does not exceed $157,500 or $315,000 (if filing jointly). However, the Wage and Capital Limitation phases in as an owner's taxable income goes from more than $157,500 to $207,500 or more than $315,000 to $415,000 (if filing jointly).

"Specified Service Trade Or Businesses" Generally Do Not Qualify For The 20% Deduction Unless Owner's Taxable Income Less Than $415,000/$207,500.

A "Specified Service Trade or Business" (SSTB) generally does not qualify for the 20% deduction. An SSTB is any trade or business activity involving 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.

Planning Alert! The 20% deduction is allowed for an owner of an SSTB if the owner's "taxable income" (computed without regard to the 20% deduction) does not exceed $157,500 or $315,000 (if filing jointly). The deduction is phased-out as an owner's taxable income goes from more than $157,500 to $207,500 or from more than $315,000 to $415,000 (if filing jointly).

Other Rules

The 20% deduction:

1. Does not reduce the owner's "self-employment" income for purposes of determining S/E Tax,
2. Does not reduce the owner's "adjusted gross income" (AGI), although it does reduce the owner's "taxable income," and
3. Is available to taxpayers using the standard deduction.

Choice of Entity.

Year-end is a good time to consider which business entity makes the most sense for your company going forward.

The tax on self employment earnings increases the Social Security tax burden on income from businesses organized as partnerships or LLCs treated as partnerships and sole proprietorships for federal tax purposes. Since all ordinary income generated and passed through to owners from an active trade or business under the partnership rules are subject to the self employment tax, utilizing an S corporation could minimize the impact.

At issue is how much of the company's profit will be subject to self-employment taxes. As a partnership, the company's profit is subject to self-employment taxes. However, as an S corporation, an owner must take "reasonable compensation" out of the company as W-2 wages which would be subject to payroll taxes, an equivalent of self-employment taxes. Any profit above these wages is not be subject to self-employment taxes and available to take out as distributions.

Equipment and Office Furniture.

If you own your own business and have plans to buy office furniture or equipment, or make certain improvements to property, make sure you are aware of the rules for S179 deductions. For 2018, the S179 deduction limit is $1,000,000 and it applies to new and used equipment. This limit is good only for equipment that is financed/ purchased and put into service prior to the end of the day, 12/31/18. The 2018 spending cap on equipment purchases is $2,500,000. This is the maximum amount that can be spent on equipment before the S179 deduction available to your business is reduced on a dollar for dollar basis. For further details you can also visit section179.org.

Income Shifting to Children.

Paying wages to a child can be a great way to shift income and reduce taxes. Many people don't pursue this option due to misunderstanding the "Kiddie Tax" rules; however, the "Kiddie Tax" only applies to investment income, not earned income such as wages from employment. The wages paid to a child are deductible if the following criteria have been met:

* The wages are paid for work performed that is related to the parent's trade, or business.
* The child must actually perform the services.
* The wages are actually paid out to the child.
* The compensation being paid must be reasonable for the services being performed.

What are the advantages of doing so?

* First of all, the income paid to your child is either taxed at your child's lower tax rate, or escapes taxation completely if the total amount paid for the year is less than the child's standard deduction ($12,000 in 2018).
* Now that the child has earned income, he/she can make contributions to a retirement plan. This is a great way for you to jump start retirement savings for your child. (Think Roth IRAs).
* And of course you get the deduction at the business level for the amounts paid to your child. You have shifted the income from your higher tax bracket to their lower bracket.

Defer Income to 2019.

Cash-method businesses that want to defer income should consider delaying the sending of late-in-the-year invoices, so payment is not received until 2019. In addition, pay as many expenses as feasible by year-end to get the deduction in 2018. Credit cards are considered the same as checks.

Accrual-method businesses should, if possible, hold off on providing goods or services to customers until after January 1.

Deductions on Bonuses for Accrual Basis Businesses.

An accrual basis corporation can take a 2018 deduction for a bonus not actually paid to its employee until the following tax year if (1) the employee doesn't own more than 50% in value of the corporation's stock, (2) the bonus is properly accrued on its books before the end of the current tax year, and (3) the bonus is actually paid within the first 2 1/2 months of the following year (for a calendar year taxpayer, within the first 2 1/2 months of 2019). For employees who are on the cash basis (for income that was deferred before it was earned), the bonus won't be taxable income until the following year. Deductions won't be allowed for bonuses to an owner-employee unless actually paid out by December 31, 2018.

Contribute or Establish a SEP or SIMPLE IRA.

A SEP IRA and a SIMPLE IRA, are types of retirement accounts for small businesses. By contributing to a retirement plan before the filing deadline (including extensions), businesses can take a deduction in the current year as if paid by December 31st. Allocating a larger portion of benefits to retirement rather than increasing employee wages allows a business a deduction for the expense without having to pay additional employment taxes.

- **SEP IRA.** A SEP IRA can be established anytime up to the filing deadline. These plans allow small businesses to contribute up to the lessor of $**55,000** or 25% of total compensation per employee in 2017, which is the maximum amount of contributions for any retirement plan option. Furthermore, SEP IRAs tend to work well for very small businesses with only a few key employees. Only the employer contributes to a SEP IRA.
- **SIMPLE IRA.** A SIMPLE IRA, is also for small businesses but has different eligibility requirements than the SEP IRA. Unlike SEP IRAs, employees are allowed to make elected contributions to their SIMPLE IRAs. Employers are usually required to make contributions to the account no matter if the employee defers or not at 3% of pay. An employee may defer up to $12,500 and an additional $3,000, of their income if they are over the age of 50 in **2018**. SIMPLE IRAs are meant for a business with under 100 employees. Also, a SIMPLE IRA is always 100% vested for every employee in the SIMPLE IRA program. In order for the SIMPLE IRA to receive contributions for the current year it must be established by October 1st. No matter which plan you choose to offer though, a contribution deduction is available if a contribution to a qualified plan is made before the filing deadline (including extensions).

Retirement Plan Selection.

If you're planning to establish a 401(k) for yourself or your employees, it could be beneficial to get it done before the end of the year. If you don't have a retirement plan in place already for 2018, you have until December 31, 2018 to establish a profit-sharing plan and still have the ability to make contributions for 2018. As noted before, a SEP IRA can be established anytime up to the extended filing deadline. Contributions to the plan can be made anytime up until the due date of the employer's return (March 15 for calendar year S corp. or partnership and April 15 for C corp.). If the return is extended, contributions can be made up until the extended due date. If you currently have a plan in place and are looking to make a change for 2019, you should be making this decision prior to December 31 also. Once 2019 begins and you have started making plan contributions, you are committed to that plan for the remainder of the year. With that in mind, now is a good time for us to discuss your retirement plan options.

The Research & Development (R&D) Tax Credit.

Historically, the benefits of the R&D tax credit have had little or no benefits for business owners. However, as a result of changes in the tax law, businesses are finally able to benefit from this business credit. In fact, federal and state tax credits can amount to as much as 20% of the costs incurred in developing new products and/or manufacturing processes, or improving existing products and processes. You can go back 3 years to claim past credits and carry forward credits for up to 20 years. The newly enhanced benefits of the R&D credit make it worthwhile for applicable businesses to look closely at the requirements.

Conclusion. This newsletter is intended to give you ideas to get you planning for **2018**. Please call us to schedule a tax planning strategy session so that we can discuss your situation in detail to see how these and other planning ideas can be used to reduce your tax bill.

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