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2018 Last-Minute Section 199A Strategies

2018 is the first year you need to do year-end tax planning for your possible new 20 percent Section 199A tax deduction.

If your taxable income is above $157,500 (or $315,000 on a joint return), this article is a must-read.

If you ignore Section 199A planning, you might be looking at a big fat $0 for your deduction amount.

But don't worry—it's not too late to bring your Section 199A deduction back to life. We'll give you four strategies you can implement before December 31, 2018.

First Things First

If your taxable income is above $157,500 (or $315,000 on a joint return), then your type of business, wages paid, and property can reduce and/or eliminate your Section 199A tax deduction.[1]

To put your need for planning into perspective, make your life easy by simply using this Section 199A Calculator to figure out your projected 2018 deduction amount.

If your deduction amount is less than 20 percent of your qualified business income (QBI), then consider using one or more of the strategies described below to increase your Section 199A deduction.

Strategy 1: Harvest Capital Losses

Capital gains add to your taxable income, and taxable income is the income that

- determines your eligibility for the Section 199A tax deduction,
- sets the upper limit (ceiling) on the amount of your Section 199A tax deduction, and
- establishes the thresholds above which you need wages and/or property to obtain your maximum deductions.

If the capital gains are hurting your Section 199A deduction, you have time before the end of the year to harvest capital losses to offset those harmful gains.

Example. Susan is single. She has QBI of $100,000 and taxable income of $170,000, of which $40,000 is net capital gain. Her business is an out-of-favor specified service business with $50,000 in wages and no qualified property.

If Susan takes no action, her Section 199A deduction is $15,000 because she is above the threshold and in the phaseout range.

If Susan harvests $13,000 in capital losses—say, from her stock portfolio—she is now below the $157,500 threshold and her Section 199A deduction increases to $20,000 (20 percent of $100,000 QBI).

By using the capital offset strategy, Susan has a total federal tax cash benefit of $3,150 from the capital loss, as follows:

- $1,950 in cash from the reduced capital gain taxes (15 percent of $13,000)
- $1,200 from the additional Section 199A deduction (24 percent of $5,000)

When drawing up strategies as we did above, make sure to use the calculator. Doing the Section 199A in your head or by hand is not only difficult but time-consuming and often confusing, and it often comes out incorrect. The calculator is a big help. (Click here to access the calculator.)

Strategy 2: Make Charitable Contributions

Since the Section 199A deduction uses taxable income for its thresholds, you can use itemized deductions to reduce and/or eliminate threshold problems and increase your Section 199A deduction.

Charitable contribution deductions are the easiest way to increase your itemized deductions before the end of the year.

Consider doing one or both of the following:

- Donate appreciated stock as we discuss in 2018 Last-Minute Year-End Tax Strategies for Your Stock Portfolio.
- Prepay (before December 31) your planned 2019 charitable contributions so you can claim them as deductions this year.

If you need a really large charitable contribution deduction to make this work, you should read Use a Conservation Easement Donation to Create a $63,000 199A Deduction.

Example. Let's assume Susan (from our example above) decides to donate appreciated stock to her favorite charity instead of harvesting losses in her stock portfolio.

She donates appreciated stock with a value of $13,000 and built-in long-term capital gain of $6,000 to her favorite charity.

If the donation increases her itemized deductions by $13,000, then her taxable income drops by $13,000. Now she is under the $157,500 threshold and her Section 199A deduction increases to $20,000 (20 percent of $100,000 QBI).

With this strategy, Susan saves $5,320 in 2018 federal income taxes from the stock donation:

- $4,120 from the $13,000 charitable contribution (32 percent of $12,000 plus 24 percent of $500); and
- $1,200 from the additional Section 199A deduction (24 percent of $5,000).

Susan also eliminated $900 in future capital gain taxes (15 percent of $6,000) because with the stock donation, she disappeared the capital gain from her portfolio.

Strategy 3: Make Retirement Contributions

Any retirement contributions you make directly reduce your taxable income—and you still have the money inside the retirement account, growing free of taxes until you take it out of the account.

If you are a sole proprietor, your retirement contributions don't reduce your QBI. Therefore, as long as your QBI is the basis for your Section 199A deduction, you can put away as much as you want using a traditional IRA, SIMPLE IRA, SEP-IRA, or individual 401(k) without damaging your Section 199A deduction.

If you are an S corporation owner, your retirement strategy can achieve the same result as the proprietor's by using an employee salary or wage contribution to the retirement plan and no contribution by the S corporation.

Example. John is married with joint taxable income of $325,000. He operates a dental practice in an S corporation. His S corporation's projected net income for 2018 is $100,000. The practice paid $180,000 in wages and has $15,000 in qualified property.

If John takes no action, his Section 199A deduction is $18,000.

Bad strategy. If John has his S corporation put $10,000 into his 401(k) plan as an S corporation contribution, then his Section 199A deduction stays at $18,000 (20 percent of QBI of $90,000). In this case, John's QBI drops to $90,000 and his taxable income drops to $315,000.

Good strategy. But if John directs $10,000 from his last paycheck into his 401(k) plan, then his Section 199A deduction increases to $20,000 (20 percent of $100,000 QBI). Here, John reduces his W-2 income by the $10,000. That reduces his personal taxable income to $315,000, but his QBI is unchanged because John's 401(k) contribution did not change the S corporation income.

Using the salary deferral saves John an additional $640 in federal income tax (32 percent of $2,000).

For more Section 199A W-2, S corporation, and proprietorship strategies that can benefit your taxes, see Don't Let the Cliff Kill Your New Section 199A Tax Deduction.

Strategy 4: Buy Business Assets

Thanks to 100 percent bonus depreciation and Section 179 expensing, you can write off the entire cost of most assets you buy and place in service before December 31, 2018.

This can help your Section 199A deduction in two ways:

1. The big asset purchase and write-off can reduce your taxable income and increase your Section 199A deduction when it can get your taxable income under the threshold.

2. The big asset purchase and write-off can contribute to an increased Section 199A deduction if your Section 199A deduction currently uses the calculation that includes the 2.5 percent of unadjusted basis in your business's qualified property (UBIA). In this scenario, your asset purchases increase your UBIA, which in turn increases the deduction you already depend on.

Take a look at Tax Reform: Wow, New 20 Percent Deduction for Business Income for what counts as qualified property.

Example. Jim, who is single, runs his medical practice in an S corporation. He has taxable income of $210,000, and the S corporation has QBI of $100,000, wages of $120,000, and UBIA of $20,000.

If Jim takes no action, his Section 199A deduction is $0 since his taxable income is over the upper threshold of $207,500 and his business is an out-of-favor specified service business.

Let’s say before December 31, 2018, Jim buys and places in service $30,000 in medical equipment that he had planned to buy over the next one to two years.

Assuming Jim can fully expense the property, he saves $14,153 in federal income taxes:

- $9,900 from the equipment write-off (35 percent of $10,000 plus 32 percent of $20,000)
- $4,253 from the Section 199A deduction (Note: After expensing the $30,000, Jim has $180,000 in taxable income, which is above the $157,500 threshold, meaning that he is in the phaseout range. To find the $4,253, use the calculator.)

Note. With the expensing, Jim reduced his taxable income to $180,000 ($210,000 minus $30,000). He also reduced his QBI to $70,000 ($100,000 minus $30,000).

Takeaways

If your taxable income is over $157,500 (or $315,000 on a joint return), you could face a reduced or eliminated Section 199A deduction.

In these cases, consider using one or more of the four strategies in this article to reduce your taxable income and increase your Section 199A deduction. The four strategies are:

1. Harvest capital losses if you have capital gain income that’s causing the trouble.
2. Make charitable contributions to increase your itemized deductions and reduce your taxable income —and consider donating appreciated long-term gain stock to come out even better.
3. Contribute to a retirement plan to lower your taxable income without decreasing your qualified QBI.
4. Buy and place in service before midnight on December 31, 2018, business assets that you can expense 100 percent to lower your taxable income. (Shucks, this lowers your QBI too, but you can still come out way ahead.)

Final point. This can get confusing. Be sure to use our Section 199A Calculator to run the numbers so you identify your correct Section 199A deduction.

Client Letter on This Article for Use by Tax Pros. Click Here.

1 Prop. Reg. Section 1.199A-1(d).