Section 179 Expensing and Bonus Depreciation

Two of the biggest tax incentives available to any business are the Section 179 expense deduction and the bonus depreciation deduction. And it's not an either/or proposition. You may be eligible for both, depending on the amount of your business's taxable income. These deductions can significantly lower your taxable income, thus saving a bundle on federal and state income taxes. Whether any last-minute purchases before the end of the year are advisable will depend not only on your business needs but whether the extra deductions available can be utilized in 2019.

Under the Section 179 expensing option, you can immediately expense the cost of up to $1,020,000 of "Section 179" property placed in service in 2019. This amount is reduced dollar for dollar (but not below zero) by the amount by which the cost of the Section 179 property placed in service during the year exceeds $2,550,000. The Section 179 deduction is also limited to your aggregate taxable income for the year derived from the active conduct of a trade or business. Thus, unlike depreciation, the Section 179 expense cannot be used to reduce income below zero. This expensing option is available to individuals, S corporations, C corporations, and partnerships. It's important to note that, to be considered Section 179 property, the property must meet certain eligibility requirements, be acquired for business use, and be acquired by purchase. In addition, certain limitations apply to the expensing of passenger automobiles and sport utility vehicles.

In addition to the Section 179 expense option, an additional first-year depreciation allowance, known as bonus depreciation, is available for qualifying property placed in service in 2019. Generally, unless you elect out of the bonus depreciation deduction, 100 percent of the cost of qualifying property, which is not expensed under Section 179, must be deducted. This applies to new or used trade or business property. The property must meet an "original use" or "used acquisition" requirement. A deduction is still available even if you use the property for personal purposes, as long as your business use is more than 50 percent. However, if your business use of the property falls to 50 percent or less, you may have to recapture your earlier deductions as income. Unlike with the Section 179 deduction, there is no taxable income limitation on a deduction for bonus depreciation.

As you can see, the purchase of a vehicle for your business could result in a substantial tax write-off. And if your business needs a large passenger vehicle, consideration should be given to purchasing a sport utility vehicle weighing more than 6,000 pounds. Vehicles under that weight limit are considered listed property and deductions are limited to $18,100 for cars, trucks and vans acquired and placed in service in 2019. However, if the vehicle is more than 6,000 pounds, up to $25,500 of the cost of the vehicle can be immediately expensed.

Qualified Improvement Property Glitch Remains Unfixed

Congress did not enact any significant business tax legislation this year. As a result, it did not fix a glitch in the Tax Cuts and Jobs Act of 2017 (TCJA) that prevents the depreciation of qualified improvement property over the 15-year life that such property was eligible for prior to 2018. Where such property is placed in service after 2017, it is still generally subject to a 39-year depreciation life and, thus, not eligible for bonus depreciation.

Qualified Business Income Deduction

Another potentially big deduction, the qualified business income deduction, is available to sole proprietors, partners in a partnership, members of an LLC taxed as a partnership, or S corporation shareholders. Trusts and estates may also be eligible for this deduction.

While the rules relating to the qualified business income deduction can be complex, the amount of the deduction is generally 20 percent of qualifying business income from a qualified trade or business. A qualified trade or business means any trade or business other than (1) a specified service trade or business, or (2) the trade or business of being an employee. A specified service trade or business is defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and 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. Engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

However, a special rule allows you to take this deduction even if you have a specified service trade or business. Under that rule, the provision disqualifying such businesses from being considered a qualified trade or business for purposes of the qualified business income deduction does not apply to individuals with taxable income of less than $160,700 (single), $160,725 (married filing separately), and $321,400 (joint filers). After an individual reaches the threshold amount, the restriction is phased in over a range of $50,000 in taxable income ($100,000 for joint filers). Thus, if your income falls within the applicable range, you are allowed a partial deduction. Once the end of the range is reached, the deduction is completely disallowed.

For purposes of the deduction, items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States. In calculating the deduction, qualified business income means the net number of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer.

Rental Real Estate

Rental real estate enterprises operated by individuals and owners of passthrough entities may also qualify for the qualified business income deduction if certain criteria are met. For example, a taxpayer's rental activity must be considerable, regular, and continuous in scope. In determining whether a rental real estate activity meets this criteria, relevant factors include, but are not limited to, the following:

(1) the type of rented property (commercial real property versus residential property);

(2) the number of properties rented;

(3) the taxpayer's or taxpayer's agent's day-to-day involvement;

(4) the types and significance of any ancillary services provided under the lease; and

(5) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

Under a safe harbor issued by the IRS, a rental real estate activity will be treated as a business eligible for the special deduction if certain requirements are satisfied, such as:

(1) separate books and records are maintained to reflect the income and expenses for each rental real estate enterprise;

(2) for rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise (with slightly less stringent requirements for rental real estate enterprises that have been in existence for at least four years);

(3) contemporaneous records have been maintained, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services; and

(4) certain compliance requirements are met.

Thus, to qualify for this deduction, it's important to determine if the safe harbor conditions are met and, if not, whether such conditions can be met by year end. Alternatively, even if the safe harbor requirements are not met, certain actions may be taken to ensure that

your real estate business falls within the "trade or business" guidelines for taking the deduction.

Finally, whether a rental real estate enterprise is considered a passive activity with respect to a taxpayer is important in determining whether losses from the activity are deductible. Generally, passive activity losses are only deductible against passive activity income. However, a deduction of up to $25,000 ($12,500 if married filing separately) may be allowed against nonpassive income to the extent an individual actively participates in the rental real estate activities. However, the deduction is subject to a phaseout for individuals with modified adjusted gross income above $100,000 (or $50,000 if married filing separately).

Vehicle-Related Deductions and Substantiation Requirements

Vehicle expense deductions are generally calculated using one of two methods: the standard mileage rate method or the actual expense method. If the standard mileage rate is used, parking fees and tolls incurred for business purposes can be added to the total amount calculated.

Since the IRS tends to focus on vehicle expenses in an audit and disallow them if they are not properly substantiated, you should ensure that the following are part of your business's tax records with respect to each vehicle used in the business:

(1) the amount of each separate expense with respect to the vehicle (e.g., the cost of purchase or lease, the cost of repairs and maintenance, etc.);

(2) the amount of mileage for each business or investment use and the total miles for the tax period;

(3) the date of the expenditure; and

(4) the business purpose for the expenditure.

The following are considered adequate for substantiating such expenses:

(1) records such as a notebook, diary, log, statement of expense, or trip sheets; and

(2) documentary evidence such as receipts, canceled checks, bills, or similar evidence.

Records are considered adequate to substantiate the element of a vehicle expense only if they are prepared or maintained in such a manner that each recording of an element of the expense is made at or near the time the expense is incurred.

Fringe Benefit/Retirement Programs

Providing fringe benefit and retirement programs to employees is a good way to attract and retain talented workers. Many businesses use benefits rather than higher wages to entice future employees. While your business is not required to have a retirement plan, there are many advantages to having one. By starting a retirement savings plan, you not only help your employees save for the future, you can also use such a plan to attract and retain qualified employees. Retaining employees longer can impact your bottom line by reducing training costs and search costs. In addition, as a business owner, you can take advantage of the plan yourself, and so can your spouse. If your spouse is not currently on the payroll, you may want to consider adding him or her as an employee and paying a salary up to the maximum amount that can be deferred into a retirement plan. So, for example, if your spouse is 50 years old or over and receives a salary of $25,000, all of it could go into a 401(k), leaving your spouse with a retirement account but no taxable income.

By offering a retirement plan, you also generate tax savings to your business because employer contributions are deductible and the assets in the retirement plan grow tax free. Additionally, a tax credit is available to certain small employers for the costs of starting a retirement plan. Please let me know if this is an option you would like to discuss further.

Increasing Basis in Pass-thru Entities

If you are a partner in a partnership or a shareholder in an S corporation, and the entity is passing through a loss for the year, you must have enough basis in the entity in order to deduct the loss on your personal tax return. If you don't, and if you can afford to, you should consider increasing your basis in the entity, for example by making a capital contribution, in order to take the loss in 2019.

Electing the De Minimis Safe Harbor

It may be advantageous to elect the annual de minimis safe harbor election for amounts paid to acquire or produce tangible property. By making this election, and as long as the items purchased don't have to be capitalized under the uniform capitalization rules and are expensed for financial accounting purposes or in your books and records, you can deduct up to $2,500 per invoice or item (or up to $5,000 if you have an applicable financial statement).

S Corporation Shareholder Salaries

For any business operating as an S corporation, it's important to ensure that shareholders involved in running the business are paid an amount that is commensurate with their

workload. The IRS scrutinizes S corporations which distribute profits instead of paying compensation subject to employment taxes. Failing to pay arm's length salaries can lead not only to tax deficiencies, but penalties and interest on those deficiencies as well. The key to establishing reasonable compensation is being able to show that the compensation paid for the type of work an owner-employee does for the S corporation is similar to what other corporations would pay for similar work. If you are in this situation, we need to document the factors that support the salary you are being paid.