2018 Year-End Business Deductions

December 9, 2018

To Small Business Clients,

Year-End Tax Deductions

Your year-end tax planning doesn't have to be hard. I have outlined below five strategies that will increase your tax deductions or reduce your taxable income so that Uncle Sam gets less of your 2018 cash.

1. Prepaying your 2019 expenses right now reduces your taxes this year, without question. While it's true you kicked the can down the road some, perhaps you have an offset with a big deduction planned for next year. And even if you don't have such a plan at the moment, you have plenty of time to create one or to put more big deductions in place for 2019.

2. The easiest year-end strategy of all is simply to stop billing your customers, clients, and patients. Once again, this kicks the can down the road some and makes your 2019 tax planning more important.

3. With 100 percent bonus depreciation and increased Section 179 expensing in 2018, you can make significant purchases of equipment, machinery, and furniture and write off 100 percent of the value. Make sure you place the assets in service on or before December 31, 2018, to get the deduction this year.

4. Charges to your credit cards can create deductions on the day of the charge. This is absolutely true, if you are a sole proprietor, or you operate as a corporation and the credit card is in the name of the corporation. But if you operate as a corporation and the credit card is in your personal name, your corporation needs to reimburse you before December 31 to create the 2018 deduction at the corporate level.

5. And finally, claim all your legitimate deductions. Don't think you have too many, and don't try to guess which of your too-many deductions could be a red flag. First, it's unlikely you could have enough deductions to create a red flag. Second, no one knows what those red flags are. Third, if the deduction is legitimate, it doesn't matter if the IRS audits it-you'll win.

As you can see from the five strategies above, there's much you can do to control your tax bite.

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Vehicle Purchase 2018

Two questions:

1. Do you need a replacement business car, SUV, van, or pickup truck?
2. Do you need tax deductions this year?

Here are some ideas for you to consider:

1. Buy a New or Used SUV, Crossover Vehicle, or Van with a GVWR Greater than 6,000 Pounds

Let's say that on or before December 31, 2018, you or your corporation buys and places in service a new or used SUV or crossover vehicle that the manufacturer classifies as a truck and that has a gross vehicle weight rating (GVWR) of 6,001 pounds or more. This newly purchased vehicle gives you four big benefits:

- Bonus depreciation of 100 percent (new, thanks to the TCJA)
- Section 179 expensing of up to $25,000
- MACRS depreciation using the five-year table
- No luxury limits on vehicle depreciation deductions

2. Buy a New or Used Pickup with a GVWR Greater than 6,000 Pounds

If you or your corporation buys and places in service a qualifying pickup truck (new or used) on or before December 31, 2018, then this newly purchased vehicle gives you four big benefits:

- Bonus depreciation of 100 percent (new, thanks to the TCJA)
- Section 179 expensing of up to $25,000
- MACRS depreciation using the five-year table
- No luxury limits on vehicle depreciation deductions

To qualify for full Section 179 expensing, the pickup truck must have

- a GVWR of more than 6,000 pounds, and
- a cargo area (commonly called a "bed") of at least six feet in interior length that is not easily accessible from the passenger compartment.

Short bed. If the pickup truck passes the more-than-6,000-pound-GVWR test but fails the bed-length test, tax law classifies it as an SUV. That's not bad. It's still eligible for expensing of up to the $25,000 SUV expensing limit plus 100 percent bonus depreciation. See Section 1 above for how this works.

3. Buy a New or Used Qualifying Cargo or Passenger Van with a GVWR Greater than 6,000 Pounds

A new or used cargo or passenger van bought and placed in service on or before December 31, 2018, can qualify for four big tax benefits:

- Bonus depreciation of 100 percent
- Section 179 expensing of up to $1,000,000
- MACRS depreciation using the five-year table
- No luxury limits on vehicle depreciation deductions

Cargo van. To qualify for full Section 179 expensing, the cargo van must

- have a GVWR of more than 6,000 pounds,
- fully enclose the driver compartment and load-carrying area,
- not have seating behind the driver's seat, and
- have no body section that protrudes more than 30 inches ahead of the leading edge of the windshield.

If the van passes the GVWR test but fails one of the other qualifying tests listed above, the law deems it an SUV.

Passenger van. If the van has a GVWR of greater than 6,000 pounds and seats more than nine people behind the driver's seat, it is a tax law–defined passenger van, not an SUV, and it qualifies for full Section 179 expensing of up to $1,000,000 and 100 percent bonus depreciation.

4. Buy a Depreciation-Limited New or Used Car, SUV, Truck, or Van

If you or your corporation buys and places in service a new or used passenger vehicle such as a car (or a pickup, SUV, or van with a GVWR of 6,000 pounds or less) on or before December 31, 2018, then you or your corporation may claim up to $8,000 in bonus depreciation.

Tax reform increased the 2018 luxury passenger vehicle depreciation limits to

- $10,000 for the first taxable year in the recovery period,
- $16,000 for the second taxable year in the recovery period,
- $9,600 for the third taxable year in the recovery period, and
- $5,760 for each succeeding year in the taxable period.

Here's how this works: Say you buy a car. You add the $8,000 in bonus depreciation to the $10,000 car limit, for a 2018 limit of $18,000. To get to this limit, you can use a combination of bonus depreciation and regular depreciation. You reduce the $18,000 limit by any personal use.

Convert Your Personal Vehicle to Business and Deduct up to 100 Percent

You probably like your personal vehicle just as it is. But wouldn't you like it far better if it were producing tax deductions? Perhaps big deductions, immediately. And the Tax Cuts and Jobs Act gives you the tax reform road map on how to do this.

Of course, to make this happen, you need to strip your personal vehicle of its personal status and re-dress it as a business vehicle. This is not difficult. In its new business dress, your former personal vehicle can qualify for up to 100 percent bonus depreciation.

Example. Sam has a personal vehicle with a tax basis for depreciation of $31,000. With 70 percent business use on this 100 percent bonus depreciation–qualifying vehicle, Sam has a new $21,700 tax deduction for this year ($31,000 x 70 percent).

How Cost Segregation Can Turn Your Rental into a Cash Cow

Cost segregation breaks your real property into its components, some of which you can depreciate much faster than the typical 27.5 years for a residential rental or 39 years for nonresidential real estate.

When you buy real property, you typically break it into two assets for depreciation purposes:

- land, which is non-depreciable; and
- building (residential is 27.5-year property; nonresidential is 39-year property).

With a cost segregation study, you make your property much more than a building on land. Here's what's possible with a cost segregation study:

- Land, which is non-depreciable
- 5-year property
- 7-year property
- 15-year property
- For the remainder, 27.5-year property or 39-year property, depending on building use

With a cost segregation study, you front-load your depreciation deductions and take them sooner, but you'll take the same total depreciation amount over the lifetime of the property.

Tax reform under the Tax Cuts and Jobs Act boosted bonus depreciation from 50 percent to 100 percent, and this new law also allows bonus depreciation on qualifying used property. Cost segregation is made to take advantage of these new law changes.

And you can apply cost segregation to rentals and offices you have had for 10 years or that you are buying tomorrow. But if the passive activity loss rules affect your ability to take immediate rental losses, we need to run your numbers to see if you can benefit and also identify what you could do to benefit even more.

Tax reform in one of its “not beneficial to you” new law sections took away your ability to do a like-kind exchange for non-real property. Therefore, if you do a cost segregation and then later use a like-kind exchange on that property, you’ll have taxable gain attributable to everything that’s not land or 27.5-year or 39-year property.

We recently saw a cost study on a new $400,000 property purchased this year. The study enabled a speed-up of $50,000 of deductions to this year’s tax return. For this taxpayer, who was in a combined federal and state income tax bracket of 40 percent, this put $20,000 in his pocket this year.

New IRS 199A Regulations Benefit Out-of-Favor Service Businesses

If you operate an out-of-favor business (known in the law as a “specified service trade or business”) and your taxable income is more than $207,500 (single) or $415,000 (married, filing jointly), your Section 199A deduction is easy to compute. It’s zero.

This out-of-favor specified service trade or business group includes any trade or business

- involving the performance of services in the fields of health, law, consulting, athletics, financial services, and brokerage services; or
- where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; or
- that involves the performance of services that consist of investing and investment management trading or dealing in securities, partnership interests, or commodities. For this purpose, a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities [Internal Revenue Code Sections 475(c)(2) and 475(e)(2), respectively].

If you were not in one of the named groups above, you likely worried about being in a reputation or skill out-of-favor specified service business. If you were worried, you joined a large group of worried businesses, because many businesses depend on reputation and/or skill for success.

For example, the National Association of Realtors believed real estate agents fell into this out-of-favor category.

But don’t worry, be happy. The IRS has come to the rescue by regulating the draconian reputation and/or skill provision down to almost nothing. The

reputation and/or skill out-of-favor specified service business includes you if you

- receive fees, compensation, or other income for endorsing products or services;
- license or receive fees, compensation, or other income for the use of your image, likeness, name, signature, voice, trademark, or any other symbols associated with your identity; or
- receive fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

Example. Harry is a well-known chef and the sole owner of multiple restaurants, each of which is a single-member LLC—disregarded tax entities that are taxed as proprietorships. Due to Harry's skill and reputation as a chef, he receives an endorsement fee of $500,000 for the use of his name on a line of cooking utensils and cookware.

Results. Harry's restaurant business is not an out-of-favor business, but his endorsement fee is an out-of-favor specified service business.

Does Your Rental Qualify for a 199A Deduction?

The IRS, in its new proposed Section 199A regulations, defines when a rental property qualifies for the 20 percent tax deduction under new tax code Section 199A.

One part of the good news on this clarification is that it does not require that we learn any new regulations or rules. Existing rules govern. The existing rules require that you know when your rental is a tax law–defined rental business and when it is not. For the new 20 percent tax deduction under Section 199A, you want rentals that the tax law deems businesses.

You may find the idea of a rental property as a business strange because you report the rental on Schedule E of your Form 1040. But you will be happy to know that Schedule E rentals are often businesses for purposes of not only the Section 199A tax deduction but also additional tax code sections, giving you even juicier tax benefits.

Under the proposed regulations, you have two ways for the IRS to treat your rental activity as a business for the Section 199A deduction:

1. The rental property qualifies as a trade or business under tax code Section 162.
2. You rent the property to a "commonly controlled" trade or business.

Your rental qualifying as a Section 162 trade or business gets you other important tax benefits:

- Tax-favored Section 1231 treatment

- Business use of an office in your home (and, if it’s treated as a principal office, related business deductions for traveling to and from your rental properties)
- Business (versus investment) treatment of meetings, seminars, and conventions

If your rental activity doesn’t qualify as a Section 162 trade or business, it will qualify for the 20 percent Section 199A tax deduction if you rent it to a commonly controlled trade or business.

Audit-Proof Your Time Spent on Rental Properties

If you claim status as a tax law–defined real estate professional who can deduct his or her rental property losses, your time record for the year must prove that you spent

1. more than one-half of your personal service time in real property trades or businesses in which you materially participate, and
2. more than 750 hours of your personal and investor services time in real property trades or businesses in which you materially participate.

If you are married, either you or your spouse must individually qualify as a real estate professional. If one spouse qualifies, both spouses qualify.

Achieving real estate professional status is the first of two steps. You face one additional hurdle. To deduct tax losses on a rental, you also must prove that you materially participated in the rental activity. If you are married, you and your spouse may count your joint efforts toward passing the material participation tests. Most of the tests for material participation are based on hours worked.

What Does This Mean to You?

In simple terms: keep a time log. In an audit of your real estate activity, the IRS tells its examiner:

Request and closely examine the taxpayer’s documentation regarding time. The taxpayer is required under Reg. Section 1.469-5T(f)(4) to provide proof of services performed and [of] the hours attributable to those services.

If you don’t have what the IRS wants, your odds of winning your rental property tax loss deductions are slim, if that. And don’t think you can create this log after the fact. Most everyone who spends the considerable time it takes to jump through the hoops to create an after-the-fact log of hours using the IRS spreadsheets loses the deductions.

IRS Says TCJA Allows Client and Prospect Business Meal Deductions

In Notice 2018-76, the IRS states that client and prospect business meals continue as tax deductions under the Tax Cuts and Jobs Act. This is very good news indeed.

Under this new IRS guidance, you may deduct 50 percent of your client and prospect business meals if

1. the expense is an ordinary and necessary expense under Internal Revenue Code (IRC) Section 162(a) and is paid or incurred during the taxable year in carrying on any trade or business;
2. the expense is not lavish or extravagant under the circumstances;
3. the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
4. the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
5. in the case of food and beverages provided during or at an entertainment activity, 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. The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

To prove your business meals, follow the two easy steps below:

1. Keep the receipt that shows the name of the restaurant, the number of people at the table, and an itemized list of food and drinks consumed.
2. On the receipt, record the name or names of the person or persons with whom you had the meal and also record the business reason for the meal.

In the event the receipt is not available, such as with the purchase of hot dogs and drinks at a baseball game while sitting in the stands, make sure to make a written note of the expenditures immediately after the game.

If you charge a business meal to a credit card, the credit card statement provides your proof of payment. When possible, always pay by credit card or write a check so that you have clear proof of payment.

Proof of payment is not proof of what you purchased, so in addition to proof of payment, keep the receipt with the notations as described earlier. With this combination of proof of payment and receipt with notations, you have what we call audit-proof documentation.

P.S. If you would like to discuss any of these strategies with me, please call or send me an email.

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