**SUPPLEMENT TO ACCOMPANY**

**INDIVIDUAL TAXATION**

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**Van-Griner**

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**INTRODUCTION**

On December 22, 2017, President Trump signed into law the *Tax Cuts and Jobs Act* (the Act) that represents the most comprehensive overhaul of the tax law in over 30 years. The Act extends to virtually every area of the law, affecting not only individuals but businesses as well. As discussed in this supplement, the Act eliminates or changes many rules that have long been a part of the tax landscape, and, at the same time, adds many new provisions.

This supplement updates the text for these revisions as well as other items of note since publication. These changes are reflected in the following pages and are referenced to the 2018 edition by chapter and page.

In order to comply with budget rules, Congress made most changes effective for tax years beginning after December 31, 2017 and before January 1, 2026. In effect, existing law is suspended until 2026. However, it is anticipated that the suspension is merely temporary and the changes ultimately will become permanent. For this reason, the supplement does not make the distinction and assumes the changes are permanent unless otherwise noted.

Highlights of the *Tax Cuts and Jobs Act*

(P.L. 115-97, 12/22/2017)

* The Act reduces the tax rates for all taxpayers, both individuals and businesses.
* The new law retains seven marginal tax rates for individuals. However, these individual rates are reduced and the spreads of the tax brackets are wider.

 **2017**: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%
 **2018**: 10%, 12%, 22%, 24%, 32%, 35%, 37.0%

* The graduated rates for all C corporations are eliminated and replaced by a single flat rate of 21%, down from the top rate of 35%.
* To address the disparity between the rates for C corporations and flow-thru businesses (partnerships, S corporations, self-employed individuals and certain rental activities),
flow-throughs are entitled to a special deduction generally equal to 20% of their “qualified business income.”
* The tax rates for dividends and capital gains remain at 0%, 15% and 20%.
* The deduction for personal and dependent exemptions is eliminated. However, a new $500 credit is created for dependents that do not qualify for the child tax credit (e.g., a 17-year old child or aged parent who are dependents). In addition, trusts do not lose their exemption deduction of $300 for a simple trust and $100 for a complex trust.
* The child tax credit is doubled from $1,000 to $2,000 and up to $1,400 is refundable. The new law establishes a new $500 credit for dependents that do not qualify for the full child tax credit of $2,000 (e.g., a qualifying child 17 or older or an aged parent).
* The standard deduction (shown below) is increased substantially, reducing the number of taxpayers that will itemize deductions.

 2018 2017
Individuals $12,000 $ 6,350
Joint returns 24,000 12,700
Head of household 18,000 9,350
Married filing separately 12,000 6,350

* The increases to the standard deduction for the elderly and blind are maintained.
* The phase-out for itemized deductions is eliminated.
* Under the revised kiddie tax rules, the child’s tax on unearned income (including dividend and long-term capital gains) is computed using the tax rates for estates and trusts rather than those of his or her parents.
* For divorces after 2018, alimony is no longer deductible and is not taxable to the recipient.
* The deduction for moving expenses is eliminated. Reimbursements for an employee’s moving expenses would be considered taxable income with no offsetting deduction.
* The deduction for qualified tuition and related expenses expired for tax years after 2017 and was not addressed by the Tax Cuts and Jobs Act. However, the Bipartisan Budget Act, enacted on February 9, 2018 renewed the deduction for 2018.
* The floor at which unreimbursed medical expenses are not deductible drops from 10% to 7.5% of AGI.
* The itemized deductions for real and personal property taxes as well as state and local income and sales taxes are now combined and limited to a maximum of $10,000. Up to $10,000 will be added back for alternative minimum tax purposes.
* Foreign real property taxes may not be deducted.
* The mortgage interest deduction continues for both a principal and second residence but is limited to the interest on mortgage loans not greater than $750,000 (down from $1,000,000, although the $1,000,000 amount continues for home mortgages obtained before December 15, 2017).
* The deduction for interest on home equity loans is eliminated. Interest on existing home equity loans was not grandfathered and is no longer deductible (assuming the loan proceeds were not reinvested in the home).
* The charitable contribution deduction was retained and the limitation on the total deductible contributions was increased from 50% to 60% of adjusted gross income. Amounts paid to colleges and universities for athletic seating rights no longer qualify as a charitable contribution deduction.
* The Act eliminates the 50% deduction for the costs of entertainment directly related to or associated with business (e.g., tickets to a ballgame or other event). As under prior law, food or beverage expenses associated with operating a business, such as meals consumed by employees while traveling for business purposes are still deductible subject to the 50% disallowance rule. The treatment of client related meals is not clear.
* Under the new law, only 50% of the costs of food and beverages for employees at a corporate snack bar or an in-house cafeteria are deductible.
* The Act clarifies that employee achievement awards shall not include cash, cash equivalents gift cards or gift certificates (unless redeemable for tangible personal property from a limited array of pre-approved items by the employer) nor vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items.
* Under the new law, employers may not deduct any expense incurred for providing transportation or any payment or reimbursement to an employee for commuting except as necessary for ensuring the safety of the employee.
* Individuals generally can no longer deduct casualty losses unless they occurred in a federally declared disaster area.
* Deductions for all miscellaneous itemized deductions including unreimbursed employee business expenses and such items as home office expenses, investment advisory expenses and tax preparation expenses are eliminated.
* The alternative minimum tax is maintained for individuals (with higher exemptions) but eliminated for C corporations.
* Under the amended bonus depreciation rules, most businesses can immediately expense 100% of the cost of qualified property. The new law eliminates the rule that bonus depreciation is available only if the “original use” of the property began with the taxpayer. So now both new and used property can be expensed.
* The amount of depreciable tangible personal property that can be expensed in the year of acquisition under § 179 is increased to $1,000,000 and begins its dollar for dollar phase-out at $2,500,000. The Act also extends the use of § 179 to certain building improvements.
* The new law streamlines the depreciation of leasehold improvements, consolidating the three categories of leasehold improvements (qualified leasehold improvements, qualified restaurant property and qualified retail improvement property) into a single category, qualified improvement property with one set of rules for all improvements.
* The annual depreciation limits on passenger automobiles are increased.
* Net operating loss (NOL) carryovers or carrybacks occurring after 2017 are deductible only to the extent of 80% of the taxpayer's taxable income. Pre-2018 NOLs are not subject to this limitation. In addition, the Act provides that post-2017 NOLs normally can only be carried forward and the carryover period is unlimited.
* The amount of net business losses of a sole proprietorship, partnership, or S corporation that can be deducted on an owner’s return is limited to $500,000 (joint return) or $250,000 (all other returns). These so-called excess business losses become part of the taxpayer’s NOL deduction.
* Funds in a § 529 college savings account can now be used for elementary and high school expenses (e.g., home schooling, private or religious school tuition)
* The deduction under § 199 related to domestic production and manufacturing activities is eliminated.
* The Act restricts the use of the like-kind exchange rules solely to exchanges of real property and not tangible personal property (e.g., vehicles and equipment). To the extent of any trade-in value, a taxable exchange would result. However, this increased basis (i.e., not just any boot paid, but the trade-in value of the now taxable exchange) could be offset by either Sec. 179 or bonus depreciation on the newly-acquired property.
* The estate tax exemption is doubled and after appropriate inflation adjustments for 2018 is $11,200,000 million (effectively is $22,400,000 for a married couple.
* The gift tax exclusion increased under the normal inflation adjustment rules to $15,000.
* Proposed changes relating to the following items were not made and, therefore, the treatment remains the same as under prior law: child and dependent care credit; deduction for student loan interest; exclusion for employer provided education assistance and employer provided housing; educational credits (American Opportunity Tax Credit (the Hope Scholarship Credit) and the Lifetime Learning Credit; gain on the sale of personal residence, adoption exclusion and credit.

CHAPTER 1: AN OVERVIEW OF FEDERAL TAXATION

**Page 1-8. Marginal Tax Rates.** The Act reduced the rates for all individual taxpayers as shown below.

 **2017**: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%
 **2018**: 10%, 12%, 22%, 24%, 32%, 35%, 37.0%

**Tax Rate Schedules.** The tax rate schedules for 2018 are shown on the next page. Note that the brackets for joint returns are exactly twice the size of those for single taxpayers, except for the 35% and 37% rates.

 **2018 Single**

 If taxable income is % on Of the
Over But not over The tax is + Excess Amount over

$ 0 $ 9,525 $ 0.00 10% $ 0
 9,525 38,700 952.50 12% 9,525
 38,700 82,500 4,453.50 22% 38,700
 82,500 157,500 14,089.50 24% 82,500
 157,500 200,000 32,089.50 32% 157,500
 200,000 500,000 45,689.50 35% 200,000
 500,000 150,689.50 37% 500,000

# **2018 Married Filing Jointly and Surviving Spouses**

 If taxable income is % on Of the
Over But not over The tax is + Excess Amount over

$ 0 $ 19,050 $ 0.00 10% $ 0
 19,050 77,400 1,905.00 12% 19,050
 77,400 165,000 8,907.00 22% 77,400
 165,000 315,000 28,179.00 24% 165,000
 315,000 400,000 64,179.00 32% 315,000
 400,000 600,000 91,379.00 35% 400,000
 600,000 161,379.00 37% 600,000

# **2018 Head of Household**

 If taxable income is % on Of the
Over But not over The tax is + Excess Amount over

$ 0 $ 13,600 $ 0.00 10% $ 0
 13,600 51,800 1,360.00 12% 13,600
 51,800 82,500 5,944.00 22% 51,800
 82,500 157,500 12,698.00 24% 82,500
 157,500 200,000 30,698.00 32% 157,500
 200,000 500,000 44,298.00 35% 200,000
 500,000 149,298.00 37% 500,000

# **2018 Married Filing Separately**

 If taxable income is % on Of the
Over But not over The tax is + Excess Amount over

$ 0 $ 9,525 $ 0.00 10% $ 0
 9,525 38,700 952.50 12% 9,525
 38,700 82,500 4,453.50 22% 38,700
 82,500 157,500 14,089.50 24% 82,500
 157,500 200,000 32,089.50 32% 157,500
 200,000 300,000 45,689.50 35% 200,000
 300,000 80,689.50 37% 300,000

**2018 Estates and Trusts** If taxable income is % on Of the
Over But not over The tax is + Excess Amount over

$0 $ 2,550 $ 0.00 10% $ 0
 2,550 9,150 255.00 24% 2,550
 9,150 12,500 1,839.00 35% 9,150
 12,500 3,011.50 37% 12,500

**Example 6.** The amounts in this example changes due to the reduction of the tax rates in 2018.

H, an unmarried taxpayer, has taxable income of $67,000 for 2018*.* Referring to tax rate for single taxpayer (not a head of household), an unmarried taxpayer with tax­able income of $67,000 has a tax of $10,679.50 as computed below. H’s marginal tax rate is 22 percent.

2018 tax on $38,700. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $ 4,453.50
Plus: Tax on income above $38,700: ([$67,000 − $38,700 = $28,300] × 22%). . . . . . . . . . . . . . . . 6,226.00 Tax liability. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $10,679.50

Compare this tax to the 2017 tax in the text. The tax for 2018, $10,679.50, has been reduced by the new law by $1,809.25 ($12,488.75 - $10,679.50).

**Page 1-9**

Corporate tax rates for 2018 and beyond are no longer progressive. The corporate income tax is now a flat rate of 21% and long-term capital gains are taxed at the same rates.

**Example 8**

K, unmarried, has 2018 taxable income of $85,000 and pays a tax of $14,689.50. Although her marginal tax rate is 22 percent, K’s average tax rate is only 17.28% ($14,689.50 ÷ $85,000).

**Page 1-10**

**Example 9**

Assume the same facts as in *Example 8* above except that K’s total economic income is $100,000, the $15,000 difference between total income and taxable income being attributable to exclusions and deductions (e.g., interest on tax-exempt bonds and the standard deduction). In such case, K would pay taxes at an effective rate of 14.69% [$14,689.50 ÷ $100,000)].

 **Page 1-13**

**EXHIBIT 1-3**

The Act eliminated the deduction for personal and dependent exemptions. As a result, the calculation of taxable income is modified.

**Page 1-14**

For purposes of computing the estate and gift tax, the Act increases the exemption amount for 2018 to $11,200,000 (effectively $22,400,000 for married couples).

**Page 1-15**

The annual gift tax exclusion is adjusted annually for inflation and rises to $15,000 per donee in 2018. Thus a husband and wife can give up to $30,000 tax-free (i.e., without using any of their exemption).

The gift tax exemption is the same as for the estate tax. The Act increases it for 2018 to $11,200,000.

The Act increases the unified credit to $4,425,800, which effectively shelters $11,200,000 from the estate and gift tax. It is important to note that the estate and gift tax are structured such that any exemption used during life is not available at death. The rules effectively prevent a taxpayer from getting two exemptions.

The wage base for Social Security is increased for 2018 to $128,400.

CHAPTER 2: TAX PRACTICE AND RESEARCH

**Page 2-3**

**PTINs**. In 2017, a federal judge ruled that while the IRS could require a PTIN, it had exceeded its authority in collecting fees. Consequently, there is no fee for the 2018 filing season. Moreover, the IRS may be required to refund over $300 million in fees that it has previously collected.

CHAPTER 3: TAXABLE ENTITIES, TAX FORMULA,
 INTRODUCTION TO PROPERTY TRANSACTIONS

**Page 3-6**

**Exhibit 3-3.** The Act eliminates the deduction for personal and dependency exemptions. However, a new partial-tax credit of $500 is available for dependents that do not qualify for the full child tax credit (e.g., a child 17 or older, an aged parent).

After 2017, the corporate tax is a flat rate of 21 percent while individual rates are progressive from 10 to 37 percent.

**Example 3.** The analysis must be revised to reflect the new 21% tax rate for corporations and a new top rate of 37% for individuals.

**Page 3-12**

**Deduction for Qualified Business Income.** To address the disparity between the tax rates for C corporations and flow-thru businesses (partnerships, S corporations, self-employed individuals and certain rental activities), flow-throughs are entitled to a special deduction generally equal to 20% of their “qualified business income.” This deduction contained in new § 199A is discussed in Chapter 19 of this supplement.This deduction is not a deduction for AGI nor is it an itemized deduction but simply a deduction in arriving at taxable income.

**Classifying Deductions.** Deductions from AGI no longer contain personal and dependency exemptions since the Act eliminates the deduction for exemptions. Deductions from AGI now consist of itemized deductions and the deduction related to qualified business income (which is not a deduction for AGI and is not an itemized deduction).

**Page 3-18**

**Adjusted Gross Income.** Under the new law, medical expenses can be deducted if they exceed 7.5% of AGI (rather than 10% of AGI).

**Example 11.** The floor for medical expenses is 7.5% of AGI or $3,000 ($40,000 x 7.5%). Thus, $7,000 of medical expenses is deductible. However, if total itemized deductions do not exceed the standard deduction (in this case $12,000), the taxpayer may receive little, if any, tax savings.

**Page 3-19**

**EXHIBIT 3-6.** Several of the items should be deleted, including

* Alimony for divorces after 2018
* Deduction for domestic production activities (§ 199)
* Moving expenses
* Tuition payments

**Itemized Deductions and the Standard Deduction.** Under the Act, itemized deductions includes all deductions other than deductions for AGI and the deduction related to qualified business income. The Act eliminated the deduction for exemptions.

As noted in the text, the purpose of creating itemized deductions was to eliminate the need for taxpayers to list or itemize every deduction. Over the years, more and more people were itemizing their deductions because they exceeded the standard deduction. With the substantial increase in the standard deduction (see below), far fewer will be itemizing, making it easier for taxpayers to comply and easier for the IRS to administer.

**Page 3-19**

**Basic Standard Deduction.** The Act substantially increases the standard deduction for 2018. In addition, it retains the additional standard deduction for elderly and blind taxpayers. Itemized deductions may be deducted only if they exceed the standard deduction, which depends on the taxpayer’s filing status. The standard deduction amounts are shown below. Note that the additional standard deduction is not available if the taxpayer itemizes.

 Additional Standard Deduction
 Standard Deduction Age 65 or Blind

 2018 2017 2018 2017

Single $12,000 $ 6,350 $1,600 $1,550
Head of household 18,000 9,350 1,600 1,550
Joint return 24,000 12,700 1,300 1,250
Married filing separate 12,000 6,350 1,300 1,250

**Standard Deduction for Dependents.** For individuals who may be claimed as dependents, the standard deduction is the larger of $1,050 or (earned income + $350 not to exceed the normal new standard deduction of $12,000) (§ 63(c)(5) and Rev. Proc. 2017-58).

**Page 3-21**

**EXHIBIT 3-7 Partial List of Itemized Deductions**

* The floor where medical expenses are not deductible is 7.5% of AGI (rather than 10% of AGI).
* Under the Act, charitable contribution deductions are limited to 60% of AGI (rather than 50%).
* All miscellaneous itemized deductions are eliminated.

**Page 3-22**

**Miscellaneous Itemized Deductions.** The new law eliminates the deduction for all miscellaneous itemized deductions. Common miscellaneous itemized deductions included unreimbursed employee business expenses (e.g., travel, entertainment, and home office), investment expenses, safety deposit box fees and tax preparation expenses. Tax preparation expenses for taxpayers who have self-employment income reported on Schedule C and rental income reported on Schedule E are still deductible on those schedules, effectively making such expenses deductible for AGI.

**Exemptions.** The deduction for exemptions is eliminated.

**Page 3-23**

**Taxable Income and Tax Rates.** The tax rate structures under the 2018 law are still graduated but the seven rates are lower than 2017: 10, 12, 22, 24, 32, 35 and 37 percent. For 2018, the 24% marginal rate applies to single taxpayers when income exceeds $82,500 but that amount is doubled for joint returns to $165,000.

**Example 14.** Note that the tax in the text using the 2017 rules and rate schedules is $17,477.50 while the tax for 2018, as computed below, is $18,323. The higher tax in 2018 results because the deduction for the four exemptions ($16,200) is eliminated in 2018 and the lower rates in 2018 are not sufficient to offset the lost benefit of the exemptions. However, these calculations do not take into account the child tax credit. As discussed in Chapter 4 below, the Act increased the child tax credit from $1,000 to $2,000.

H and W are married and file a joint return for 2018*.* They have AGI of $151,000, two dependents, and itemized deductions of $30,800. Their taxable income is $120,200, computed as follows:

Adjusted gross income . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $ 151,000

Minus: Itemized deductions. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ( 30,800)

Personal exemptions . . . . . . . . . . . . . . . . . . . . . . . . . . . , . . . . . . . . . . . . . ---------

Equals: Taxable income. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $ 120,200

The tax for a married couple filing jointly on this amount computed using the 2018 rate schedules is $18,323 as shown below.

Tax on $77,400 $10,452.50
Plus: Tax on excess at 22% ([$120,200 − $77,400 = $42,800] × 0.22 + 9,416.00
Equals: Total tax $18,323.00

**EXHIBIT 3-8 Partial List of Tax Credits**

* The credits contained in Exhibit 3-8 generally remain but certain credits have been revised. For example, the child tax credit has been increased from $1,000 to $2,000 per child.
* The 10% credit for rehabilitation of structures placed in service before 1936 is repealed.

**Page 3-23**

**EXHIBIT 3-9 Partial List of Other Taxes**

The taxes contained in Exhibit 3-9 continue, including the alternative minimum tax for individuals (but not for corporations).

**Page 3-30**

**Introduction to Property Transactions.** The TCJA makes no changes in the basic rules concerning gains and losses from sales or other dispositions of property discussed in this chapter. The rates for long-term capital gains of 0, 15 and 20 percent remain the same and are applied in the same manner. However, the income levels at which they apply do not specifically correspond with the breakpoints of the 10% or 15% brackets. See Chapter 16 of this supplement.

CHAPTER 4: PERSONAL AND DEPENDENCY EXEMPTIONS;
 FILING STATUS, DETERMINATION OF TAX, ETC.

**Page 4-2**

The deduction for personal and dependency exemptions is repealed. Technically, however, that is accomplished by setting the personal exemption amount to zero. The effect is to leave all of the other rules concerning dependents in place. Consequently, the definition of dependents is retained and still relevant for various purposes in the Code (e.g., child tax credit, new partial child tax credit, surviving spouse and head of household filing status). Where necessary, the amount of the exemption is considered $4,150 (see Act § 11041(a)(2) and Code § 151(d)(5)(A)).

**Page 4-12**

**Phase-Out of Personal and Dependency Exemptions.** Since the deduction for exemptions is eliminated, the phase-out rules are no longer needed.

**Page 4-13**

**Child Tax Credit.** The child tax credit (§ 24(h)(1)) is increased from $1,000 to $2,000 for each qualifying child. In addition, up to $1,400 of the credit is refundable (e.g., if the taxpayer owes zero taxes, he or she could still benefit and receive up to $1,400; see Chapter 13 for calculation). The basic child tax credit remains available only for children under the age of 17.

**Partial Child Tax Credit for Dependents. U**nder the new law, a nonrefundable credit of $500 is allowed for each dependent of the taxpayer other than a qualifying child (e.g., a 17-year-old dependent or an older parent who lives with a child). Thus, the rules for determining whether an individual is a dependent remain significant.

The Act increases the threshold dollar amounts at which the child tax credit begins to phase-out. The starting point (modified AGI) is $400,000 for joint returns and $200,000 for all others. These are not indexed for inflation.

**Page 4-17 and 4-18**

**Surviving Spouse.** As explained in the text, an individual qualifies as a surviving spouse only if he or she maintains a home for a dependent child. For this purpose, the rules defining dependents in this chapter still apply. This is true even though the Act eliminates the deduction for exemptions.

**Page 4-18**

**Head of Household.** To qualify as a head of household, an individual must maintain a home for a qualifying child or a dependent relative. For this purpose, the rules regarding dependents (qualifying child and qualifying relative discussed earlier in the chapter) still apply. This is true notwithstanding the Act’s elimination of the deduction for exemptions.

**Page 4-27**

**Standard Deduction for Dependents.** For individuals who may be claimed as dependents, the standard deduction is the larger of $1,050 or (earned income + $350 not to exceed the normal standard deduction of $12,000) (§ 63(c)(5) and Rev. Proc. 2017-58). The substantial increase in the standard deduction makes shifting earned income to a child very attractive under the new law.

**Kiddie Tax.**  The Act significantly altered the manner in which the kiddie tax is computed. As noted in the text, the kiddie tax generally extends to children who at the close of the taxable year are either under 19 or are full-time students under the age of 24 and are not self-supporting. For these children, the new law taxes their unearned income at the rates applying to estates and trusts (see below) to the extent it exceeds $2,100 (twice the child’s standard deduction of $1,050). The child’s taxable income attributable to earned income is taxed at the normal rates for individuals. Under the new approach, the child's tax will no longer be affected by the tax situation of the child's parent or the unearned income of any siblings.

 2018 Tax Rates for Estates and Trusts

 If taxable income is % on Of the
Over But not over The tax is + Excess Amount over

$0 $ 2,550 $ 0.00 10% $ 0
 2,550 9,150 225.00 24% 2,550
 9,150 12,500 1,839.00 35% 9,150
 12,500 3,011.50 37% 12,500

As shown above, a child would reach the highest tax bracket with having only $14,600 of unearned income ($14,600 - $2,100)! To contrast just how drastic that change is, in 2017 the “kiddie tax” would not have reached the highest tax bracket until the parents income had surpassed $470,700 (assuming a joint return).

Taxpayers in any bracket should evaluate the tax position of young children as may be affected by the new tax law. For children with assets producing income in excess of $2,100, moving those assets back to their parents’ custody may result in a slimmer tax bill at the end of the year.

CHAPTER 5: GROSS INCOME

**Page 5-18**

**Cash Method.** The new law substantially increases the number of taxpayers eligible to use the cash method of accounting. Beginning in 2018, the cash method may be used by all taxpayers whose average annual gross receipts do not exceed $25,000,000—up from previous threshold of $5,000,000. The $25,000,000 number is adjusted annually for inflation. In addition, prior law required corporations to meet the gross receipts test for all prior years before they could use the cash method. Under the Act, businesses need only meet the test for the three-year testing period that precedes the year of change and not all prior years.

**Page 5-19**

**Accounting for Inventory.** As discussed in Chapter 10, taxpayers who meet the $25,000,000 gross receipts test are not required to account for inventories. Instead, they may use an accounting method for inventories that either (1) conforms to the taxpayer’s financial accounting treatment or (2) treat the inventories as non-incidental materials and supplies and account for them accordingly.

**Page 5-26**

**Prepaid Service Income and Advance Payments.** The Act generally codifies the treatment of advance payments prescribed by Rev. Proc. 2004-34 discussed in the text. Taxpayers that use the accrual method and actually receive an advance payment have two options: report the entire payment in the year received; or report for the first year the amount that it reports for financial accounting purposes and report the balance of the payment in the following year.

For accrual basis taxpayers, revised § 451(b) limits the possibilities for deferral with a global approach. Accrual basis taxpayers must recognize income no later than the tax year in which the income is taken into account on (1) an applicable financial statement (AFS) or (2) another financial statement to be specified by the IRS. For this purpose, an AFS is generally a financial statement which has been audited and is certified as being prepared in accordance with generally accepted accounting principles (§ 451(b)(3)). Note that the rule does not apply to a taxpayer (e.g., small businesses) that does not have a financial statement which meets the criteria set forth in § 451.

**Page 5-28**

**Long Term Contracts.**  Under the new law, more businesses will be able to use the completed contract method. Previously, only businesses whose average annual gross receipts did not exceed $10 million were allowed to use the completed contract method. The Act increases the gross receipts maximum to $25 million.

**Page 5-34 and 5-35**

**Unearned Income of Children.** As explained in Chapter 4, the new law alters the kiddie tax. The tax is now computed using the tax rates for estates and trusts. See Chapter 4, page 4-27 above.

CHAPTER 6: INCLUSIONS AND EXCLUSIONS

**Page 6-3**

**Dividend Income: Tax Rates.** The thresholds at which the special rates for dividends and long-term capital gains apply are:

Capital gains and dividends rate **0%** **15%** **20%**

Married filing jointly $0 - $77,200 77,201 - $479,000 Over $479,000
Single (not filing head of household) 0 - 38,600 38,601 - 425,800 Over 425,800
Head of household 0 - 51,700 51,701 - 452,400 Over 452,400
Married filing separately 0 - 38,600 38,601 - 239,500 Over 239,500
Trusts and estates 0 - 2,600 2,601 - 12,700 Over $12,700

Note that these breakpoints do not correspond to those for the taxpayer’s regular marginal rates. For example, for married filing jointly taxpayers, the 12% bracket runs through $77,400 while the breakpoint for the 0% rate on capital gains and dividends is $77,200.

**Page 6-4**

**Corporate Dividends Received Deduction.** The Act reduces the corporate dividends received deduction as follows:

 Dividends Received Deduction

 Stock Ownership Previous law **New law**

 < 20% 70% 50%
 > 20% & < 80% 80% 65%
 > 80% 100% 100%

**Page 6-9**

**Educational Savings Bonds.** This exclusion escaped repeal and continues under the Act. Therefore, if mom and dad had the foresight to purchase these bonds, they can redeem them and use the tax-free proceeds and interest to pay the cost of their kids going to school!

**Page 6-15**

**529 Plans.** The new law expands the eligible uses of 529 plans. Beginning in 2018, up to $10,000 per year per beneficiary can be withdrawn from a 529 plan to be used to pay the costs of tuition incurred in connection with enrollment or attendance at an elementary or secondary public, private, or religious school (§ 529(c)(7)).A 529 plan cannot be used for home schooling. It should be emphasized that the $10,000 limitation is per student. In addition, if the student is a beneficiary of multiple 529 plans, the total contribution to all plans in the aggregate cannot exceed $10,000.

**Page 6-18**

**529 Plans and Achieving a Better Life Experience (ABLE) Accounts.** Under the new law, tax-free rollovers from 529 plans to ABLE accounts are allowed. According to the Act, a distribution (rollover) from a 529 account is tax free if, within 60 days of the distribution from a 529 beneficiary’s account, it is transferred to an ABLE account for the same beneficiary or the beneficiary’s family. The amount of the annual tax-free rollover is limited to the amount of the annual gift tax exclusion, $15,000 in 2018.

 The rollover provision should be particularly beneficial when the 529 beneficiary no longer needs the amounts in the 529 account to pay for qualified higher education expenses and either the beneficiary or a member of the beneficiary's family is disabled or blind. The tax deferral will continue, and distributions from the ABLE account will be tax-free if used for the designated beneficiary's qualified disability expenses.

 The Act also allows beneficiaries of ABLE accounts to contribute to their own ABLE accounts and secure the special saver’s credit normally allowed for contributions to retirement plans by lower-income individuals. The maximum saver’s credit is $1,000 (50% x the maximum contribution of $2,000). (See Chapter 18 of the text).

**Page 6-20**

**EXHIBIT 6-5 Taxable and Nontaxable Employee Compensation**

Changes made by the Act make the following items taxable:

* Direct moving expenses (e.g., employer reimbursements for moving van, transportation, and related expenses are taxable). The rule does not apply to members of the armed forces.
* Qualified bicycle commuting reimbursements

**Reimbursement of Employee Business Expenses.** Under the new law, reimbursements for certain employee business expenses such as moving expenses and nondeductible entertainment items would be taxable. Moreover, since employees can no longer deduct moving expenses, they would have taxable income without an offsetting deduction. If an employer treats the payment or reimbursement of an employee’s moving expenses as compensation (e.g., W-2 wages), the employer could deduct the expense as compensation. See discussion in Chapter 8, eliminating the moving expense deduction for employees.

**Page 6-21**

**Employer Achievement Awards.** The Act clarifies what constitutes tangible personal property. As revised, tangible personal property does not include cash, cash equivalents, gift cards, gift coupons, or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer). In addition, tangible personal property does not include vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities and similar items.

**Page 6-32**

**Employer Provided Educational Assistance Plans.** While this exclusion was on the chopping block, it survived. Therefore, the new law continues to allow an exclusion from wages for federal income, payroll and unemployment taxes of up to $5,250 of graduate or undergraduate education costs even if they are not related to the employee’s current job. Note that work-related education is excluded as a working condition fringe benefit. Consequently, if an employer pays part of an employee’s education cost (directly to the university or a reimbursement to the employee), that amount is nontaxable (§ 127).

**Page 6-33**

**Section 132 Fringe Benefits.** In an effort to offset the revenue loss associated with proposed tax cuts, the Act takes aim at the tax treatment of several popular employer-provided fringe benefits. Tax reform may affect fringe benefit programs in two ways: repeal of the exclusion from income for certain statutory benefits and denial of an employer tax deduction for many fringe benefits.

**EXHIBIT 6-7 Nontaxable Fringe Benefits under § 132**

**Qualified Bicycle Commuting Reimbursements**. The Act eliminates the exclusion for qualified bicycle commuting reimbursements. Beginning in 2018, such reimbursements would be considered taxable income.

**Qualified Transportation Fringes.** While the Act retains the exclusion for qualified transportation fringes (parking, mass transit passes and vanpooling), it eliminates the employer’s deduction for such items. Similarly, no deduction is allowed for transportation expenses that are the “equivalent of commuting for employees” (e.g., between the employee's home and the workplace), except as provided for the safety of the employee.

**On-Premise Gyms and Athletic Facilities.** Under the Act, no deduction is allowed for benefits provided in the form of gyms or other athletic facilities on the employer’s premises (owned, leased or otherwise). Similarly, employers may not deduct costs of amenities provided to an employee that are “primarily personal in nature and that involve property or services not directly related to the employer's trade or business.” However, a deduction is allowed to the extent that such benefits are treated as taxable compensation to the employee.

**Page 6-35**

**De Minimis Fringe Benefits: In-House Cafeterias, Snack Bars.** As revised, § 274(o) allows a deduction for 50% of any expense for meals provided through an in-house cafeteria or snack bar or some other means on the premises of the employer. Similarly, no deduction is allowed for meals furnished on the business premises for the convenience of the employer (e.g., meals taken by hotel security in a hotel restaurant while they are working). Meals and snacks are still nontaxable to the employees (§ 132(e). Beginning in 2027, none of the cost meals would be deductible.

**Page 6-36**

**On-Premise Gyms and Athletic Facilities.** As noted above, an employer is not allowed a deduction for benefits provided in the form of on-premises gyms or other athletic facilities, or for amenities provided to an employee that are “primarily personal in nature and that involve property or services not directly related to the employer's trade or business. However, if the employer treats such benefits as taxable compensation to an employee (or includible in gross income of a recipient who is not an employee), the employer may deduct the cost.

**Page 6-37**

**Qualified Tuition Reduction by Educational Institution.** This exclusion survived. So when mom goes to work for a university (doing jobs her children would never dream of doing), the tuition waiver she garners for her kids is still nontaxable.

**Page 6-39**

**Alimony Deduction and Exclusion.** In a somewhat surprising revision, Congress scrapped a 75-year old tax deduction for alimony. Under the new law, alimony is nondeductible for the spouse that pays the alimony and is nontaxable to the spouse who receives the alimony payments. The rules for child support and property settlements are not changed and are neither deductible nor taxable. The new rule is effective for divorce or separation decrees finalized (or, modified and which “expressly state that the new rule would apply”) after 2018.

 The change was directed at a potential tax reduction technique. The old law provided a benefit to couples where the high-income, high-bracket, individual paid the alimony and got a deduction while the low-income low-bracket spouse paid little tax. Couples arguably could get divorced and be better off tax wise. For example, assume high-earning Spouse A agrees to make alimony payments of $100,000 annually for 10 years to Spouse B. If Spouse A is in the 37% tax bracket, he or she might save $37,000 a year through the deduction, while Spouse B—who is in a lower tax bracket, say 12%—could owe $12,000 on the $100,000.

 In justifying its repeal of the alimony deduction, the House Ways and Means Committee said the change "prevents divorced couples from reducing income tax through a specific form of payments unavailable to married couples."

The treatment of alimony depends on when the divorce agreement became final. For divorces prior to 2019, alimony is deductible by the payer and taxable to the payee. For divorces after 2018, payments of alimony are not deductible by the payer and are not taxable to the payee

The post-2018 treatment can apply to pre-2019 divorces if the agreement is modified and it expressly states that the 2019 treatment applies.

**Page 6-55**

**Gambling Winnings (and Losses).** Gambling winnings are taxable. However, what about losses and any related expenses? Taxpayers are permitted to claim a deduction for wagering losses to the extent of wagering winnings. However, under current law, other deductions connected to wagering (e.g., first-class travel, luxury hotel, limousine rides, admission fees to high-end poker games) could be claimed regardless of wagering winnings. In other words, if a professional gambler broke even wagering, he could still claim a deduction for the other expenses and those might be deductions for AGI on Schedule C. Under the new law, a gambler’s other deductions would be added to his or her losses and any excess would not be deductible. As a result, there would be no possibility of deducting such expenses on Schedule C as a business endeavor.

This change is intended to clarify that the limitation on losses from gambling applies not only to the actual costs of wagers incurred by an individual, but extends to other expenses incurred by the individual in connection with the conduct of that individual’s gambling activity. Prior to these changes, professional gamblers were allowed to deduct separately expenses incurred in carrying out wagering transactions.

CHAPTER 7: OVERVIEW OF DEDUCTIONS AND LOSSES

**Page 7-8**

**Reasonable Compensation for Highly Compensated Employees**. Although not discussed in the text, under current law, a deduction for compensation paid or accrued with respect to a “covered employee” of a publicly traded corporation is limited to no more than $1 million per year. However, current law contained exceptions for: (1) commissions; (2) performance-based remuneration, including stock options; (3) payments to a tax-qualified retirement plan; and (4) amounts that are excludible from the executive’s gross income.

While it may pay to be the boss, apparently Congress wants no share in the cost. Under the new law, the $1,000,000 cap is retained but the exceptions for commissions and performance-based compensation are repealed. As revised, Apple would not have been able to deduct most of CEO Tim Cook’s 2016 salary of about $10 million (excluding stock awards). In addition, the definition of “covered employee” is expanded to include the principal executive officer, the principal financial officer (anyone who holds these positions at any time during the year), and the three other highest-paid officers. If an individual is a “covered employee” with respect to a corporation for a tax year beginning after Dec. 31, 2016, the individual remains a covered employee for all future years. Finally, some suggest that the revised definition of publicly held corporation may extend to large private C or S corporations (that are not publicly held).

According to some, there is a bright side to the change. Even though the excess compensation will no longer be deductible, such employers will no longer need to comply with the strict rules that were necessary to maintain qualified performance-based compensation arrangements.

**Page 7-19**

**Miscellaneous Itemized Deductions.** The Act, arguably in an attempt to simplify the law (and increase revenue), eliminates the deduction for all miscellaneous itemized deductions. As shown on page 21, miscellaneous itemized deductions consist primarily of unreimbursed employee business expenses, investment expenses and tax preparation expenses. These expenses are no longer deductible. However, take a closer look. This rule hits a long, long list of possibilities. Think close to home. Joe Employee, a CPA, wants to get a Masters in Taxation and his employer will not pay the bill. Arguably, his $20,000 expense for that or an MBA is deductible but since it is a miscellaneous itemized deduction, there is no deduction for him. Presumably, had his employer reimbursed the cost, it is a wash since the expense is no longer a miscellaneous itemized deduction because it is reimbursed.

There are many more examples of miscellaneous itemized deductions that got the ax, including: dues to a chamber of commerce; dues to professional societies, educator expenses, home office expenses, job search expenses, licenses and regulatory fees, business liability insurance premiums, malpractice insurance premiums, § 179 on a computer an employee’s employer requires for use in his or her work, medical exams required by an employer, passport and visa fees for a business trip, research expenses of a college professor, subscriptions to professional journals, tools and supplies used in the employee’s work, business gifts, union dues and expenses, work clothes and uniforms, work related education, expenses for a hobby (to the extent of the hobby’s income), mobile phones and the list goes on. All of these and more are no longer deductible. If the expense is in fact classified as a miscellaneous itemized deduction, it is not deductible regardless of the amount.

As explained earlier, miscellaneous itemized deductions were deductible only to the extent they exceeded 2% of the taxpayer’s AGI. In many cases, the taxpayer’s total miscellaneous itemized deductions did not exceed the 2% threshold so they provided little benefit. The new law eliminates any benefit.

It should be emphasized that in Rev. Rul. 92-29, the IRS ruled that taxpayers who own a business, farm, rental real estate or have royalty income are allowed to allocate a portion of the total cost of preparing their tax return to the cost of preparing Schedule C (trade or business income), Schedule E (rental and royalty income), or Schedule F (farm income). By so doing, these costs sidestep the 2% classification and are deducted for AGI. The same holds true for expenses incurred in resolving tax controversies, including expenses relating to IRS audits or business or rental activities.

**Phase-out of Itemized Deductions.** The new law eliminates the 3% phase-out or cutback of itemized deductions.

**Page 7-27**

**Contingent Attorney Fees.** Under the new law, a deduction for litigation costs advanced by an attorney to a client in contingent-fee litigation would not be allowed as a deduction until the contingency is resolved.

**Page 7-35**

**Illegal Kickbacks, Bribes, and Other Payments**

**Amounts Paid For Sexual Harassment Subject to Non-Disclosure Agreement.** Recently, the news has been filled with stories about sexual abuse claims against powerful actors, journalists, politicians and executives (e.g., [Hollywood](http://www.chicagotribune.com/topic/south-florida/hollywood-SFL00012-topic.html) mogul [Harvey Weinstein](http://www.chicagotribune.com/topic/entertainment/movies/harvey-weinstein-PECLB005319-topic.html), former Fox News host Bill O’Reilly, Congressman Al Franken). These stories often mention payments—hush money—that either the perpetrators or their employers made to silence the victims who accused them of misconduct. These settlements often require alleged victims to sign a nondisclosure agreement — essentially a pledge of secrecy — in exchange for a cash payment. In one report, Bill O’Reilly was said to have paid $32 million of hush money in a sexual harassment settlement. Apparently, these payments are sufficiently related to the company or celebrity’s business, that they are arguably deductible as an ordinary and necessary business expenses. Under prior law, hush money related to sexual harassment settlements could be treated as a business expense. The Act adds a new provision, § 162(q)(2), that provides that no deduction is allowed for any settlement or payment related to sexual harassment or sexual abuse. This is one of several situations where what otherwise might be considered a business expense is not deductible. Other “business” expenses that are specifically disallowed include any illegal bribe, illegal kickback, or other illegal payment; certain lobbying and political expenses; any fine or similar penalty paid to a government for the violation of any law; and two-thirds of treble damage payments under the antitrust laws.

**Page 7-36**

**Local Lobbying Expenses.** Section 162(e) currently allows a deduction for lobbying expenses only if they are incurred for the purpose of influencing legislation at the local level. But that all came to a halt with the enactment of the new law. Under the Act, the deduction for local lobbying expenses (including that for Indian tribal governments) is eliminated.

CHAPTER 8: EMPLOYEE BUSINESS EXPENSES

**Page 8-5**

**Deduction for Qualified Tuition and Fees.** The deduction for qualified tuition and related expenses expired at the close of 2017. The Tax Cuts and Jobs Act did not extend it. However, the Bipartisan Budget Act of 2018 enacted on February 9, 2018 reinstated the deduction for 2018.

**Page 8-7**

**Coverdell Accounts (§ 530).** The Act generally prohibits new contributions to Coverdell education savings accounts after 2017. For more discussion, see Chapter 18.

**Page 8-8**

**Deduction for Expenses of Primary and Secondary School Teachers.** Although there was discussion about increasing the amount of the deduction, it was not changed under the Act and remains at $250.

**Page 8-11**

**Moving Expenses**. The Act eliminates the deduction for moving expenses with one exception. Members of the Armed Forces who (1) are on active duty and who move (2) pursuant to a military order and (3) incident to a permanent change of station can deduct their moving expenses assuming they satisfy the various requirements (the distance and time tests).

Previously, when an employer paid for a worker’s moving expenses (either directly or by reimbursement), the amount was not taxable to the employee and the employer was allowed to deduct the cost. Under the new law, reimbursements or direct payments are taxable to the employee who has no offsetting deduction and the employer cannot deduct the expense. However, if the employer treated the reimbursement as compensation, the expense would be deductible.

**Page 8-13**

The remaining expenses discussed in this chapter (i.e., expenses for a home office, transportation and travel, meals and entertainment) are potentially deductible by both employees and self-employed individuals. As explained in the update for Chapter 7, the new law eliminates the deduction for all miscellaneous itemized deductions. Consequently, to the extent that these expenses are unreimbursed employee business expenses, they would be considered miscellaneous itemized deductions and nondeductible. Note, however, that this change does not make these expenses unimportant. Such expenses might be incurred by self-employed individuals in which case the expenses would be deductible for AGI and reported on Schedule C. Similarly, if the expenses related to rental or royalty income, they are deductible for AGI and reported on Schedule E. If they relate to farming, they are deductible for AGI and reported on Schedule F.

**Page 8-36 through 8-39**

**Business Meals and Entertainment.** The Act took dead aim at the deduction for business meals and entertainment expenses. Entertainment took a direct hit while, for the most part, 50% of the meals survived.

As discussed in the text, under prior law, entertainment expenses could be deducted only if they were “*directly related*” or *“associated with*” the taxpayer’s business. That generally meant that a deduction (think tickets to a game or a play) was allowed as long as business was discussed before, during or after the entertainment activity.

The new law no longer cares whether business was discussed before, after or during the ball game, in the golf cart or at dinner. The Act, specifically revised § 274(a) to provide that no deduction shall be allowed for any “activity” which is of a “type generally considered to constitute entertainment, amusement, or recreation.” With the slash of a pen, Congress put an end to the deduction for the costs of tickets to sporting events, Broadway plays, and the like.

Under prior law, a deduction also was allowed for membership dues to clubs but only if the taxpayer could establish that the facility was used primarily for the furtherance of the taxpayer's trade or business. As a practical matter, that did not prove difficult. For years, these clubs, with their deep red carpets, oak-paneled rooms and portraits of board members dating to 19th century, were a place where business was discussed and deals were sealed. Membership was required and the dues were deductible. Despite their apparent necessity, the new law eliminated the deduction.

However, as under prior law, 50% of the cost of food or beverage expenses associated with operating a business, such as meals consumed by employees while traveling for business purposes is still deductible. “Free food” that many companies provide their workers—the snack bar or in-house company cafeteria—is still tax-free to the employees but the employer can deduct only 50% of the cost. In addition, as pointed out on page 8-40 of the text, § 274(e) provides that the restrictions on entertainment expenses do not apply to a number of “innocent” situations. To summarize:

|  |  |  |
| --- | --- | --- |
| Type | 2017 Expenses (Old Rules) | 2018 Expenses (New Rules) |
| Office holiday parties, golf outings, annual picnic, primarily for employees | 100% deductible | 100% deductible |
| Entertaining clients | 50% deductible | Meals – 50% deductible |
| Event tickets, 50% deductible | No deduction for entertainment |
| Tickets to qualified charitable events |
| Employee travel meals | 50% deductible | 50% deductible |
| Meals provided for the convenience of the employer | 100% deductible if excludible from employee’s gross income as de minimis fringe; otherwise 50% deductible | 50% deductible |
| Entertainment and meals for employees included in W-2 | 100% deductible | 100% deductible |

**Page 8-41. Example 43.** The outcome of this example is unchanged by the new law.

CHAPTER 9: CAPITAL RECOVERY: DEPRECIATION, AMORTIZATION
 AND DEPLETION

**Page 9-20**

The Act changed the ADS life of residential rental property under Section 168(g)(2)(C) from 40 years to 30. For MACRS, the life remains at 27.5 years.

The ADS method becomes more important under the new law. Beginning in 2018, the Act provides that the deduction of interest expense for any business with average annual gross receipts in excess of $25 million will be limited. As discussed in Chapter 10 (this supplement) the maximum interest deduction cannot exceed 30% of taxable income with certain adjustments. This limitation on interest expense may significantly impact many businesses. However, businesses that are engaged in "real property trades or businesses" (leasing, construction, development, acquisition, operation, management or brokerage of real property per § 469(c)(7)) can avoid the interest limitation if they elect to depreciate their residential and nonresidential real estate, as well as qualified improvement property, using the ADS method. In short, these businesses can trade off a 30% limitation for depreciation over a longer life.

**Page 9-22**

Under the Act, the several categories of leasehold improvements are condensed to one. All leasehold improvements are now treated the same way and depreciated using the straight-line method, a half-year convention and a depreciable life of 15-years. They are not eligible for bonus depreciation.

**Page 9-25**

**Limited Expensing.** For tax years beginning after 2017, the maximum amount that can be expensed under § 179 is increased to $1,000,000. However, this amount begins to phase-out once $2,500,000 of qualifying assets are placed in service. In addition, the definition of eligible property has been expanded. Section 179 makes the following types of building improvements eligible for the immediate write-off:

* Roofs
* Heating, ventilation, and air-conditioning property
* Fire protection and alarm systems; security systems

**Page 9-27**

**Bonus Depreciation.** The Act modifies bonus depreciation. Taxpayers will be able to immediately expense 100% of the cost of qualified property acquired and placed in service after Sept. 27, 2017. This is up from the 50% allowed under prior law. In addition, the original use requirement no longer applies (§ 162(k)(2)(A)(ii) and (E)(ii)). However, this deduction is not available for any property used in a real property trade or business (e.g., a rental activity and real property businesses to be identified; see House Report on p. 187 in Conference Committee Report). Nevertheless, § 179, as noted above now allows immediate expensing for assets “used in connection with lodging.”

**Page 9-28**

**Qualified Property.** The new law modifies the definition of qualified property that is eligible for bonus depreciation (see § 168(k)(2)(A)). The definition is significant since it determines whether a business is allowed to immediately expense an asset or depreciate it over some longer life. Below are the changes.

* Qualified improvement property related to qualified leasehold improvements is removed from the list (see revised rules above)
* Qualified film, television, and live theatric productions are now eligible.
* Businesses that furnish or sell various types of energy are not eligible (e.g. utility companies that provide electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline).
* Businesses with floor-plan financing (e.g., auto dealers) cannot use bonus depreciation if the floor-plan financing interest is deducted in full.

**Note:** In the paragraph above the heading “Computation of Bonus Depreciation” it states.

As discussed above, under the special depreciation limitations of § 280F for so-called listed property (e.g., automobiles and ~~computers~~), ADS is required.

Strike computers from the parenthetical note. Computers are no longer listed property.

**9-30**

**Luxury Automobile Limitations.**

**EXHIBIT 9-11 Section 280F Depreciation Limits for Autos**

The Act amends § 280F to increase the annual depreciation limits on passenger autos used for business. They are:

First year of service $10,000 (+ $8,000 with bonus depreciation for total $18,000)
Second year of service 16,000
Third year of service 9,600
Thereafter 5,760

**Page 9-35**

Under the Act, computers are not listed property so the limitations of § 280F can be ignored. As a result, employees no longer must meet the qualified business use test in order to expense their computer costs under § 179. This means that their use need not be for the convenience of the employer or a condition of employment (see § 280F(d)(3)(A)). Under prior law, the IRS and the courts took the position that if these two tests were not met, the employee had no business use and, therefore, no deduction was available. With this requirement eliminated, employees who were denied a deduction in the past should now be able to expense all or a percentage of the computer’s cost without concern. See *Robert L. and Ellen H. Bryant v. Comm*., 74 AFTR 2d 94-6388, (CA-3, 1994) aff’g TC Memo 1993-597 where a school teacher was denied a deduction for the cost of a computer purchased principally to help her in posting grades. In that case, the Third Circuit agreed with the Tax Court that Mrs. Bryant’s computer was not used for the convenience of the employer since her employer provided computers for her use at school. It now appears that Mrs. Bryant would be able to deduct at least a portion of the cost under the new law except, unfortunately, it now would be a nondeductible miscellaneous itemized deduction.

CHAPTER 10: CERTAIN BUSINESS DEDUCTIONS AND LOSSES

**Page 10-7**

**Casualty and Theft Losses.** Under the Act, personal casualty and theft losses of an individual are deductible only to the extent they are attributable to a federally declared disaster. Section 165(i)(5) defines a federally declared disaster as any disaster subsequently determined by the President to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Disasters include those related to storms, tornadoes, hurricanes, winds, mudslides, earthquakes. In 2014, the IRS designated the outbreak of Ebola in West African countries as a qualified disaster. This new limitation should substantially reduce the number of taxpayers who claim a casualty loss deduction.

However, in a year that a taxpayer has personal casualty gains (e.g., insurance proceeds exceeded the property’s cost), special rules apply regarding losses that were not attributable to a federally declared disaster. The taxpayer can deduct any casualty losses that did not occur in a federally declared disaster—nonfederal casualties—to the extent of the casualty gains. In addition, special rules must be observed in applying the 10% of AGI floor.

**Page 10-14**

**NOL Deduction.** The Act makes several changes to the use of an NOL arising in 2018. Beginning in 2018:

* The 2-year carryback period (except for farming businesses) is eliminated. Therefore, NOLs can only be carried forward.
* NOLs are carried forward indefinitely. The 20-year carryover period is eliminated for NOLs occurring in 2018 and beyond.
* The NOL deduction is limited to 80% of pre-NOL taxable income.  However, NOLs existing prior to 2018 are not subject to the 80% limit.

Observe that the rules for NOLs arising before 2018 remain the same. These pre-2018 NOLs can be carried back 2 years and carried forward 20 years. In addition, there is no taxable income limit imposed on the usage of pre-2018 NOLs. The new rules require separate tracking of pre-2018 and post-2017 NOLs.

**New Limitation on Excess Business Losses.** The Act creates an additional limitation for so-called excess business losses (EBLs) (§ 461(l)). The effect is to limit the amount of net business losses from an unincorporated business (e.g., losses from a sole proprietorship, S corporation or partnership) that can be deducted from an active—in contrast to passive—owner’s return.

According to the new rule, the maximum loss allowed is $500,000 for joint returns and $250,000 for others. The loss in excess of the allowed amount (the excess business loss) becomes part of the taxpayer’s NOL and would be carried forward indefinitely under the Act. As part of the NOL, the EBL would be subject to the 80% of taxable income limitation discussed above.

An excess business loss for the year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer, over the sum of aggregate gross income or gain of the taxpayer from those trades or business plus the threshold amount ($500,000 or $250,000). The $500,000 and $250,000 are adjusted annually for inflation. The computation is shown below.

 Business losses
 (Business income + ($250,000 or $500,000))
 Excess business losses (to NOL)

The excess business loss rules are not as oppressive as the passive activity loss rules discussed in Chapter 12. Losses from passive activities can be used only to offset income from other passive activities. Unused passive losses are carried forward until (1) the taxpayer has passive income, (2) the taxpayer sells the investment or (3) he, or she dies, which allows the taxpayer to use any suspended loss. In contrast, the excess business loss rules for active businesses allow what some would believe is a reasonable loss amount ($250,000 or $500,000), and the excess is an NOL carryover, which is more useful and valuable than a suspended passive loss. Note that the excess business loss rules are applied after the passive loss rules.

**Example.**  Last year, Sam Callum, single, took a sabbatical leave from his position as a professor of computer science to develop a new technology to replace conventional passwords. At a recent IT conference, he met a potential investor in his project, Maggie Baker. Maggie is married and she and her husband have done well, together earning more than $700,000 a year from their technology jobs. Maggie and her husband believed that Sam had a good idea and decided to join forces. To this end, Sam and Maggie formed a partnership. Unfortunately, the partnership, like many start-ups, did not do as well as expected. In the first year of operations, 2018, it suffered a net loss of $800,000. Sam and Maggie each reported their respective shares of the loss, $400,000, on their 2018 individual tax returns (Schedule E).

The excess business loss rule limits the amount of loss that Sam can use to offset his other income to $250,000. The remaining loss of $150,000 ($400,000 - $250,000 threshold for single taxpayers) is considered an excess business loss and becomes an NOL. It would be combined with any of the $250,000 loss that Sam is not able to use for 2018. Under prior law, Sam could have carried the NOL back to offset his professorial salary. However, under the new law, the NOL must be carried forward, most likely to years where Sam may have little, if any, income. Consequently, he obtains little immediate benefit from the operating loss.

 The story for Maggie has a much better ending. The excess business loss rule does not apply since her share of the loss, $400,000, is less than the $500,000 threshold for joint returns. She can use the entire loss to offset the income of her and her husband.

**Page 10-19**

**Gambling Losses and Deductions.** See page 6-55 of this supplement.

**Page 10-20**

**Exceptions to Inventory Requirement.** In a step toward simplification, the Act generally exempts taxpayers whose average annual gross receipts are less than $25 million from the requirement to keep inventories. Instead, they must use a method of accounting for inventories that either (1) treats inventories as non-incidental materials or supplies (as discussed in the text), or (2) conforms to the taxpayer's financial accounting treatment of inventories.

**Page 10-22**

**UNICAP**. The Act expands the exception for small taxpayers from the UNICAP rules. Under the new rules, any taxpayer (other than certain tax shelters) whose average annual gross receipts are less than $25 million is not subject to the UNICAP rules for that tax year.

**Page 10-32**

**Qualified Production Activities Deduction.** The Act eliminates the qualified production activities deduction and § 199.

CHAPTER 11: ITEMIZED DEDUCTIONS

**Page 11-2**

**Medical Expenses.** The Act reduces the floor below which medical expenses are not deductible from 10% to 7.5% of AGI.

**Page 11-16**

**Casualty and Theft Losses.** The Act severely curtails the deduction for personal casualty losses, limiting the deduction to only those occurring in a federally declared disaster area. See page 10-7 of this supplement for further discussion.

**Page 11-18**

**Deduction Limitation for State and Local Taxes.** Under prior law, taxpayers could deduct from their taxable income as an itemized deduction several types of taxes paid at the state and local level, including real and personal property taxes, income taxes, and/or sales taxes. The Act retains the deduction for each of these taxes. However, the new rule requires taxpayers to combine the deduction for all of these taxes and imposes a limitation of $10,000 on the total. Any excess is not deductible.

Note that in making these calculations, foreign real property taxes may *not* be deducted.

Since the alternative minimum tax was retained for individuals (with higher exemption and phase-out thresholds), state and local taxes that are deducted (at least to the extent of the $10,000 allowed) will still be a preference for alternative minimum tax purposes.

**Page 11-24**

**Deduction for Qualified Residence Interest (Home Mortgage Interest).** The deduction for mortgage interest on a principal residence as well as a second home continues. However, the maximum amount deductible is limited to the interest on mortgage loans not greater than $750,000 (down from $1,000,000, although the $1,000,000 amount continues for home mortgages obtained before December 15, 2017). Taxpayers who refinance these homes (e.g., to get a lower interest rate) are still subject to the previous $1,000,000 cap as long as the new loan does not exceed the amount refinanced.

 Technically, the amount of deductible interest with respect to a qualified residence is limited to that on acquisition indebtedness. The new law reduces the amount of eligible acquisition indebtedness from $1,000,000 to $750,000.

**Deduction for Interest on Home Equity Indebtedness.** The deduction for interest on home equity loans is eliminated. Interest on existing home equity loans was not grandfathered and is no longer deductible unless the loan was used to substantially improve the home. This will require new strategies for homeowners who utilized home equity loans. However, as noted above, the interest on a home equity loan remains deductible as long as the proceeds are used to substantially improve the home. Mortgage interest on second homes can be deducted but is subject to the overall $750,000 limit.

**Limitation on Deduction of Interest of Businesses.**  While the new tax law might be characterized as pro-business, not everything is roses. One of the new unfavorable rules is a limitation on the deduction of interest expense. However, the limitation affects only businesses with average annual gross receipts that exceed $25 million. It is also important to note that this limitation applies not only to corporations but also to all types of businesses, regardless of form.

The limitation may have been sparked by Congress’ concerned with the growth in the amount of debt issued by businesses. For example, large corporations have borrowed heavily to buy back their own stock and have been able to deduct the interest expense. According to estimates, corporations bought back roughly $250 billion of stock in the first half of 2017 and large portions of these buybacks were done with borrowed money. Congress has also worried about the increasing number of leveraged buyouts that create high levels of debt on which the interest is deductible.

Regardless of the reason, under the revised rules, § 163(j) denies a deduction for net interest expense (interest expense in excess of interest income) that exceeds 30 percent of a business’ taxable income (technically, 30% of adjusted taxable income or ATI). Any interest amounts disallowed are carried forward to the succeeding five tax years.

From 2018 through 2021, the computation of ATI should approximately reflect a business’ earnings before interest, taxes, depreciation, and amortization (EBITDA). Thereafter, the definition of ATI changes to approximate earnings before interest and taxes (EBIT) because the deductions for depreciation, interest and amortization will not be excluded from ATI.

There are some exceptions.

* Real property trades or businesses can avoid the interest expense limitation if they elect to use ADS to depreciate “applicable real property” used in a trade or business.
* Farming businesses can avoid the limitation if they choose to use ADS to depreciate *any* property used in the farming business with a recovery period of 10 years or more.
* Interest related to “floor plan financing” is exempt (i.e., financing for the acquisition of motor vehicles including RVs, boats or farm machinery for sale or lease and secured by such inventory).

**Page 11-31**

**Student Loan Interest**. The treatment of student loan interest is unchanged by the Act.

**Page 11-40**

**Charitable Contribution Deduction For Amounts Paid For College Athletic Seating Rights.** Previously, special rules applied to certain payments to colleges and universities in exchange for which the payer received the right to purchase tickets or seating at an athletic event. The payer was permitted to treat 80% of such a payment as a charitable contribution. The Act eliminates this deduction.

**Page 11-41**

**Charitable Contributions.** The 50% limitation under Code §170(b) for cash contributions to public charities and certain private foundations is increased to 60%.

**Page 11-52**

**Phase-Out of Itemized Deductions.** The Act eliminates the 3% cutback or phase-out of itemized deductions.

CHAPTER 12: Deductions for Certain Investment Expenses and Losses

**Page 12-2**

**New Limitation on Excess Business Losses.** As noted in Chapter 10 of this supplement, the new law goes beyond the limitation on passive losses and creates a limitation on so-called excess business losses (EBLs) of all taxpayers other than a C corporation. In the case of a partnership or S corporation, the EBL rules are applied at the partner or shareholder level. The limitation is an extension of the limit for excess farm losses that existed under prior law. The effect is to limit the amount of net business losses that can be deducted from an *active*—in contrast to passive—owner’s return. The maximum loss allowed is $500,000 for joint returns and $250,000 for others. These amounts are adjusted annually for inflation.

The excess loss over the allowed amount becomes part of the taxpayer’s net operating loss that under the new law can only be carried forward. An excess business loss for the taxable year is generally the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer, over the sum of the aggregate gross income or gain of the taxpayer attributable to those trades or businesses plus a threshold amount. The thresholds are adjusted annually for inflation.

At this point, it is unclear how the net business loss is to be calculated. For example, can a loss resulting from an investment in an S corporation or partnership and which is reported on Schedule E be used to offset wages (or guaranteed payments of partners) or interest income from a partnership or S corporation? The new law produces a long list of questions that the IRS will need to address.

The excess business loss rule is not as draconian as the passive activity loss rules. Losses from passive activities may only offset income from other passive activities, until and unless the taxpayer sells the investment realizing the loss or dies. The excess business loss rule for active businesses allows what some would believe is a reasonable loss amount, and the excess is an NOL carryover, which is more useful and valuable than a suspended passive loss.

CHAPTER 13: THE ALTERNATIVE MINIMUM TAX AND TAX CREDITS

**Page 13-6**

**AMT Exemptions.** For individual taxpayers, the Act increased the AMT exemption amounts (§ 55(d)) and the thresholds at which these exemptions begin to phase-out as follows (25% for each dollar of alternative minimum taxable income over the phase-out starting point):

|  |  |  |  |
| --- | --- | --- | --- |
|  | Exemption Amount | Phase-OutBegins | Phase-OutComplete |
| Married filing jointly or surviving spouse | $109,400 | $1,000,000 | $1,437,600 |
| Unmarried individuals |  70,300 | 500,000 | 781,200 |
| Married filing separately |  54,700 | 500,000 | 718,800 |

**Page 13-29**

**Credit for Rehabilitation Expenditures.** Under the new law, for amounts paid or incurred after Dec. 31, 2017, the 10% credit for qualified rehabilitation expenditures with respect to a pre-1936 building is repealed. The 20% credit for qualified rehabilitation expenditures with respect to certified historic structures must now be claimed ratably over a 5-year period beginning in the tax year in which a qualified rehabilitated structure is placed in service.

**Page 13-39**

**Employer-Provided Child Care Credit.** The new law repeals the employer-provided child care credit, effective for tax years beginning after 2017.

**Employer Credit for Paid Family and Medical Leave**. The federal Family and Medical Leave Act (FMLA) guarantees employees up to 12 weeks of job-protected leave annually to care for a new baby or ill family member, or when they themselves are unable to work because of a serious health condition. Under this law, no pay is required. In addition, the law applies only to companies with 50 or more employees. The Tax Cuts and Jobs Act aims to encourage more employers to participate in this program as well as offer paid time-off by providing a credit for wages paid during the employee’s absence.

New § 45S allows businesses to claim a general business credit equal to 12.5% of the amount of wages paid if the following criteria are met.

* The wages must be paid to qualifying employees.
* Wages must be paid during any time such employees are on family and medical leave.
* Wages qualify as long as the rate of payment is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.
* The maximum family leave to be taken into account for a taxable year is 12 weeks.

A “qualifying employee” is any employee who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60% of the compensation threshold for highly compensated employees.

Employers can claim the credit only if they have a policy providing a minimum of two weeks of paid leave for family and medical leave per year for all qualifying full-time employees and provide a commensurate amount of leave for part time employees on a pro-rata basis.

The credit is for wages paid after Dec. 31, 2017, but *not* beginning after Dec. 31, 2019,

**Page 13-40**

**Orphan Drug Credit Modified (§45C).**  Under current law, a drug manufacturer is permitted to claim a credit equal to 50% of qualified clinical testing expenses. The new law reduces the credit to 25%. The new rule applies for amounts paid or incurred after 2017.

**Credit for Plug-In Electric Vehicles (§30D).** The Act retains the credit for plug-in electric drive motor vehicles (e.g., a Tesla or Chevy Volt). There is a 200,000 unit limit at the manufacturer level, but none at the consumer level.

**Page 13-42**

**Child Tax Credit.** The child tax credit (§ 24(h)(1)) is increased from $1,000 to $2,000 for each qualifying child. In addition, as explained below, up to $1,400 of the $2,000 credit is refundable. The credit remains only for children under the age of 17 (age 16 or younger at the end of the year).

In addition, under the new law, a credit of $500 is allowed for each dependent of the taxpayer other than a qualifying child (e.g., a 17-year old child living with the taxpayer or the taxpayer’s parent who lives with the taxpayer and qualifies as the taxpayer’s dependent). This new credit compensates taxpayers who previously could claim an exemption deduction for other dependents like their parents.

The Act increases the threshold dollar amounts at which the credit begins to phase-out. The starting point (modified AGI) is $400,000 for joint returns and $200,000 for all others. These amounts are not indexed for inflation.

**Page 13-43**

**Residential Energy Efficient Property Credit.**  Currently, a taxpayer may claim a 30% credit for the purchase of qualified geothermal heat pump property, qualified small wind energy property and qualified solar electric property. Effective for property placed in service after 2016, the Act *retroactively* extends the credit for residential energy efficient property for all qualified property placed in service before 2022, subject to a reduced rate of 26% for property placed in service during 2020 and 22% for property placed in service during 2021.

CHAPTER 15: NONTAXABLE EXCHANGES

**Page 15-4. Qualified Property.** Under the new law, the nonrecognition treatment for like kind exchanges is allowed solely for real property. Tangible personal property such as cars (personal vehicles as well as those of rental car companies), trucks, airplanes, machinery, construction equipment, art, currency, and coins are no longer eligible for like kind exchange treatment.

For the thousands of people who annually purchase a new car or truck and trade in their old one, their trade-in would be a taxable exchange. Taxpayers would be treated as if they sold their car for the amount of the trade-in value. For most individuals, the exchange would result in a nondeductible loss since the value received is less than the owner’s basis and the vehicle was not used in a trade or business or held for investment. If the taxpayer should have a gain, the gain would be capital gain. For taxpayers who use their car for business purposes, any gain would be taxable (probably § 1231 gain as discussed in Chapter 17) and any loss normally would be considered a deductible ordinary loss (see discussion of § 1231 in Chapter 17). For businesses, any increase in basis (i.e., notjust any boot paid, but the trade-in value of the now taxable exchange) could be offset by either Sec. 179 or bonus depreciation on the newly-acquired property.

CHAPTER 16: PROPERTY TRANSACTIONS: CAPITAL GAINS AND LOSSES

**Page 16-4**

**Definition of a Capital Asset and Intellectual Property.** Under current law, all property held by a taxpayer (whether or not connected with the taxpayer’s trade or business) is generally considered a capital asset under §1221(a). However, there are large categories of property that do not qualify. Assets specifically excluded from the definition of a capital asset include real or depreciable property used in a trade or business (e.g., most of business’ plant, property and equipment) and certain self-created intangibles (e.g., copyrights, musical compositions). However, most intellectual property, patents and the like, have long been considered capital assets. That has meant that inventors and creators who sell their ideas and those who buy them—prior to patenting and actual commercial use of the patent—could treat the profits from those sales as capital gains that are taxed at a lower rate than ordinary income. The new tax law significantly alters this treatment.

The Act partially strips away favorable capital gain treatment for intellectual property. To accomplish this, the Act expands the list of property that is not a capital asset to include most intellectual property, including a “patent, invention, model or design (whether or not patented), a secret formula or process.” Although a patent loses its capital asset status under § 1221, it appears that § 1235 would still allow capital gain treatment. However, capital gain treatment under § 1235 is presumably not available for inventions, models or designs, secret formulas or processes that are not patented. Perhaps clarification will be forthcoming.

The Act also maintains the special election to treat musical compositions and copyrights in musical works as a capital asset.

CHAPTER 18: EMPLOYEE COMPENSATION AND RETIREMENT PLANS

**Page 18-29**

**Coverdell Accounts (§ 530).** The Act generally prohibits new contributions to Coverdell education savings accounts after 2017.

CHAPTER 19: TAXATION OF BUSINESS FORMS AND THEIR OWNERS

**Page 19-1**

**Qualified Business Income Deduction**

As this chapter illustrates, business owners have choices regarding the legal structure they can use to conduct their business. For tax purposes, there are two types of organizations: (1) C corporations that are treated as separate taxable entities and (2) pass-through entities (PTEs). PTEs include partnerships, S corporations, sole proprietorships (self-employed individuals) and owner-operated rental activities where the income flows through and is taxed to the owner(s). For the business owner, the obvious question is which form is better for tax purposes.

At first glance, it appears that C corporations would be the least preferable since the income is potentially taxed twice, first at the corporate level and again when it is distributed to an owner as a nondeductible dividend. Recognize, however, that this second tax can be avoided to the extent that the distribution from the corporation is characterized as a deductible salary (or the dividend is taxed at a 0% rate). In fact, if all of the corporation’s income were to be distributed as deductible salaries, the corporation would not pay any tax and the tax burden would be shifted to the individual. However, most business owners recognize that mere survival as well as long-term success require steady sustained growth. For this reason alone, they usually reinvest a large share of the entity’s profits in the business. In that case, the analysis becomes a bit different. If the owner’s objective is to maximize the amount that can be reinvested after-taxes, what form of business is best?

 Under the new law, the taxable income of C corporations is taxed at a flat rate of 21 percent. In contrast, the income of PTEs potentially can be taxed at the highest individual rate of 37 percent. Assuming all of the income that the PTE produces is taxed at the highest rate and is reinvested in the business, C corporations would appear to have a significant tax advantage. On the margin, the corporate rate is 16% lower (37% - 21% = 16%). While there is much more to the analysis, it appears that the tax playing field is significantly tilted toward C corporations.

When Congress reduced the corporate tax rate, it recognized the disparity in the rates between corporations and PTEs. As a result, it made a noble attempt to fix what is almost an insurmountable problem given the current structure of the U.S. tax laws. Generally, the Act introduces new rules that reduce the effective rate at which the income of PTEs is taxed. This is done operationally by allowing the owners of PTEs to claim a deduction equal to 20% of the net income that flows through or which is allocated to them. In a simple world, if the PTE produces $100 of income, only 80% or $80 is ultimately taxed to the owner. Unfortunately, as might be expected, it is not that easy. Moreover, the new rules also try to prevent PTEs from recharacterizing wage income into favorably taxed business income.

As seen below, the calculation of the deduction is incredibly complex, full of never before heard of terms requiring lengthy definitions, as well as a handful of acronyms, limitations and more. Some of the complexity is directly attributable to Congress’ preference for capital-intensive businesses—those that earn by investing in machinery, equipment and other tangible assets—over service businesses. For this reason, the law is tilted to those that can manufacture, build and produce products. Simply put, providing goods is better than providing services. This bias runs throughout § 199A. For this reason:

* The 20% deduction generally is not available where the PTE’s business primarily involves the performance of mostly services (e.g., accountants, lawyers, doctors, financial advisors) but there are exceptions for small service businesses.
* The deduction is based on the PTE’s business income and not investment income; and
* The deduction is limited based upon how much the PTE pays in wages or invests in machinery, equipment, and other tangible property. Again, there are exceptions for small businesses.

**Qualified Business Income Deduction (§ 199A)**

**The Rule.** New § 199A generally allows owners of PTEs to claim a deduction equal to 20% of the owner’s qualified business income (QBI). QBI is normally the ordinary net income of PTE that is allocated or flows through to the owner from a qualified trade or business (QTB). In this regard, QBI includes rental income but does not include interest, dividends and capital gains or losses. Note that a single taxpayer could own one or more QTBs (e.g., interests in several partnerships).

The deductible amount for each QTB of the taxpayer is the *lesser* of (§ 199A(b)(2)):

1. 20% of QBI (qualified business income) or $xxx,xxx
2. The greater of (a) or (b)**\***(a) 50% of (total W-2 wages paid by the business)$ yyyy

(b) 25% of share W-2 of wages $x,xxx
 + 2.5% of share of unadjusted basis of tangible depreciable property xxx

Total $x,xxx
Greater of (a) or (b) $ yyyy

\* Note that the items below, 2(a) and 2(b), serve as potential limitations of the basic 20% deduction. For purposes of discussion, item (a) will be referred to as the wage limitation and item (b) as the property limitation (no doubt the regulations will create something more appropriate). Importantly, both of these limitations contained in item 2 above are ignored if the owner’s taxable income does not exceed $315,000 for joint returns and $157,500 for all other returns (§ 199A(b)(3)).

As seen above, § 199A starts by granting a PTE owner a deduction equal to 20% of the net income that flows through to the owner (20% of QBI). However, that tentative deduction may be reduced by the limitations based on the amount of W-2 wages paid by the PTE and the amount the PTE has invested in tangible depreciable property (e.g., plant, property and equipment but not land). Observe that if the company’s payroll and investment in fixed assets were substantial enough, these potential limitations would not be applicable.

**Example 1.** T is single. He owns 30% of the stock in an S corporation that produced ordinary income of $3,000,000. His share is $900,000. His tentative QBI deduction is $180,000 (20% x $900,000). The next step is to consider the limitations. His total taxable income from all sources exceed the $157,500 safe harbor threshold for single taxpayers so the potential limitations apply. The S corporation paid total W-2 wages of $1,000,000 and the total unadjusted basis of property held by the corporation is $100,000. T is allocated 30% of these items. What is T’s QBI deduction?

As shown below, T’s QBI deduction is $150,000. It is the lesser of: (1) the tentative QBI deduction of $180,000 (20% x his share of QBI of $900,000) or (2) the greater of the wage limitation, $150,000 (50% x wages of $300,000), or the limitation related to wages and property $75,750 [(25% x wages of $300,000 = $75,000) + (2.5% x unadjusted basis of property of $30,000 = $750). Note that the deduction is *not* the lesser of the three quantities.

 Total T’s share (30%) Total
Lesser of (1) or (2):

1. QBI (20%) $3,000,000 $900,000 $180,000

2. Greater of

(a) W-2 wages $1,000,000 $300,000 x 50% $150,000 $150,000

(b) W-2 wages $1,000,000 300,000 x 25% $75,000
 Property $100,000 30,000 x 2.5% 750
 Total $75,750

As noted above, as long as the owner’s taxable income from all sources is less than certain thresholds ($315,000 for joint returns and $157,500 for all others), the wage and property limitations are ignored completely (i.e., 2(a) or (b) above). In such case, the deduction is simply 20% of QBI. However, if total taxable income from all sources exceeds these thresholds, the limitation is no longer zero. Instead, the limitation phases in over $100,000 of taxable income for joint returns and $50,000 for others. Thus if taxable income exceeds the $315,000 threshold by $100,000, 100% ($100,000 excess/$100,000), the full limitation applies. If taxable income is less, the calculation is more complex as illustrated below (see § 199A(b)(3)).

**Example 2.** H and W are married. H owns a 20% interest in an S corporation. His share of the S corporation’s income is $300,000. His allocable share of W-2 wages paid by the S corporation is $40,000 and his share of the unadjusted basis of qualified property held by the S corporation is $0. Assume the couple’s total taxable income is $375,000 ($300,000 of from the S Corporation). Since H’s income from an S corporation is $300,000 his tentative QBI deduction is $60,000 (20% x $300,000) before any possible reductions.

His tentative wage limitation is $20,000 (50% x $40,000 wages), causing a potential drop in his QBI deduction from $60,000 to $20,000 or a $40,000 decrease. However, had the couple’s taxable income been $315,000 or less, none of the $40,000 decrease would have occurred and QBI deduction would have been $60,000. Instead of applying the decrease in one fell swoop and to avoid a cliff effect, this $40,000 *decrease* is spread over $100,000 or 40% for every dollar over $315,000. Since their taxable income is $375,000 or $60,000 more than the $315,000 threshold there is a $24,000 decrease (40% x $60,000) and the QBI deduction is $36,000.

1. QBI deduction before limitations ($300,000 x 20%) $60,000
2. Greater of (a) or (b) (a) Normal wage limit = Wages x 50% = $40,000 x 50% = $20,000
 (b) Property limitation =
 Wages x 25% = $40,000 x 25% $10,000
 + 2.5% x $0 unadjusted basis of property 0
 Property limitation $10,000

QBI deduction if full wage limitation above applied (greater of (a) or (b)) $20,000

Tentative QBI deduction $60,000
-Excess amount\* (potential decrease in QBI deduction = $60,000 - $20,000 = $40,000)
-Ignore both limitations if taxable income < $315,000 but taxable income is $375,000
-Taxable income in excess of threshold ($375,000 - $315,000 = $60,000)
-Phase in of limitation range $100,000
-Percentage disallowed 60% ($60,000/$100,000) of $40,000 benefit = $24,000 (24,000)
QBI deduction $36,000

\*Name per § 199A(b)(3)(ii)

The QBI deduction is neither a deduction for AGI nor an itemized deduction but rather a deduction from taxable income. It does not reduce the owner’s self-employment income or the income from the business reported on Schedule C, E or F. Note also that the owner need not be active in the business to qualify for the deduction.

The QBI deduction also includes 20% of qualified dividends from REITs (real estate investment trusts) and 20% of income from a publicly traded partnership income. These situations are not covered in this discussion.

**Qualified Business and Specified Service Trade or Businesses (§ 199A(d)).**  The 20% deduction is only allowed for a qualified trade or business (QTB). A QTB means any trade or business other than that of being an employee (generally, employees are considered in the business of being an employee) and a “specified service trade or business.” The specified service businesses that do qualify include any business involving the performance of services in the following fields (generally § 1202(e)(3)(A)

* Health
* Law
* Accounting
* Consulting
* Financial services, brokerage services, investing, investment management or trading or dealing in securities
* 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,

However, a business that involves the performance of engineering or architectural services is blessed and is considered a QTB.

Most importantly for small businesses, under §199A(d)(3) the exclusion of specified service businesses does not apply if the individual’s taxable income is less than the safe harbor thresholds mentioned above: taxable income less than $315,000 for joint filers ($100,000 phase-in to $415,000) and $157,500 ($50,000 phase-in to $207,500) for all other taxpayers. In other words, when individuals have taxable income that does not exceed these thresholds, they can claim the QBI deduction.

Note also that the QBI deduction is based only on the net business income of the PTE that flows through to the owner; it does not apply to any amount paid by the PTE to the taxpayer in respect of any services rendered by the owner to the PTE (e.g., salaries or guaranteed payments to partners).

**Example 3.** B, a CPA, a partner in a regional accounting firm. She is married, and the couple has taxable income of $600,000. Her distributive share of the income from the accounting firm is $500,000. Her allocable share of the W-2 wages of the law firm is $100,000, and her allocable share of the unadjusted basis of the assets of the business is $20,000. B is not entitled to a QBI deduction, because a law firm is a specified service business and B's personal taxable income exceeds the $415,000 safe harbor, meaning she is completely phased-out of any possible deduction.

**Example 4.** Same as above, except B is a partner of a local accounting firm and has taxable income is $300,000. Her share of the income of the accounting firm is $200,000, her share of the W-2 wages is $60,000, and her share of the assets of the partnership is $40,000. Even though B makes her living providing services, she is blessed. She may take the QBI deduction because her taxable income is below $315,000, the start of the phase-in threshold. As a result, B can take a deduction of 20% of $200,000, or $40,000 and is taxed on $160,000 rather than $200,000. Note also that the 50% of wages limitation and the property limitation of 25% of wages + 2.5% of unadjusted basis do not apply since B’s taxable income is less than $315,000 for joint filers.

If the individual has taxable income over the threshold levels, phase-in rules similar to the ones discussed above apply. Remember the key number here is the individual’s taxable income and not the PTE’s taxable income

**Property Limitation.** For purposes of the 2.5% property limitation, the computation uses the unadjusted basis, meaning the asset’s original cost before any depreciation. In addition, only “qualified property” is included. To be considered qualified under § 199A(b)(6) and included in the computation, the property

1. Must be tangible depreciable property subject to depreciation.
2. Must be owned at the end of the year.
3. Must be used at any point of the year in the production of QBI.
4. Must be held within its depreciable period, which begins when the asset is placed in service and ends at the later of 10 years or the last day of the last full year in the asset’s regular (not ADS) depreciation period. For example, if the taxpayer purchased 5-year property, its depreciable period would end in year 10.

For an excellent discussion of § 199A see the articles in *Forbes* by Tony Nitti <https://www.forbes.com/sites/anthonynitti/2017/12/26/tax-geek-tuesday-making-sense-of-the-new-20-qualified-business-income-deduction/#c67dee044fda>

**Page 19-19**

**Corporate Tax Rates.** Under the new law, the tax rates for corporations have been reduced to a single rate of 21 percent.

**Page 19-20**

**Corporate Dividends Received Deduction.** The Act reduces the dividends received deduction as follows:

 Dividends Received Deduction

 Stock Ownership Previous law **New law**

 < 20% 70% 50%
 > 20% & < 80% 80% 65%
 > 80% 100% 100%

**Page 19-26**

**Net Operating Losses.** The Act makes several changes to the use of an NOL. Beginning in 2018:

* The 2-year carryback period (except for farming businesses) is eliminated. Therefore, NOLs can only be carried forward.
* NOLs are carried forward indefinitely. The 20 year carryover period is eliminated except for pre-2018 NOLs.
* The NOL deduction is limited to 80% of taxable income, determined without regard to the NOL deduction itself.  However, NOLs existing prior to 2018 are not subject to the 80% limit.

**Example 11 on page 19-26.** Assume the $45,000 NOL occurred in 2018. Under the new law, the NOL could not be carried back. Instead, the NOL can only be carried forward and there is no limitation on the carryover period.

**Page 19-27**

**Alternative Minimum Tax (AMT).** The Act repeals the AMT for corporations.

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