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The background is a collage. The top half shows a close-up of a US one hundred dollar bill, with the portrait of Benjamin Franklin and the word 'ONE' visible. The bottom half shows wooden blocks spelling out 'TAX' in a row, with the number '1' under the 'T' and 'A', and '8' under the 'X'. The blocks are resting on a surface that appears to be a US tax form, with some text like 'THIS NOTE IS LEGAL TENDER FOR ALL DEBTS, PUBLIC AND PRIVATE' visible.

# 2018 Individual Tax Update

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# ... 2018 Individual Tax Update

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## ... 2018 Individual Tax Update

On December 22, 2017, President Trump signed into law, the Tax Cuts and Jobs Act (TCJA). The Act includes provisions that significantly affect the taxation of individuals. This Act will affect every individual by significantly changing the filing of 2018 tax returns. Unless noted, the effective date for the provisions discussed is January 1, 2018, and the sunset date is December 31, 2025.



## ... 2018 Individual Tax Update (con't.)

The Tax Policy Center, a nonpartisan think tank, estimates the TCJA will provide *80 percent* of U.S. households with a tax cut in 2018, while *15 percent* of taxpayers will see little or no change, with the remaining *5 percent* paying more. Middle class households will see their taxes cut by roughly \$900 or 1.6 percent, while lower income households will realize a more modest tax cut. The top 1 percent of taxpayers, making \$733,000 and more, will have taxes cut by approximately \$50,000 or 3.4 percent. Among middle-income households, approximately 90 percent will pay less, while 7 percent will pay more.

## Key Provisions Related to Individual Income Taxes

- Individual Income Tax Brackets:
  - The TCJA reduces individual tax rates for tax years 2018 through 2025.
  - The number of income tax brackets remain at seven, but the income ranges in several brackets have been changed and each new bracket has lower rates with the top rate reduced from 39.6 percent to 37 percent.
  - This has the effect of reducing taxes for most income levels.
  - A comparison of the current rates and the new rates are, as follows:

# Individual Income Tax Rates

## Single Filers (2018)

Under Previous Law		Tax Cuts and Jobs Act	
Rate	Income Bracket	Rate	Income Bracket
10%	\$0-9,525	10%	\$0-9,525
15%	\$9,525-38,700	12%	\$9,525-38,700
25%	\$38,700-93,700	22%	\$38,700-82,500
28%	\$93,700-195,450	24%	\$82,500-157,500
33%	\$195,450-424,950	32%	\$157,500-200,000
35%	\$424,950-426,700	35%	\$200,000-500,000
39.6%	\$426,700 and up	37%	\$500,000 and up

## Married Filing Jointly - MFJ (2018)

Under Previous Law		Tax Cuts and Jobs Act	
Rate	Income Bracket	Rate	Income Bracket
10%	\$0-19,050	10%	\$0-19,050
15%	\$19,050-77,400	12%	\$19,050-77,400
25%	\$77,400-156,150	22%	\$77,400-165,000
28%	\$156,150-237,950	24%	\$165,000-315,000
33%	\$237,950-424,950	32%	\$315,000-400,000
35%	\$424,950-480,050	35%	\$400,000-600,000
39.6%	\$480,050 and up	37%	\$600,000 and up

## ... Capital Gains and Qualified Dividend Rates

- The Act generally retains present-law maximum rates on net capital gains and qualified dividends. It retains the breakpoints that exist under pre-Act law, but indexes them for inflation using C-CPI-U in tax years after December 31, 2017.
- Capital gain rates remain at 0 percent, 15 percent and 20 percent.
- For 2018, the 15 percent breakpoint is: \$77,200 for joint returns and surviving spouses (half this amount for married taxpayers filing separately), \$51,700 for heads of household, \$2,600 for trusts and estates, and \$38,600 for other unmarried individuals. The 20 percent breakpoint is \$479,000 for joint returns and surviving spouses (half this amount for married taxpayers filing separately), \$452,400 for heads of household, \$12,700 for estates and trusts, and \$425,800 for other unmarried individuals.
- Net capital losses remain capped at \$3,000 annually.



## ... Planning Point

- It is important to always try and maximize the 0 percent capital gains rate. If you have or are expecting significant net long term capital gain income (including qualified dividends) it may make sense to defer, where possible, sources of ordinary income to reduce your taxable income and maximize the 0 percent capital gains rate.
  - A couple (MFJ) with only net long-term capital gain income and utilizing the standard deduction would pay \$0 tax on the first \$101,200 of net LTCG income.
  - A couple (MFJ) with \$40,000 of ordinary income and \$75,000 of net long-term capital gain income and utilizing the standard deduction would pay tax on only \$13,800 of the capital gain income (\$61,200 would be taxed at 0 percent).

## ... Other Rate Related Items

- The [Section 121](#) exclusion of gain on the sale of a primary residence remains intact.
- The maximum tax rate for depreciation recapture remains at 25 percent while gains from collectibles (*i.e., art, rugs, antiques, metal, gems, stamps, coins, alcoholic beverages, etc., that are capital assets*) is 28 percent.
- The Net Investment Income Tax (NIIT) still applies to certain taxpayers whose modified adjusted gross income exceeds certain thresholds.
- Under the new rate structure the marriage penalty has been somewhat mitigated and comes into play for joint filers with income in excess of \$600,000, whereas under the prior rate structure, the penalty was imposed at income over \$156,150.

## ... Estates and Trusts Income Tax Rates

<u>Ordinary Taxable Income</u>	<u>Tax Rate</u>
\$ 0 - \$ 2,550	10%
\$ 2,550 - \$ 9,150	24%
\$ 9,150 - \$12,500	35%
Over \$12,500	37%

### Capital Gains and Dividends

- 15 Percent Rate Threshold - \$2,600  
(0 Percent Rate under \$2,600).
- 20 Percent Rate Threshold - \$12,700.

## ... Modifications to the Kiddie Tax

- Act modifies the kiddie tax to effectively apply the estates and trusts ordinary and capital gains rates to the net unearned income of a child.
  - As under pre-Act law, earned income is taxed according to an unmarried taxpayer's brackets and rates.
- No change in law as to whom the tax applies.
  - Under age 19, by the close of the tax year, or is a full-time student under age 24;
  - Has at least one living parent at the close of the tax year;
  - Has unearned income of more than \$2,100 (for 2018); and
  - Doesn't file a joint return.
- Eliminates the need to coordinate filing with the parents return.



## ... Individual Alternative Minimum Tax

- The alternative minimum tax (AMT) is a tax system separate from the regular tax that is intended to prevent a taxpayer with substantial income from avoiding tax liability by using various exclusions, deductions and credits.
- The Act adjusts the AMT exemption amounts in 2018 for non-corporate taxpayers, as follows:
  - Married Joint - \$109,400 (*was \$84,500*).
  - Single & HOH - \$70,300 (*was \$54,300*).
  - Married Filing Separately - \$54,700 (*was \$42,250*).
  - Estates and Trusts - \$22,500 (*was \$24,100*).

## ... Individual Alternative Minimum Tax (con't.)

- Under the Act, the above exemption amounts are reduced (not below zero) to an amount equal to 25 percent of the amount by which the alternative taxable income of the taxpayer exceeds the phase-out amounts, increased, as follows:
  - Married Filing Joint - **\$1 million** (*was \$164,000*).
  - All other taxpayers (other than estates and trusts) - **\$500,000** (*was \$123,100*).
  - Estates and Trusts - \$75,000 (*was \$75,000; i.e., no change*).
- **Note:** With the repeal of dependent exemptions, the \$10,000 limitation on SALT deductions, the disallowance of miscellaneous itemized deductions and the increase in the AMT exemption amounts and thresholds, many taxpayers that were in AMT in prior years will *not* be going forward.

# Changes to Itemized Deductions, the Standard Deduction, Dependent Exemptions and the Child Tax Credit

## ... State, Local, Sales and Property Tax Deduction

- The deduction for state and local income tax, sales tax and property taxes ("SALT deduction") is capped at \$10,000.
  - This will have more impact on taxpayers with more expensive property, generally those who live in higher-income areas, or people in states with higher state tax rates (NY, NJ, CA, etc.).
- This provision alone, combined with the increased standard deduction will reduce the number of people that will itemize in 2018 and forward.



## ... State, Local, Sales and Property Tax Deduction (con't.)

- Many taxpayers that had large SALT deductions were subject to AMT.
  - With revised AMT rules (discussed previously), the negative impact should be less than anticipated.
- Prepayment in 2017 issues – Internal Revenue Service Code Section 164(b)(6) states: “an amount paid in a taxable year beginning before January 1, 2018, with respect to a state or local income tax imposed for a taxable year beginning after December 31, 2017, shall be treated as paid on the last day of the taxable year for which such tax is so imposed.”

## ... State, Local, Sales and Property Tax Deduction (con't.)

- **Note:** \$10,000 aggregate limitation doesn't apply to:
  - (i) Foreign income, war profits, excess profits taxes;
  - (ii) State and local, and foreign, real property taxes; and
  - (iii) State and local personal property taxes,
  - If those taxes are paid or accrued in carrying on a trade or business or in an activity described in Code Section 212 - *Expenses for the Production of Income*.
- So, deductions for state, local and foreign property taxes, and sales taxes, that are deductible in computing income on an individual's Schedule C, Schedule E or Schedule F on the individual's tax return, are allowed in full.

## ... State, Local, Sales and Property Tax Deduction (con't.)

- Several states, including New York State, have attempted to work around the SALT limitation.
  - **New York**, Connecticut, New Jersey and Maryland have filed a lawsuit in the U.S. District Court claiming that the reduction of the state and local tax (SALT) is unconstitutional and exceeds Federal authority to impose a Federal income tax. The lawsuit also claims that the SALT deduction cap disproportionately benefits other states at the expense of the plaintiff states and will significantly increase the Federal tax liability for residents of each of the plaintiff states.

## ... State, Local, Sales and Property Tax Deduction (con't.)

- New York State established a new optional Employer Compensation Expense Tax (ECET) that employers can elect to pay if they have employees that earn over \$40,000 annually in wages and compensation in New York State. TSB-M-18(1)ECEP.
- The Internal Revenue Service issued Proposed Regulations and News Release 2018-172, August 23, 2018, clarifying that contributions in exchange for state or local tax credits under which the amount otherwise deductible as a charitable contribution would generally be reduced by the amount of any state or local tax (SALT) credit received or expected to be received by the contributing taxpayer.



## ... Mortgage Interest Deduction

- Mortgage interest deduction for principal residence and one second home is lowered from total loan balances of \$1 million under current law to \$750,000.
  - Applies to debt incurred after December 15, 2017.
  - The \$1 million limitation remains for older debt (grandfathered).
- Interest from home equity loans (aka second mortgages) is no longer deductible unless used for acquisition purposes. No grandfather provision.
- Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing or substantially improving a qualified residence of the taxpayer and which is secured by the residence.

## Charitable Contribution Deduction Limitation Increased

- For contributions made in tax years beginning after December 31, 2017 and before January 1, 2026, the 50 percent AGI limitation under Code Section 170(b) for cash contributions to public charities and certain private foundations is increased to 60 percent.
- Beginning in 2018, no charitable deduction is allowed for any payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event.

## ... No Deduction for Amounts Paid for College Athletic Seating Rights

- Under pre-Act law, special rules applied to certain payments to institutions of higher education in exchange for which the payor received the right to purchase tickets or seating at an athletic event.
  - The payor could treat 80 percent of such payment as a charitable contribution.

## ... Gambling Losses

- Beginning in 2018, the limitation on gambling losses is modified to provide that all deductions for expenses incurred in carrying out wagering transactions (i.e., traveling to and from the casino), and not just the gambling losses, are limited to the extent of gambling winnings.
- The 2011 Tax Court decision in *Mayo* provided that non-wagering expenses (i.e., expenses incurred in traveling to and from the casino) were deductible business expenses and not part of the gambling losses which would be limited to gambling winnings.
  - The decision only applied to those who were in the trade or business of gambling.



## ... Miscellaneous Itemized Deductions

- Beginning in 2018, the Act suspends all miscellaneous itemized deductions that are subject to the 2 percent floor under present law.
  - Examples include: employee business expenses, tax preparation fees, job search expenses, union dues, dues to professional societies, investment expenses, etc.
- Biggest impact will be on sales people who incur significant business expenses in their line of work and are not reimbursed under an **accountable plan**.
- **Planning Point:** *Approach employer to establish an accountable plan for expense reimbursements. The combination of a lower salary/commission structure, plus non-taxable reimbursements can provide greater benefit.*

## ... Pease Limitation on Itemized Deductions Eliminated

- Under pre-Act law, higher-income taxpayers who itemized their deductions were subject to a limitation on these deductions (commonly known as the “Pease” limitation).
  - The limitation reduces the majority of itemized deductions by 3 percent of the amount by which a taxpayer’s adjusted gross income exceeds a certain threshold, up to a maximum of 80 percent of itemized deductions.
  - 2017 Thresholds were: MFJ - \$313,800 and Single - \$261,500.
- Beginning in 2018, the “Pease” limitation on itemized deductions is suspended but will return in 2026, if the law is not made permanent or extended.

## ... Standard Deductions

- Act nearly doubles the standard deduction.
  - Married Joint Filers - from \$12,700 to \$24,000.
  - Single - from \$6,350 to \$12,000.
  - Heads of Household - from \$9,350 to \$18,000.
  - No changes were made to the current law with regard to the additional standard deduction for the elderly (age 65) and blind. Remain at \$1,300 each for MFJ/MFS, \$1,600 each for Single.
- Previously, about 70 percent of families choose the standard deduction rather than itemized deduction; this could now rise to over 84 percent.
- With the cap on SALT at \$10,000, joint taxpayers will need in excess of \$14,000 of other allowable deductions to continue to itemize.

## ... Personal Exemptions

- The bill eliminates the personal exemption, which was a deduction of \$4,050 (2017) per taxpayer and dependent.
- Negative impact softened/eliminated by increased and expanded child tax credit for children under age 17.
- As a result of phase-outs under prior law, many high-income taxpayers received no benefit for personal exemptions. Single filers phased out with AGI between \$261,500 and \$384,000. MFJ filers phased out with AGI between \$313,800 and \$436,300.
- Taxpayers in AMT received no benefit for dependent exemptions under prior law.

## ... Child Tax Credit

- Beginning in 2018, the Act doubles the child tax credit (for children under age 17) from \$1,000 to \$2,000, \$1,400 of which will be refundable.
  - It also provides a new \$500 credit for other dependents.
- The credit begins to phase-out for taxpayers with AGI in excess of \$400,000 (married joint) and \$200,000 (for all other taxpayers).
  - These phase-out thresholds are not indexed for inflation.
  - Prior phase-outs were at \$110,000 (MFJ), \$75,000 (single) and \$55,000 (MFS).
- **Note:** The significant increase in the phase-out thresholds will result in more taxpayers being eligible for the credit and increased credits for those previously eligible. The increased and expanded credit offsets the loss of the dependent exemption in many cases.



## ... Impact of Changes

### Change in Tax on \$200,000 AGI, Use of Standard Deduction, No Children

Filing Status MFJ	2017	2018	Change
Taxable Income	\$ 179,200	\$ 176,000	\$ (3,200)
Income Tax	37,061	30,819	(6,242)

Filing Status Single	2017	2018	Change
Taxable Income	\$ 189,600	\$ 188,000	\$ (1,600)
Income Tax	46,070	41,850	(4,220)

### Change in Tax on \$200,000 AGI, Use of Standard Deduction, 2 Children < 17

Filing Status MFJ	2017	2018*	Change
Taxable Income	\$ 171,100	\$ 176,000	\$ 4,900
Income Tax	34,793	26,819	(7,974)

*\*Note: 2018 tax reduced by \$4,000 child tax credit.*

## ... Impact of Changes (con't.)

### Change in Tax on \$200,000 AGI, \$28,000 Id's (taxes \$18K, Mtg \$6K, Cont \$4K), No Children

Filing Status MFJ	2017	2018	Change
Taxable Income	\$ 163,900	\$ 176,000	\$ 12,100
Income Tax	32,777	30,819	(1,958)

Filing Status Single	2017	2018	Change
Taxable Income	\$ 167,950	\$ 180,000	\$ 12,050
Income Tax	40,008	39,290	(718)

### Change in Tax on \$200,000 AGI, \$28,000 Id's (taxes \$18K, Mtg \$6K, Cont \$4K), 2 Children < 17

Filing Status MFJ	2017	2018*	Change
Taxable Income	\$ 155,800	\$ 176,000	\$ 20,200
Income Tax	30,509	26,819	(3,690)

*\*Note: 2018 tax reduced by \$4,000 child tax credit.*

## ... Impact of Changes (con't.)

### Change in Tax on \$300,000 AGI, \$52,000 Id's (taxes \$35K, Mtg \$10K, Cont \$7K), No Children

Filing Status MFJ	2017	2018	Change
Taxable Income	\$ 239,900	\$ 273,000	\$ 33,100
Income Tax	54,834	54,549	(285)
AMT	5,987	-	(5,987)
Total Tax	\$ 60,821	\$ 54,549	\$ (6,272)

Filing Status Single	2017	2018	Change
Taxable Income	\$ 246,401	\$ 273,000	\$ 26,599
Income Tax	65,612	71,240	5,628
AMT	6,929	-	(6,929)
Total Tax	\$ 72,541	\$ 71,240	\$ (1,301)

### Change in Tax on \$300,000 AGI, \$52,000 Id's (taxes \$35K, Mtg \$10K, Cont \$7K), 2 Children < 17

Filing Status MFJ	2017	2018*	Change
Taxable Income	\$ 231,800	\$ 273,000	\$ 41,200
Income Tax	52,239	50,549	(1,690)
AMT	8,582	-	(8,582)
Total Tax	\$ 60,821	\$ 50,549	\$ (10,272)

\*Note: 2018 tax reduced by \$4,000 child tax credit.

## ... Healthcare Deductions

- Beginning in 2019 (not 2018), the Affordable Care Act Shared Responsibility Penalty is **permanently** reduced to zero (no sunset provision).
- The Act leaves intact the 3.8 percent Net Investment Income Tax and the .9 percent additional Medicare tax enacted by the Affordable Care Act.
- The Act expands amount of out-of-pocket medical expenses that may be deducted by lowering threshold from 10 percent of AGI to 7.5 percent of AGI, but only for 2017 (retroactively) and 2018.
  - For 2019 and later years, the threshold will increase to 10 percent.
- **Note:** In most cases, without proper planning or a catastrophic event, it is very hard to exceed these thresholds.

## ... Planning for 2018 and Beyond

- Under the new law, taxpayers (MFJ) will need allowable itemized deductions of \$14,000, in addition to the \$10,000 SALT deduction in order to obtain a benefit over the \$24,000 standard deduction. With proper planning, this can be achieved through:
  - Carefully timing the payment of itemized deductions that will result in a current year benefit.
    - Bunching deductible medical expenses to exceed the AGI limitation in (7.5 percent in 2018), where possible.



## ... Planning for 2018 and Beyond (con't.)

- Bunching charitable contributions every other year or consider funding a donor advised fund to fund your contributions going forward.
- Receiving employee business expense reimbursements under an accountable plan. This can be a win-win situation for both you (payment of expenses with pre-tax dollars) and your employer (reduction in employer payroll taxes).

## ... Other Notable Changes

- On the following slides, we will review some of the other notable changes contained in the Act impacting individual income taxes beginning in 2018.

## ... Education Deductions and Credits

- No major changes are made to education deductions and credits.
  - The teacher deduction for unreimbursed classroom expenses remains at \$250.
  - Unfortunately, no changes to the Lifetime Learning Credit, American Opportunity Credit and Student Loan Interest deduction, as this area could have used some simplification.
  - The above-the-line deduction for qualified higher education expenses expired at the end of 2017. It's uncertain whether this provision will be further extended, made permanent or left expired.

## ... Education Deductions and Credits (con't.)

- The Act modifies Section 529 plan rules.
  - For 2017 distributions, “qualified higher education expenses” expanded to include tuition at an elementary or secondary public, private or religious school, and various expenses associated with home school.
  - The amount of cash distributions from all 529 plans with respect to a beneficiary during any tax year can't, in the aggregate, include more than \$10,000 in above-described expenses (i.e., elementary school and secondary school tuition) incurred during the tax year.
  - **Note:** In addition to Federal tax benefits, currently over 30 states (including New York) offer full or partial state tax deductions for contributions to a 529 plan. ([www.nysaves.org](http://www.nysaves.org)).

## ... Alimony Deduction

- Alimony paid to an ex-spouse will no longer be deductible by the payor.
  - In addition, alimony payments will no longer be included in the recipient's gross income.
- This effectively shifts the tax burden of alimony from the recipient to the payor and eliminates any tax imbalance between the payor and payee (i.e. payor is in a 30 percent tax bracket and recipient is in a 15 percent tax bracket).
- This provision is effective for divorce and separation agreements signed or modified after December 31, 2018.



## ... Recharacterization of Roth Conversions Eliminated

- The Act provides that the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA.
  - Thus, recharacterization cannot be used to unwind a Roth conversion.
  - Why would you want to unwind?
- However, recharacterization is still permitted with respect to other contributions.

## ... Recharacterization of Roth Conversions Eliminated (con't.)

- These changes are effective for plan years beginning after December 31, 2017.
- **Note:** The IRS has clarified in a FAQ posted to its website that reconversions back into a traditional IRA were permitted through October 15, 2018.
  - A Roth IRA conversion after January 1, 2018, cannot be recharacterized.

## ... Exclusion for Moving Expense Reimbursements Suspended & Moving Expenses Deduction Suspended

- Beginning in 2018, the exclusion for qualified moving expense reimbursements is suspended, along with the deduction for moving expenses.
- **Exception:** Does not apply to members of the Armed Forces on active duty (and their spouses and dependents) who move pursuant to a military order and incident to a permanent change of station.

## ... Treatment of Carried Interest

- Under pre-Act law, an owner of a partnership interest who receives payments in connection with the performance of services (i.e., a fund manager) is entitled to long-term gain treatment upon the sale of partnership interests held for greater than one year.
  - This is typically known as a “carried interest.”
- For tax years beginning after December 31, 2017, the Act imposes a three-year holding period requirement in order for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain rather than ordinary income.

## ... New Limitations on “Excess Business Loss”

- Beginning in 2018, the Act provides that a non-corporate taxpayer's “excess business loss” is disallowed.
- Code Section 461(l) limits the ability of non-corporate taxpayers to use trade or business losses against other sources of income, such as wages and other compensation fees, interest, dividends and capital gains.
  - The practical result is that the business losses of a non-corporate taxpayer for a tax year can offset no more than \$500,000 (for married individuals filing jointly), or \$250,000 (for other individuals), of a taxpayer's non-business income for that year.



## ... New Limitations on “Excess Business Loss” (con’t.)

- Any loss that is disallowed as an excess business loss is treated as an NOL carryover to the following tax year under Code Section 172.
- The requirement that excess business loss be carried forward as part of an NOL forces taxpayers who have losses in excess of the thresholds to wait at least one year to get a tax refund in connection with those excess losses.

## ... New Limitations on “Excess Business Loss” (con’t.)

### Example:

- In 2018, T, a single taxpayer, has deductions of \$500,000 from a business. T's gross income from the business is \$200,000. T's excess business loss is \$50,000 ( $\$500,000 - (\$200,000 + \$250,000)$ ). The \$50,000 excess business loss is treated as part of the taxpayer's net operating loss (NOL) carryforward in later years.
  - In the case of a partnership or S corporation, the provision applies at the partner or shareholder level.

## ... Casualty Losses/Disaster Relief

- Beginning in 2018, personal casualty and theft losses of an individual are deductible only to the extent they are attributable to a Federally declared disaster (“Federal disaster losses”).
  - Under prior law, a deduction was allowed for losses resulting from a casualty or theft of personal use property. A casualty is the damage, destruction or loss of property resulting from sudden, unexpected or unusual identifiable events, such as car accidents, storms, hurricanes, earthquakes and floods.

## ... Student Loan Discharged on Death or Disability

- Under an exception to the rule requiring the inclusion of cancellation of debt (COD) in income, gross income will not include any amount for the discharges of indebtedness for certain student loans that are discharged on account of:
  - Death; or
  - Total and permanent disability of the student.
- Applies to both student loans and private education loans.
- For discharges occurring after December 31, 2017.

## ... Net Operating Loss Deductions

- A net operating loss (NOL) deduction is allowed in computing taxable income for a tax year in an amount equal to the aggregate of the NOL carryovers and NOL carrybacks to that year.
  - Under pre-Tax Cuts and Jobs Act law, the NOL deduction was not subject to a limitation based on taxable income and could fully offset a taxpayer's income in the year the loss was carried.



## ... Net Operating Loss Deductions (con't.)

- New law.
  - The Act limits the NOL deduction to 80 percent of taxable income, determined without regard to the NOL deduction itself.
  - The Act eliminates the two-year carryback rule (*exceptions apply for farming losses and property and casualty insurance companies*) and allows the losses to be carried forward indefinitely.
    - The provision allowing indefinite carryovers and modifying carrybacks generally applies to losses arising in taxable years beginning after December 31, 2017.

## ... Net Operating Loss Deductions (con't.)

### Example:

- In 2018, a calendar-year taxpayer has a \$90,000 NOL. It has no other NOL carryovers. It carries forward the NOL to 2019, a year in which it has taxable income of \$50,000. The taxpayer's 2019 NOL deduction is limited to \$40,000 ( $\$50,000 \times 80$  percent).
- The remaining \$50,000 unused NOL can't be deducted in 2019, but can be carried forward indefinitely.

## ... Certain Self-Created Property Not Treated as Capital Asset

- Effective for dispositions after December 31, 2017, Code Section 1221(a)(3), was amended to exclude of patents, inventions, models or designs (whether or not patented) and secret formulas or processes, which are held either by the taxpayer who created the property or by a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created), from the definition of a “capital asset.”
- Accordingly, sale of such assets will now result in an ordinary gain as opposed to a capital gain.
  - Potential 17 percent tax differential.

## ... Deduction for Living Expenses of Members of Congress Eliminated

- For tax years beginning after December 22, 2017, members of Congress cannot deduct living expenses when they are away from home.
  - Under pre-Act law, the deductible amount was limited to \$3,000 per year.

## Head of Household Filing Status Added to Paid Preparer Due Diligence Requirements

- Under pre-Tax Cuts and Jobs Act law, any person who is a tax return preparer for any return or claim for refund who fails to comply with due diligence requirements imposed by IRS Regulations with regard to determining the eligibility for, or the amount of, a child tax credit, an American Opportunity tax credit, or an earned income tax credit must pay a penalty of \$500 (as adjusted for inflation) for each failure.
- Effective for tax years beginning after December 31, 2017, the Act expands the due diligence requirements for paid preparers to cover determining eligibility for a taxpayer to file as head-of-household.



# Overview and Examples: The Code Section 199A - Qualified Business Income Deductions

## Overview

- Applies to:
  - Sole-proprietorships (Schedule C).
  - Rental property trade or businesses (Schedule E).
  - Disregarded entities (SMLLCs' Schedule C, Schedule E).
  - Pass-through entities (Schedule K-1 reported on Schedule E).
  - Trusts and estates, REITs and qualified cooperatives.
- Potential limitations:
  - Taxable income (20 percent of adjusted taxable income).
  - AGI threshold limitations (\$157,500-\$207,500/\$315,000-\$415,000).
    - Wage (W-2 wages) and property limitations (UBIA).
  - Non-specified service business (NSSB) and specified service businesses (SSB).

## ... Example #1 - General Application (*Under Thresholds*)

- Tom, a single taxpayer, earns \$100,000 of pass-through QBI in a company he operates as an S corporation which is a NSSB. His taxable income (before the 199A deduction) on his Form 1040 is \$110,000.
  - The QBI limit = \$20,000. ( $\$100,000 \times 20 \text{ percent}$ ).
  - Taxable Income limit = \$22,000. ( $\$110,000 \times 20 \text{ percent}$ ).
- Tom can utilize a QBI deduction of \$20,000. The lesser of the two amounts.
- **Observation:** If Tom's taxable income on Form 1040 was only \$50,000 (*as a result of itemized or other deductions*) Tom's taxable income limitation would have been \$10,000 ( $\$50,000 \times 20 \text{ percent}$ ) and Tom would have been limited to a QBI Deduction of \$10,000.

## ... Example #2 - Multiple Sources (*Under Thresholds*)

- Martin (MFJ), owns three rental properties (Schedule E's) and is a shareholder in an S corporation (Schedule K-1). Martin's taxable income is \$300,000.
  - Rentals: One property generates \$10,000 of rental income. Another property generates \$20,000 of net rental income. A third property loses \$15,000.
  - Pass-Through: The S corporation Schedule K-1 reports QBI of \$60,000.
- The QBI limit = \$15,000.  $(\$10,000 + \$20,000 - \$15,000 + 60,000 \times 20 \text{ percent})$ .
- Taxable income limit = \$60,000.  $(\$300,000 \times 20 \text{ percent})$ .
- Martin can utilize a QBI deduction of \$15,000. The lesser of the two amounts.

## ... Example #3 (NSSB Over Threshold)

- Jim (MFJ) has \$365,000 of taxable income, \$250,000 of QBI which is from a **NSSB** he operates through an S Corporation. The business has Unadjusted Basis in Assets (UBIA) of \$100,000 and pays \$50,000 in W-2 wages. As Jim's taxable income exceeds the taxable income threshold (\$315,000), he is subject to the W-2 wage/property limitation.
  - The QBI limit = \$50,000. ( $\$250,000 \times 20 \text{ percent}$ ).
  - Taxable income limit = \$73,000. ( $\$365,000 \times 20 \text{ percent}$ ).
  - *Wage and property limits (greater of):*
    - W-2 Wage limitation = \$25,000 ( $\$50,000 \times 50 \text{ percent}$ ).
    - W-2 & UBIA limitation = \$15,000 ( $\$50,000 \times 25 \text{ percent, plus } \$100,000 \times 2.5 \text{ percent}$ ).



## ... Example #3 (NSSB Over Threshold) (con't.)

- As Jim's taxable income falls between the upper and lower threshold amounts and the W-2 and property limitation is less than the regular QBI limit, the deduction will be phased out and fall somewhere between the regular QBI limit (\$50,000) and the wage and property limit (\$25,000).
- In this situation, the taxpayer's AGI falls halfway between the upper and lower threshold amount and under the limitation formula the taxpayer's allowable QBI deduction will be \$37,500, calculated, as follows:
  - *Reduction % = 50 percent  $((\$365,000 - \$315,000)/\$100,000)$ .*
  - *Reduction amount = \$12,500  $((\$50,000 - \$25,000) \times 50 \text{ percent})$ .*
  - *QBI deduction = \$37,500  $(\$50,000 - \$12,500)$ .*

## ••• Taxable Income Limitations with Regard to NSSB QBI

- A taxpayer with income generated from an NSSB will receive:
  - Taxable income below the thresholds (\$157,500/\$315,000):
    - The maximum benefit (20 percent) of the QBI.
  - Taxable income between the thresholds (\$157,500-\$207,500) / (\$315,000-\$415,000):
    - If the wage and property limitation exceeds the general limitation (20 percent), the taxpayer will receive the full 20 percent no matter where the AGI falls within the phase-out range.
    - If the general limitation exceeds the wage and property limitation, the taxpayer will receive an amount between the wage and property limitation and the general limitation (as illustrated in Example #3 above).

## ... Taxable Income Limitations with Regard to NSSB QBI (con't.)

- Taxable income above the upper thresholds (\$207,500/\$415,000):
  - If the wage and property limitation exceeds the general limitation (20 percent), the taxpayer will receive the full 20 percent no matter what level of AGI.
  - If the general limitation exceeds the wage and property limitation, the taxpayer will receive an amount equal to the wage and property limitation.

**Observation:** A taxpayer with QBI from an NSSB can receive the full 20 percent QBI regardless of the their taxable income if they are not limited under the wage and property limitations. This is not the case with qualified business income sourced from an SSB.

**Note:** *Taxable income limitation may reduce the amounts calculated above.*

## ... Example #4 (SSB Over Threshold)

- The same facts as in Example #3, except that Jim's QBI of \$250,000 is generated from an SSB. The limitations applicable to QBI generated from an SSB are subject to more aggressive phase-outs and the benefit is phased out completely once the taxpayer's taxable income equals or exceeds the higher threshold.
- The additional limitation applies an "applicable percentage" to all the pass-through items and reduces them by that percentage. The applicable percentage is calculated in the same manner as the reduction percentage in Example #3. The applicable percentage in this example would be 50 percent.  $((\$365,000 - \$315,000) / \$100,000)$ .
- In calculating the limitation, the taxpayer would use the following items flowing through from the S corporation:



## ... Example #4 (SSB Over Threshold) (con't.)

- QBI: \$125,000 (\$250,000 from SSB x 50 percent).
  - Wages: \$25,000 (\$50,000 from SSB x 50 percent).
  - UBIA: \$50,000 (\$100,000 from SSB x 50 percent).
- As a result, the taxpayer's QBI limits for the S corporation income is calculated, as follows:
  - The QBI limit = \$25,000. ( $\$125,000 \times 20 \text{ percent}$ ).
  - Taxable income limit = \$73,000. ( $\$365,000 \times 20 \text{ percent}$ ).
  - *Wage and property limits (greater of):*
    - W-2 Wage limitation = \$12,500 ( $\$25,000 \times 50 \text{ percent}$ ).
    - W-2 & UBIA limitation = \$7,500 ( $\$25,000 \times 25 \text{ percent, plus } 50,000 \times 2.5 \text{ percent}$ ).
- **Note:** *This calculation is the same for an NSSB but the amounts utilized have been adjusted by the "Applicable Percentage."*



## ... Example #4 (SSB Over Threshold) (con't.)

- Under this scenario, the taxpayer's AGI falls halfway between the upper and lower threshold amount and under the limitation formula, the taxpayer's allowable QBI deduction would be \$18,750 calculated, as follows:
  - *Reduction % = 50 percent  $(\$365,000 - \$315,000) / \$100,000$ .*
  - *Reduction amount = \$6,250  $(\$25,000 - \$12,500 \times 50 \text{ percent})$ .*
  - *QBI deduction = \$18,750  $(\$25,000 - \$6,250)$ .*

## ... Taxable Income Limitations with Regard to SSB QBI

- A Taxpayer with income generated from an SSB will receive:
  - Taxable Income below the thresholds (\$157,500/\$315,000):
    - The maximum benefit (20 percent) of the QBI.
  - Taxable income between the thresholds (\$157,500-\$207,500) / (\$315,000-\$415,000):
    - If the wage and property limitation exceeds the general limitation (20 percent), the taxpayer will receive the full 20 percent no matter where the AGI falls within the phase-out range.
    - If the general limitation exceeds the wage and property limitation, the taxpayer will receive an amount between the wage and property limitation and the general limitation (as illustrated in Example #4 above).
    - **IMPORTANT NOTE:** Income, wage and property amounts used in these calculations are reduced proportionately subject to “applicable percentage” before entering into calculations.

## ... Taxable Income Limitations with Regard to SSB QBI (con't.)

- Taxable income above the upper thresholds (\$207,500/\$415,000):
  - Based on the use of the “Applicable Percentage” in the calculation, the taxpayer will receive no QBI deduction for income generated in an SSB once the top taxable income limitation is reached.

## Summary - Application Notes

- Where a taxpayer has multiple sources of QBI and is subject to the wage and property limitations, the QBI deduction will be calculated separately for each activity using the applicable data (wages & UBIA) from that activity.
- The separately calculated QBI deductions are then combined to determine the taxpayer's potential QBI deduction.
- A taxpayer may not utilize the wages/UBIA from one activity to calculate the QBI deduction in another activity, unless that taxpayer can aggregate the trades or businesses - special rules apply.
- Losses from an activity reduce the taxpayer's combined QBI - special rules apply.

## Summary - Application Notes (con't.)

- If the net annual amount of a Taxpayer's QBI is a loss, the "carryover qualified business loss" is treated as a loss in the succeeding year's application. This has the effect of reducing the Section 199A deduction for the subsequent year.
  - Does not reduce taxable income in the subsequent year.
- The Section 199A deduction cannot be taken as part of an NOL to be carried forward.
- Section 199A is only an income tax deduction. The deduction does not reduce "self-employment tax" or "net investment income tax."
- The Section 199A deduction is not added back in the calculation of the AMT.



## ... Section 199A - Planning Opportunities

- The planning opportunities available under Section 199A will vary based on each taxpayer's individual situations, but may include:
  - Conversion of W-2 income into QBI income (shareholders);
  - Reduce guaranteed payments, increase income allocations partners/members);
  - Aggregation of QBI trades or businesses where permitted (special rules apply);
  - Minimize phase-outs by increasing W-2 wages and UBI where possible;
  - Rental properties - increasing participation/services to bring to a level of a trade or business. The AICPA is currently requesting that the Internal Revenue Service classify all rental real estate as a trade or business for purposes of Section 199A; and
  - Controlling taxable income to maximize QBI deductions - Forgo bonus depreciation and Section 179 to maintain a consistent level of taxable income.

## ... Other Recent Changes/Legislation

- Expiring individual tax provisions:
  - The above-the-line deduction for certain higher-education expenses, including qualified tuition and related expenses, under Code Section 222;
  - The treatment of mortgage insurance premiums as qualified residence interest under Code Section 163(h)(3)(E); and
  - The exclusion from income of qualified cancelled mortgage debt income associated with a primary residence under Code Section 108(a)(1)(E).

## ... Other Recent Changes/Legislation (con't.)

- 2019 Qualified retirement plan amounts (**IRS Notice 2018-83**).
  - Elective deferral limit for employees participating in 401(k), 403(b) and most 457 plans has increased from \$18,500 to \$19,000.
  - Limit on annual contributions to an IRA has increased from \$5,500 to \$6,000 (last increase was in 2013).
  - Limit on annual contributions to a SIMPLE plan increased from \$12,500 to \$13,000 for 2019.
  - Benefit limit for defined benefit plans has increased from \$220,000 to \$225,000; and defined contribution plan limit has increased from \$55,000 to \$56,000.
  - Catch-up contribution limits, if you're 50 or older in 2019, remain unchanged at \$6,000 for workplace plans, \$3,000 for SIMPLE plans and \$1,000 for IRAs.

## ... Other Recent Changes/Legislation (con't.)

- Social Security wage base increases for 2019:
  - The Social Security Administration (SSA) announced that the maximum earnings subject to the Social Security component of the FICA tax will increase from \$128,400 to \$132,900 for 2019.
  - This means that for 2019, the maximum Social Security tax that employers and employees will each pay is \$8,239.80 (\$132,900 x 6.2 percent).

## ... Tax Reform 2.0?

- Protecting Family and Small Business Tax Cuts Act of 2018 (*H.R. 6760*).
  - Would make most provisions from TCJA permanent.
- Family Savings Act of 2018 (*H.R. 6757*).
  - Provide rules for multiple employer plans and pooled employer plans that would "allow small businesses to join together to create a 401(k) plan more affordably."
  - Treat certain taxable non-tuition fellowship and stipend payments as compensation for IRA purposes.
  - Repeal the maximum age for traditional IRA contributions.
  - Exempt individuals with certain account balances from required minimum distribution (RMD) rules.
  - Allow treatment of a plan adopted by the filing due date for year as in effect as of close of year.



## ... Tax Reform 2.0? (con't.)

- Family Savings Act of 2018.
  - Modify nondiscrimination rules to protect older, longer service participants.
  - Expand Section 529 plans.
  - Allow penalty-free withdrawals from retirement plans for individuals in case of birth of child or adoptions.
- American Innovation Act of 2018 (H.R. 6756).
  - Simplify and expand deductions for start-up and organizational expenditures under Code Section 195.
  - Preserve start-up net operating losses (NOLs) and tax credits after ownership change.

# Key Provisions Related to Estate and Gift Tax

## ... Estate and Gift Tax Changes

- For estates of decedents dying and gifts made after December 31, 2017, the Act doubles the base estate and gift tax exemption amount from \$5 million to \$10 million.
- The \$10 million amount is indexed for inflation occurring after 2011, and is expected to be approximately \$11.2 million in 2018 (\$22.4 million per married couple).
- Sunset provision: The increased basic exclusion will not apply to estates of decedents dying and gifts made after December 31, 2025.
- The language in the Act does not mention generation-skipping transfers, but because the GST exemption amount is based on the basic exclusion amount, generation-skipping transfers will also see an increased exclusion amount.

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# Conclusion

