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TAX PLANNING 2019

While most taxpayers have now filed their first tax return under the law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, some got an unwelcome surprise that they won't want repeated on their 2019 tax returns. That surprise came in the form of reduced tax refunds or, in some cases, tax payments due. Although this was due to a confluence of factors, the most notable one was the failure of individuals to adjust their payroll withholding deductions. While they were realizing the benefit of the reduced tax rates under the TCJA in their paychecks, because of changes to the employer withholding tax tables, many individuals did not adjust their withholdings for the decrease in, or the elimination of, deductions taken in prior years. A priority for 2019 year-end tax planning is ensuring that the amount of payroll taxes being withheld from a taxpayer's wages in 2019, or the amount of estimated payments being made for 2019, will cover the taxpayer's 2019 tax liability. In addition, the following are some yearend strategies for practitioners to consider when advising individuals and clients who file Schedule C, Profit or Loss from Business, on tax planning options for the 2019 tax year.

BUNCHING DEDUCTIONS IN ALTERNATE YEARS: With the increase in the standard deduction to $12,200 (single taxpayers and married filing separately), $18,350 (head of household), and $24,400 (joint returns and surviving spouses), and the $10,000 limitation placed on state and local tax (SALT) deductions, many individuals are not getting as great a benefit from itemizing deductions as they had in the past. Where an individual's total itemized deductions will come close to, but not exceed, the standard deduction for 2019 and/or 2020, one strategy to consider is bunching certain itemized deductions into alternate tax years. This means, to the extent practical, increasing or bunching medical and charitable contribution expenses into alternate years so that, along with a taxpayer's annual mortgage interest and SALT deductions, total itemized deductions exceed the standard deduction, thus giving the taxpayer a greater deduction based on those expenses. In the other years, the taxpayer takes the standard deduction. For taxpayers interested in making a large charitable contribution in one year instead of spreading the same amount over several years, practitioners should recommend using a donor-advised fund (DAF). Taxpayers can take a charitable deduction for the year the contribution to the DAF is made, while spreading the actual distributions to charities out over several years, allowing the taxpayer to later determine the amount of contributions and the organizations he or she wants to contribute to.

USING AN HSA TO DEDUCT MEDICAL EXPENSES: In 2019, medical expenses are only deductible as an itemized deduction to the extent they exceed 10% of adjusted gross income. And, as noted, since the standard deduction will exceed a taxpayer's itemized deductions in many situations, taxpayers lose what benefit they might have gotten from paying large medical bills. One way around this is to establish a health savings account (HSA) to pay medical expenses.

Contributions to an HSA are a deduction from gross income up to a maximum amount, which is adjusted yearly for inflation. To be eligible, an individual must be covered under a high deductible health plan, which an individual can obtain on his or her own or through an employer and have no other health coverage except certain permitted coverage. For 2019, the maximum deduction for contributions to an HSA for individuals with self-only coverage is $3,500, while the maximum deduction for those with family coverage is $7,000.

STRATEGIES INVOLVING SALT DEDUCTIONS: For individuals, the limitation on SALT deductions that took effect in 2018, which is $10,000 for single and married taxpayers filing joint returns ($5,000 for married individuals filing separate returns), has been very unpopular with high-income individuals in high-tax states. Some in Congress are trying to pass legislation that would eliminate or raise the cap on SALT deductions. So, if a taxpayer who is itemizing deductions can postpone paying 2019 state income or real or personal property taxes until 2020, there is a possibility that a favorable change in the law could yield a larger state tax deduction in 2020. Alternatively, if an individual's SALT deduction is less than the $10,000 cap in 2019 but is expected to exceed the cap in 2020, consideration should be given to prepaying 2020 state income and property taxes in 2019 if possible. IRS guidance provides that whether a taxpayer can deduct a prepayment of 2020 state or local real property taxes in 2019 depends on whether the 2020 real property taxes are assessed in 2019. A prepayment of anticipated 2020 real property taxes that have not yet been assessed is not deductible in 2019. And if a taxpayer is postponing a payment of 2019 state income taxes to 2020, it's important to ensure enough of the state tax payment has been made in 2019 to avoid any underpayment-of-tax penalties.

SCHEDULE C TAXPAYERS: While the TCJA suspended the miscellaneous itemized expense deduction through 2025, and thus the ability of employees to deduct home office expenses, the home office deduction is still available for Schedule C taxpayers. And, if those taxpayers have been using the simplified method of calculating their home office deduction, the actual-expense method may be worth a second look considering the SALT and mortgage interest limitations enacted under the TCJA. Under the simplified method of calculating a home office deduction, the number of square feet in the home office, up to a maximum of 300 square feet, is multiplied by $5, thus allowing a maximum home office deduction of $1,500. It's simple because taxpayers don't have to document their actual expenses, or the allocation factor used. However, although the actual-expense method requires additional work, it may yield a larger home office deduction. Under the actual-expense method, a portion of the taxpayer's mortgage interest and SALT expenses, which may be limited as a result of TCJA changes if reported on Schedule A, Itemized Deductions, are reported as above-the-line expenses on Schedule C. Thus, nondeductible Schedule A expenses can be transformed into deductible Schedule C expenses. Additionally, expenses that would not otherwise be deductible, such as utilities, insurance, security, and repairs, are converted into deductible expenses. One thing to remember, however, is that depreciation also needs to be calculated under the actual-expense method and, when a home is later sold, that depreciation will be recaptured as ordinary income. Finally, deductible home office expenses cannot exceed income from the taxpayer's Schedule C business.

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PLANNING FOR THE QBI DEDUCTION: Perhaps one of the biggest changes to come out of the TCJA is the qualified business income (QBI) deduction under Sec. 199A. While this deduction can provide substantial tax savings to those who qualify, it can also be quite complex. The deduction is available to sole proprietors, partners in partnerships, members in limited liability companies taxed as partnerships, shareholders in S corporations, and some trusts and estates. The amount deductible is generally up to 20% of the QBI received from a qualified trade or business. If the business is not a qualified trade or business, the deduction may be limited based on the taxpayer's taxable income. A qualified trade or business is any Sec. 162 trade or business except a trade or business conducted by a C corporation, the trade or business of performing services as an employee, and, for taxpayers with taxable income that exceeds a threshold amount, specified service trades or businesses (SSTBs). An SSTB includes many types of personal-service-based trades or businesses, including any trade or business involving the performance of services in the fields of health, law, and accounting, and any trade or business where the principal asset is the reputation or skill of one or more of the business's employees or owners. If the taxable income of a taxpayer operating an SSTB is below the threshold amount, the SSTB's QBI is eligible for the full QBI deduction. A partial deduction may be available if the taxpayer's taxable income is above the threshold amount and does not exceed a second higher threshold amount. For 2019, those thresholds are $321,400 and $421,400 for a joint return, $160,700 and $210,700 for single and head-of-household filers, and $160,725 and $210,725 for married taxpayers filing separately. A business owner has several options to minimize taxable income and stay below the applicable thresholds, thus preserving a QBI deduction. For example, consideration should be given to either (1) purchasing needed business vehicles, tools, or equipment that can be expensed under Sec. 179, or (2) postponing the receipt of income into 2020. It won't matter if the owner's trade or business is an SSTB if he or she can keep taxable income below the applicable thresholds, which are high enough to make the rule disqualifying SSTBs inapplicable to many taxpayers.

QBI DEDUCTIONS FOR RENTAL REAL ESTATE ACTIVITIES: Rental real estate activities are not specifically listed as an SSTB, and the IRS has indicated that a taxpayer with rental property may be eligible for the QBI deduction if certain conditions are met. There is still time between now and the end of the year to get taxpayers into compliance so they can secure a QBI deduction with respect to their rental activities. Under a safe harbor rule in Notice 2019-07, income from a taxpayer's rental real estate activities qualifies for the QBI deduction if the following conditions are met: (1) separate books and records are maintained that reflect income and expenses for each rental real estate enterprise; (2) 250 or more hours of rental services are performed per year with respect to the rental enterprise; and (3) the taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: Hours of all services performed;

Description of all services performed; Dates on which those services were performed; and Who performed the services. Under the safe harbor, commercial and residential real estate cannot be combined in the same enterprise. Thus, if a business owner has those activities intertwined and can split them into two separate enterprises, this should be done before year end. In addition, triple-net lease arrangements do not qualify for the safe harbor.

However, a safe harbor is just that — a safe harbor. Even if a real estate enterprise does not meet the safe harbor requirements, that doesn't necessarily mean it won't qualify as a Sec. 162 trade or business eligible for a QBI deduction. A taxpayer can always fall back on using facts and circumstances to prove that real estate activities qualify as a Sec. 162 trade or business and thus qualify for a QBI deduction. To be engaged in a trade or business under Sec. 162, the taxpayer must be actively involved in the activity with continuity and regularity, and the primary purpose for engaging in the activity must be for income or profit. Obviously, though, if a taxpayer can meet the safe harbor rules, a QBI deduction has a better chance of being upheld. Thus, to the extent a taxpayer can meet the safe-harbor criteria but is not presently doing so, actions should be taken prior to Dec. 31 to bring the taxpayer into compliance with the safe-harbor rules. That may mean separating the books and records of each rental property and ensuring that 250 hours of rental services are performed with respect to each rental property. Caution: Treating a rental real estate activity as a trade or business may have implications with respect to the requirement to file Forms 1099 for that business.

NEW KIDDIE TAX RULES: As a result of the TCJA, children's net unearned income over $2,200 is taxed at trust and estate tax rates that, depending on the level of income being taxed, can result in higher taxes than if that income was taxed at individual tax rates. However, if the child is under age 19 or a full-time student under age 24, and both the child and the parent meet certain qualifications, the parent can elect to report the child's income on the parent's return. Depending on the level of income being reported, this strategy could reduce overall taxes.

RETIREMENT PLAN CONTRIBUTIONS: Finally, it's always a good plan to save for retirement. And, in some cases, the money socked away in a qualified retirement vehicle can substantially reduce taxable income. For 2019, employees can defer up to $19,000 of income into a 401(k), plus catch-up contributions of $6,000 if they are age 50 or older. Alternatively, business owners can establish a simplified employee pension plan for themselves and contribute the lesser of $56,000 or 25% of net earnings from self-employment up to $280,000. Still other options include contributions to various types of IRAs, although the contribution limits are much lower, income limitations may apply, and contributions to Roth IRAs are not deductible.