Tax Update: Legislative Developments and Tax Planning for Law Firms and Attorneys

Presented by
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Legislative Developments and Tax Planning for Law Firms and Attorneys

Tax Cuts and Jobs Act (H.R. 1)

Business Provisions
Business Provisions

- Property Accounting
- Entertainment Expenses
- Business Credits
- Business Interest Expense Deduction
- Pass-Through Specific Topics
- C Corporation Specific Topics

Property Accounting Changes

- Bonus Depreciation for new and used property purchased and placed in service after September 27, 2017

<table>
<thead>
<tr>
<th>Placed In Service Year</th>
<th>Bonus Depreciation Percentage</th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>General Qualified Property</td>
<td>Longer Production Period Property &amp; Certain Aircraft</td>
</tr>
<tr>
<td>September 28, 2017 – December 31, 2022</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>2023</td>
<td>80%</td>
<td>100%</td>
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<tr>
<td>2024</td>
<td>60%</td>
<td>80%</td>
</tr>
<tr>
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</tr>
<tr>
<td>2026</td>
<td>20%</td>
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</tr>
<tr>
<td>2027</td>
<td>None</td>
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</tr>
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</table>
Property Accounting Changes

- Bonus Depreciation for property purchased but not placed in service before September 28, 2017 or under construction on September 28, 2017

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<tr>
<td>September 28, 2017 – December 31, 2017</td>
<td>50%</td>
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<td></td>
</tr>
<tr>
<td>2018</td>
<td>40%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td>30%</td>
<td>40%</td>
<td></td>
</tr>
<tr>
<td>2020</td>
<td>None</td>
<td>30%</td>
<td></td>
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</table>

- Section 179 Expensing
  - Maximum amount that may be expensed increased to $1 million (increase from $500,000)
  - The dollar limit is reduced dollar-for-dollar to the extent the total cost of section 179 property exceeds $2.5 million (increase from $2 million)
  - Both amounts will be adjusted annually for inflation
  - Qualifying property now includes qualified improvement property and certain improvements (roofs, HVAC property, fire protection and alarm systems and security systems made to nonresidential real property and placed in service after the date the realty was placed in service)
Property Accounting Changes

▪ “Qualified leasehold improvement property”, “qualified restaurant property” and “qualified retail improvement property” are combined into a single definition of “qualified improvement property”

▪ 15 year recovery period for qualified improvement property – eligible for bonus and section 179

▪ If a real estate business elects out of the new interest expense deduction limitation rules, they will be required to use the Alternative Depreciation System (ADS)
  ▪ 40 years for commercial buildings
  ▪ 30 years for residential buildings
  ▪ 20 years for all qualified improvement property

Entertainment Expenses

▪ 100% Expense Disallowance for:
  ▪ Entertainment, amusement, or recreation expenses
  ▪ Membership dues for a club organized for business, pleasure, recreation or other social purposes
    ▪ Facility expenses used in connection with the above
  ▪ Qualified transportation fringe benefits (except for ensuring employee safety)

▪ The exception for entertainment directly related to the active conduct of a trade or business is repealed

▪ 50% disallowance for employer expenses associated with providing food and beverages to employees through an eating facility meeting the de minimis fringe requirements

▪ Applicable for amounts paid or incurred after December 31, 2017
Business Credits

- Employer Credit for Paid Family and Medical Leave
  - Available for employers who give full time employees > 2 weeks of FMLA and give part time employees a comparable pro rata amount
  - Credit is equal to 12.5% of wages paid to the qualified employees while on FMLA
    - To qualify FMLA wages must be at least 50% normal wages, and for every percentage point over 50%, credit increases by .25 percentage points (capped at 25%)
  - Effective for wages paid in tax years beginning after December 31, 2017 (but not after December 31, 2019) – only for 2018

Limitation on Business Interest Deduction

- Net interest expense deduction will be limited to 30% of the business's adjusted taxable income
- For tax years beginning after December 31, 2017 through December 31, 2021 adjusted taxable income is calculated as taxable income adjusted for the following items:
  - Investment Interest Income/Expense
  - Business Interest Income/Expense
  - Non Trade/Business Gains
  - 20% Deduction for Pass-Through Income
  - Non Trade/Business Deduction/Loss
  - Net Operating Loss Deduction
  - Depreciation, Amortization, and Depletion
Limitation on Business Interest Deduction

- For tax years beginning after December 31, 2021, adjusted taxable income is calculated as taxable income less the following items:
  - Investment Interest Income/Expense
  - Non Trade/Business Gains
  - Non Trade/Business Deduction/Loss
  - Business Interest Income/Expense
  - 20% Deduction for Pass-Through Income
  - Net Operating Loss Deduction

- Businesses with average annual gross receipts (3 year period) less than $25 million are exempt
- Certain real estate and farming businesses that use ADS can elect out
- Disallowed interest can be carried forward indefinitely
- The disallowance occurs at the filer level, not at the taxpayer level
  - NOTE: this is important for partnerships
Limitation on Business Interest Deduction – Partnership Specific

- Limitation will be applied at the partnership level
- Any deduction allowed for business interest will be a part of determining non-separately stated taxable income of the partnership
- Double Counting Rule: prevents partners from including a partnership’s adjusted taxable income in determining their individual business interest limitation
- Does not include separately stated income items (i.e. 1231 gain or loss)

Limitation on Business Interest Deduction – Partnership Specific

- Double Counting Rule Example:
  - Partnership ABC has 2 50/50 partners, XYZ Corporation and an individual
  - ABC generates $200 of noninterest income and $60 of business interest expense
    - Business interest expense will be limited to $60 ($200x30%), so ABC reports ordinary business income of $140. Each partner receives $70
  - XYZ has net taxable income of $0 from other operations and additional business interest expense of $25
    - Without the double counting rule, XYZ would be able to use the $70 generated from ABC to calculate an additional $21 of allowable business interest expense (70x30%)
Partners will be able to use excess/unused taxable income limitations from partnerships in computing their interest limitation:

- Example: same partnership and facts as previous slide except they only have $40 of interest expense but still have a limit on the interest deduction of $60
  - The excess limit is $20 and the excess taxable income is $66.67 ($20/$60x$200)
  - XYZ business interest deduction is limited to 30% of its adjusted taxable income plus its share of the excess taxable income (30%×(0+$33.33), or $10.
  - XYZ will carryforward the disallowed portion of $15

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Special carryforward rules for partnerships:

- Excess business interest generated by a partnership will not be treated as paid or accrued by the partnership in the following tax year
- Rather, the excess business interest will be allocated to the partners in the year it is generated.
  - Will be allocated in the same manner as non-separately stated income items of the partnership
  - Will be treated as paid or accrued by the partner in the next tax year that the partner has excess taxable income from the partnership, but only to the extent of the excess income
- Partners’ basis will be reduced by the amount of allocated excess business interest
### Special carryforward rules for partnerships (cont.):

- If a partner disposes of a partnership interest, their basis in the excess business interest is increased by the excess of:
  - The amount basis was reduced divided by the amount of excess business interest allocated to the partner that is being treated as a carryforward item.

### Limitation on Business Interest Deduction – Partnership Specific

- The double counting rule and the excess taxable income limitation rule work the same for S Corps as they do for partnerships.
- S Corps are not eligible for either special carryforward rules available to partnerships.

### Limitation on Business Interest Deduction – S Corp Specific
Limitation on Business Interest Deduction – C Corp Specific

- It is unclear how the new limitation will work with other interest disallowances deferral provisions that already exist in the IRC.

- The bill defines business interest as “any interest paid or accrued” but does not specify if that should include interest that has been disallowed or deferred due to another IRC section.
Pass-Through Tax Deduction

- Domestic “qualified business income” (QBI) will be eligible for a 20% deduction
- QBI defined as all domestic business income other than investment income
- Deduction generally limited to the greater of 1) 50% of W-2 wages paid with respect to the qualified trade or business or 2) the sum of 25% of W-2 wages paid plus 2.5% of the unadjusted basis of all qualified property
  - W-2 wages for this deduction are defined as the sum of wages subject to withholding, elective deferrals and deferred compensation paid by the business in the tax year
  - Qualified property is generally defined as tangible property subject to depreciation, held by a qualified trade or business, and used in the production of qualified business income
  - If taxpayer’s taxable income is less than $315,000 (MFJ) or $157,500 (all other filing statuses) they are exempt from the W-2 wage limit
  - REIT dividends and PTP income are excluded from the W-2 wage limit

Pass-Through Tax Rate Detail

- “Specified service businesses” excluded from the 20% deduction
  - IRC defines a specified service business as “any trade or business involving the performance of services... where the principal asset of such trade or business is the reputation or skill of one of more of its employees”
  - Engineering and architecture services excluded (get the deduction)
  - Exception: taxpayers with taxable income less than $315,000 (MFJ) or $157,500 (all other filing statuses) are exempt from the specified service businesses limitation
- Deduction applicable for tax years beginning after December 31, 2017 and before January 1, 2026
S Corporation Conversion to C Corporation

- S Corporations that revoke their S election during the two-year period beginning on the enactment date and have the same owners on both the enactment date and revocation date

- Distributions from a terminated S Corporation will be treated as being paid: (1) from Accumulated Adjustments Account and then (2) from Earnings & Profits

- Adjustments under section 481(a) are accounted for over a six-year period

S Corporation Conversion to C Corporation

- 2nd provision: revises the treatment of distributions following a conversion to C corp. status

- Extends the beneficial treatment of distributions beyond the post-transition termination period (“PTTP”)

- Distributions of cash by an eligible terminated S corp. after PTTP ends would be treated as coming out of their AAA or E&P in the same ratio as the AAA bears to the corporation’s accumulated E&P

- Means that even after PTTP expires, a portion of distributions are eligible to be treated as a return of capital (and a capital gain if a shareholder’s basis gets to zero)
C Corp Specific Topics

- Flat tax rate of 21% effective beginning tax year 2018
- Net Operating Loss (NOL) Deduction
  - Limited to 80% of taxable income
    - Applies to losses arising in tax years after December 31, 2017
    - Two buckets of NOLs:
      - Pre 2018 NOLs – treat the same as before
      - Post 2017 NOLs – 80% rule and indefinite carryforward
- Two-year NOL carryback rule eliminated, but twenty-year carryforward rule extended to be an indefinite carryforward
- Capital loss carryback/carryforward not addressed

General Changes

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General Changes

- Corporate Alternative Minimum Tax (AMT) repealed
  - AMT credit carryovers can be used to reduce a corporation’s regular tax liability
  - For tax years 2018 through 2020, 50% of AMT credit carryovers that exceed a corporation’s regular tax liability are refundable
    - Remaining credit carryovers would be fully refundable in tax year 2021

Not Included in the Tax Cuts and Jobs Act

- What isn’t changing:
  - Shortening of recovery period for nonresidential real and residential rental property
  - Modification of any of the energy credits included in the House bill
  - Repeal of the Work Opportunity Credit
  - Private activity bond reform
  - Repeal of professional sports stadium construction tax-exempt bond issues
  - Repeal of long-term capital gain treatment on sale or exchange of patents
Questions

Individual Provisions
Individual Provisions

- Tax Brackets, Calculations and Credits
- Adjustments to Income
- Itemized Deductions
- Miscellaneous Changes

Tax Brackets, Calculations and Credits
## Tax Rates

### Pre-Reform Law

<table>
<thead>
<tr>
<th>Individual Income Tax Rates</th>
<th>2017 Reform Act</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For tax year 2017, there are seven regular individual income tax brackets of 10%, 15%, 25%, 28%, 33%, 35% and 39.6%, and five categories of filing status. The income levels for each bracket threshold are indexed annually based on increases in the Consumer Price Index (CPI).</strong></td>
<td><strong>The Act has seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35% and 37%. These brackets apply to tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026.</strong></td>
</tr>
<tr>
<td><strong>Married Filing Jointly and Surviving Spouses:</strong></td>
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</tr>
<tr>
<td>10% (taxable income not over $18,650)</td>
<td>10% (taxable income not over $19,050)</td>
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<tr>
<td>15% (over $18,650 but not over $75,900)</td>
<td>12% (over $19,050 but not over $77,400)</td>
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<tr>
<td>25% (over $75,900 but not over $153,100)</td>
<td>22% (over $77,400 but not over $165,000)</td>
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<tr>
<td>28% (over $153,100 but not over $233,350)</td>
<td>24% (over $165,000 but not over $315,000)</td>
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<tr>
<td>33% (over $233,350 but not over $416,700)</td>
<td>32% (over $315,000 but not over $400,000)</td>
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<tr>
<td>35% (over $416,700 but not over $470,700)</td>
<td>33% (over $400,000 but not over $600,000)</td>
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<tr>
<td>39.6% (over $470,700)</td>
<td>35% (over $600,000)</td>
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<tr>
<td><strong>Married Filing Separately:</strong></td>
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<tr>
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<tr>
<td>15% (over $9,325 but not over $37,950)</td>
<td>12% (over $9,525 but not over $38,700)</td>
</tr>
<tr>
<td>25% (over $37,950 but not over $76,675)</td>
<td>22% (over $38,700 but not over $82,500)</td>
</tr>
<tr>
<td>28% (over $76,675 but not over $111,665)</td>
<td>24% (over $82,500 but not over $157,500)</td>
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<tr>
<td><strong>Head of Household:</strong></td>
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<tr>
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The income threshold amounts for each rate bracket will be indexed for inflation using C-CPI-U in tax years beginning after Dec. 31, 2018. The requirement to index the amounts for inflation using the C-CPI-U would not expire. The bill would simplify the “kiddie tax.”
Tax Rates

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<tr>
<td>Short-term capital gains are taxed as ordinary income.</td>
<td>Under the Act, the breakpoints between the 0% and 15% rates and between the 15% and 20% rates are the same as under present law. For tax years beginning in 2018, the rate thresholds are as follows:</td>
</tr>
<tr>
<td>For tax year 2017, taxpayers in the 10% and 15% tax brackets pay no tax on long-term gains on most assets. Taxpayers in the 25%, 28%, 33% or 35% income tax brackets face a 15% rate on long-term capital gains. For those in the top 39.6% bracket for ordinary income the rate is 20%.</td>
<td>Married Filing Jointly and Surviving Spouses:</td>
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<td>15% rate threshold – $77,200</td>
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The above 15% and 20% threshold amounts apply to tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026. These amounts will be indexed for inflation using C-CPI-U in tax years beginning after Dec. 31, 2018. The requirement to index amounts for inflation using C-CPI-U will not expire.

Personal Exemptions

- Under prior law, the taxpayer, the taxpayer’s spouse and any dependents were each allowed a personal exemption deduction ($4,150 for 2018) subject to phase out for high income taxpayers.
- Under the new law, the personal exemption deduction is repealed and merged with a higher standard deduction.
- The new law is effective starting in 2018 and sunsets at the beginning of 2026 so would not apply to taxable years beginning after December 31, 2025.
Individual Alternative Minimum Tax (AMT)

- Although not repealed outright few will pay it
- In addition exemption amounts raised substantially
  - $109,400 MFJ
  - $70,300 Single
  - $54,700 for Married Taxpayers Filing Separately
- Phase out of these exemption amounts not to begin until
  - $1M for Married Filing Joint and Surviving Spouses
  - $500,000 for Single and Married Taxpayers Filing Separately
- 2018 through 2025 – all amounts indexed for inflation after 2018

**AMT Example:**

Comment: Although AMT was retained for individuals, few will pay it. The main reason for this however is the elimination of the regular tax deduction for items that traditionally caused a taxpayer to incur AMT in the first place as well as the much higher limit for AMT exemption phase out.
Kiddie Tax

- “Kiddie tax” applied by utilizing ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child.
- Taxable income attributable to earned income is taxed according to an unmarried taxpayers’ brackets and rates.
- Taxable income attributable to net unearned income is taxed according to the brackets applicable to trusts and estates, with respect to both ordinary income and income taxed at preferential rates.
- A child’s tax is no longer affected by the tax situation of the child’s parent or the unearned income of any siblings.

Enhancement of Child Tax Credit and New Family Tax Credit

- Under prior law, the child tax credit was $1,000 per qualifying child.
- Starting in 2018, under the new law, the child tax credit is increased to $2,000 per qualifying child.
- Up to $1,400 of the child tax credit is refundable under the new law.
- The new law also raises the adjusted gross income phase-out thresholds from $110,000 to $400,000 for joint filers and from $75,000 to $200,000 for all others.
Enhancement of Child Tax Credit and New Family Tax Credit

- The new law requires the taxpayer to provide a social security number (SSN) for each qualifying child for whom the credit is claimed on the return.

- The new law also provides for a $500 nonrefundable credit for qualifying dependents other than children.

- The SSN requirement (discussed above) does not apply to the nonrefundable credit for a dependent other than a child.

- The changes to the child tax credit and new family tax credit are effective starting in 2018 through 2025.

Adjustments to Income
Adjustments to Income

- Alimony
  - Under prior law alimony was typically deducted by payor and reported as income by recipient
  - Under new law no longer a deduction or reportable as income
  - Effective dates delayed:
    - For new agreements after December 31, 2018
    - For existing agreements modified due to law change

- Moving expenses and moving reimbursements
  - Moving expense deductions suspended for 2018 through 2025
  - Moving reimbursements formerly treated as non-taxable fringe benefits taxable for 2018 through 2025
  - Exception – still a non-taxable fringe for active duty Armed Forces moving under orders to a new permanent station
### Adjustments to Income

- **Roth IRA Recharacterization**
  - Conversions from a traditional IRA or other retirement plan to a Roth IRA can no longer be recharacterized to a traditional IRA.
  - Annual Roth contributions can still be recharacterized as traditional IRA contributions.
  - Effective beginning in 2018.

### Adjustments to Income

- **Tax Benefits for Education**
  - **Section 529 Plans**
    - Distributions of up to $10,000 per year allowed for elementary or secondary public, private or religious schools
    - 529 plan distributions can be rolled over to an ABLE account, up to the annual limit (the annual gift tax exclusion)
  - **Discharge of Student Loans**
    - Excludes from taxable income the discharge of student loans due to the death or disability of the student
Itemized Deductions

- Medical Expense Floor
  - Under prior law the medical floor for 2017 would have been 10%
  - Under the new law the medical floor has been reduced to 7.5% for 2017 – 2018
    - The 7.5% floor applies for both regular tax and alternative minimum tax (AMT)
Itemized Deductions

- **State and Local Taxes**
  - Prior law allowed deductions for the higher of income or sales tax plus real estate and personal property tax
  - **New law creates a $10,000 Schedule A cap for all of these tax types for 2018 through 2025**
  - Special provision prohibiting prepayment of 2018 taxes
  - Taxes paid for a trade or business - such as real estate tax on a rental property - are not affected by the $10,000 Schedule A cap

Itemized Deductions

- **Home mortgage and home equity interest**
  - Prior law generally allowed interest on $1 million of debt to acquire a home and $100,000 of home equity debt
  - For 2018 through 2025 the new law eliminates the interest deduction for home equity debt and caps interest on acquisition debt at $750,000
  - These provisions apply to **new** acquisition debt. If you had a $1 million loan in place or a binding contract before December 15, 2017, the new limits don’t apply. Old debt can even be refinanced in certain cases. Note - these transition rules do **not** apply to home equity loans
Itemized Deductions

- Charitable contribution changes
  - The tax act raises the 50% limit to 60% for cash gifts to public charities for 2018 through 2025
    - Gifts in excess of 60% can be carried forward for five years
    - Other charitable giving rules remain the same
  - New law denies deductions for college athletic seating rights and tightens charitable receipt requirements

- Miscellaneous 2% deductions and overall limits
  - Prior law allowed a variety of Schedule A deductions subject to a 2% AGI floor
  - The tax act suspends these 2% deductions and eliminates the overall limit on Schedule A deductions for 2018 to 2025
  - Standard deductions offer an alternative to itemizing. Increased to $24,000 for married couples filing a joint return, $18,000 for head-of-household and $12,000 for all others.
  - Overall itemized deduction limitation (3% of AGI) was repealed
Eliminates the shared responsibility payment (Affordable Care Act) for individuals failing to maintain minimum essential coverage by reducing the penalty for such failure to zero

- Applicable to months beginning after December 31, 2018
  - Still in effect for 2017 and 2018
- No sunset on this elimination
Not Included in the Tax Cuts and Jobs Act

- Home sale gain exclusion modifications
  - Exclusion still $500k MFJ; $250 Single
  - Principal residence for 2 years in aggregate of previous 5 before sale still qualifies

Questions
Your opinion matters!

Please take a moment to evaluate this session.

Thank you!