

## **The Tax Cuts and Jobs Act of 2017**

*Richard Hammar's analysis regarding how the new legislation will affect churches and church staff.*

On December 22, 2017, President Donald Trump signed into law the \$1.5 trillion, 1,097-page Tax Cuts and Jobs Act of 2017. In brief, the Act amends the Internal Revenue Code to reduce tax rates and modify credits and deductions for individuals and businesses.

With respect to individuals, the bill:

- replaces the seven existing tax brackets (10%, 15%, 25%, 28%, 33%, 35%, and 39.6%) with seven new and lower brackets (10%, 12%, 22%, 24%, 32%, 35%, and 37%),
- substantially increases the standard deduction, thereby reducing significantly the number of taxpayers who will itemize deductions,
- repeals the deduction for personal exemptions,
- doubles the child tax credit and establishes a new family tax credit,
- repeals most itemized deductions,
- limits the mortgage interest deduction for debt incurred after November 2, 2017, to mortgages of up to \$750,000 (currently \$1 million),
- caps the deduction for state and local income or sales taxes not paid or accrued in a trade or business at \$10,000,
- consolidates and repeals several education-related deductions and credits,
- modifies the alternative minimum tax (AMT) to make it apply to fewer taxpayers, and
- modifies the estate and generation-skipping transfer taxes to exempt most taxpayers.

For businesses, the Act reduces the corporate tax rate from a maximum of 35% to a flat 21% rate.

The Act also repeals or modifies several additional credits and deductions for individuals and businesses.

**Key point.** *The new law temporarily changes the structure of the individual income tax by modifying the rate structure so that the tax brackets are 10-percent, 12-percent, 22-percent, 24-percent, 32-percent, 35-percent and 37-percent. The bill temporarily increases the size of the standard deduction (for 2018 the standard deduction is \$24,000 for joint filers, \$18,000 for heads of household and \$12,000 for other filers), and temporarily eliminates personal exemptions. These provisions "sunset" for taxable years beginning after December 31, 2025 unless extended by Congress.*

### **Part 1: Tax Law Changes Directly Impacting Churches and Church Staff**

The Act's provisions having the most relevance to churches and church staff are summarized below.

#### **1. Church political activities**

Churches and other charitable organizations described in section 501(c)(3) of the tax code generally are exempt from federal income tax and are eligible to receive tax-deductible contributions so long as they are organized and operated exclusively for one or more tax-exempt purposes constituting the basis of their tax exemption. These purposes include religious, charitable, and educational. In addition, charitable organizations may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office. The prohibition on such political campaign activity is absolute and, in general, includes activities such as making contributions to a candidate's political campaign, endorsements of a candidate, lending employees to work in a political campaign, or providing facilities for use by a candidate. The absolute prohibition on campaign activities was added in 1954 by the so-called "Johnson amendment" (named for Senate majority leader Lyndon Baines Johnson).

Many other activities may constitute political campaign activity, depending on the facts and circumstances. The sanction for a violation of the prohibition is loss of the organization's tax-exempt status, although the tax code provides three other possible penalties: an excise tax on political expenditures, termination assessment of all taxes due, and an injunction against further political expenditures.

The House bill (H.R.1) provided that an exempt organization would not lose its exempt status solely because of the content of any statement that: (1) was made in the ordinary course of the organization's regular and customary activities in carrying out its exempt purpose; and (2) resulted in the organization incurring not more than de minimis incremental expenses.

The Senate did not include this provision in its version of the tax bill, and a joint House-Senate conference committee did not adopt the House bill provision in the final text of the new law. As a result, the prohibition of political campaign activity by churches remains intact and unchanged.

## **2. Charitable contributions**

The Act impacts charitable contributions in the following two ways:

### ***(1) increase in standard deduction***

Tax Cuts and Jobs Act of 2017 retains a deduction for charitable contributions, but the deduction will be available to a smaller number of donors because of a substantial increase in the standard deduction.

Under prior law, individuals who did not elect to itemize deductions could reduce their adjusted gross income ("AGI") by the amount of the applicable standard deduction in computing taxable income. The standard deduction is the sum of the basic standard deduction and, if applicable, the "additional" standard deduction for taxpayers who are 65 years of age or older, or blind.

The basic standard deduction varies depending on a taxpayer's filing status. For 2017, the amount of the basic standard deduction was \$6,350 for single individuals and married individuals filing separate returns, \$9,350 for heads of households, and \$12,700 for married individuals filing a joint return and surviving spouses. The amount of the standard deduction was indexed annually for inflation.

The Tax Cuts and Jobs Act temporarily increases the basic standard deduction for individuals regardless of filing status. The amount of the standard deduction is to \$24,000 for married individuals filing a joint return, \$18,000 for head-of-household filers, and \$12,000 for all other individuals. The amount of the standard deduction would be indexed for inflation using the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) for taxable years beginning after December 31, 2018, instead of the traditional Consumer Price Index for All Urban Consumers (CPI-U).

The additional standard deduction for the elderly and the blind is not affected. The increase of the basic standard deduction would not apply to taxable years beginning after December 31, 2025.

**Key point.** *The dollar amounts for bracket thresholds and the standard deduction are adjusted for inflation and then rounded to the next lowest multiple of \$100 in future years. Unlike prior law, which used the Consumer Price Index for All Urban Consumers (CPI-U), the new inflation adjustment uses the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) which, according to the Bureau of Labor Statistics, will "trend slightly lower than the CPI-U."*

The significantly increased standard deduction will reduce the number of persons who are able to itemize deductions on Schedule A (Form 1040) from 30 percent to as few as 5 percent of all taxpayers. The result will be a significant decrease in the number of taxpayers who can claim a tax deduction for contributions they make to churches and other charities. Will the loss of a charitable contribution deduction by 95 percent of all taxpayers disincentivize them from making contributions to their church or favorite charities? Possibly. Note the following considerations:

- Estimates of the impact of the new law on charitable giving differ widely. Many leaders of religious and charitable organizations are warning of dire reductions in charitable giving resulting from the Act's substantial increase in the standard deductions. A recent article in the *Journal of Philanthropy* estimates that charitable giving will decline by as much as 3-4 percent (\$20 billion) annually due to the increase in the standard deduction. Also sounding the alarm are several prominent and high-profile charities, including the Independent Sector, the National Council of Nonprofits, the Council on Foundations, the Salvation Army, and Catholic Charities. But some question the severity of the impact on charities, noting that an expected decline in charitable giving of 3-4 percent can hardly be called "dire" or "devastating."
- IRS Statistics demonstrate that the taxpayers who give the largest percentage of their income to charity are lower income individuals who claim the standard deduction and therefore receive no "benefit" in the form of an itemized deduction for making gifts to charity. To illustrate, IRS statistics from the 2014 Statistics of Income (SOI) bulletin reveal that the taxpayers making the largest gifts to charity as a percentage of adjusted gross income were those with AGI under \$25,000. These taxpayers contributed, on average, 12.3 percent of their AGI to charity. Taxpayers with AGI of \$25,000 to \$50,000 were the next most generous, giving 6.8 percent of their AGI to charity. In other words, those persons giving the largest percentage of their AGI to charity were those with the least income, even though few of them had itemized deductions in excess of the standard deduction and therefore received no tax "benefit" from giving to charity. Conversely, taxpayers making the most income generally give the

smallest percentage to charity. According to the 2014 SOI, taxpayers giving the least to charity were those with an AGI of \$200,000 to \$500,000 (2.6 percent) and \$500,000 to \$1 million (2.8 percent)--even though these taxpayers *could deduct charitable contributions on their tax return* (though reduced by the so-called "Pease limitation," defined below).

- Some are suggesting that some donors will be incentivized to give more to charity because of their concern over the potentially negative impact of the Act's substantial increase in the standard deduction on charitable giving.
- Perhaps more so than any other charitable donors, those who give to their church or other religious organization do so out of a desire to benefit the recipient rather than provide a tax break for themselves. Of course, the same could be said for many who donate to secular charities.
- Some tax advisors are recommending that donors consider "bunching" their contributions to charity, making no contributions in one year, and doubling contributions in the next so that the augmented amount will exceed the standard deduction and allow persons to deduct their contributions as an itemized deduction. Whether this strategy will gain traction with church members remains to be seen. Remember, it would only be appealing to the 5% of taxpayers whose contributions exceed their standard deduction.
- The Act retains seven income tax brackets, but at lower tax rates and thresholds, than its predecessor. Generally, lower tax brackets decrease the value of charitable contributions since they reduce marginal income by a lesser amount. This is another example of how the new tax law may suppress charitable giving, at least for higher income individuals.
- Should the substantial increase in the standard deduction result in a material decline in charitable giving, there will be increasing pressure on Congress from a wide array of prominent religious and secular charities to provide relief.

"According to estimates by the staff of the Joint Committee on Taxation, approximately 94-percent of taxpayers will claim the standard deduction under the bill, up from approximately 70-percent under present law. These taxpayers will no longer have to file Schedule A to Form 1040." *Joint House-Senate Conference Committee report*

## **(2) percentage limits on charitable contributions**

Charitable contributions by individual taxpayers are limited to a specified percentage of AGI. Previously, the deduction for charitable contributions by an individual taxpayer of cash and property could not exceed 50 percent of the taxpayer's AGI. The Tax Cuts and Jobs Act increases the percentage limit from 50 percent to 60 percent of AGI.

**Key point.** *The House bill contained a number of other modifications of the charitable deduction, including an increase in the charitable mileage rate that were rejected by the Senate and not incorporated into the final text of the Act.*

## **3. Qualified tuition reduction exclusion**

Many churches operate schools and offer tuition discounts to employees of both the school and church whose children attend the school. For example, a church operates a private school (kindergarten through grade 12). The annual tuition is \$4,000. The school allows the children of its employees to attend at half tuition. Are there tax consequences to these tuition discounts? Do the tuition reductions represent taxable income to the parents, or are they nontaxable? If they are nontaxable, what conditions apply?

Section 117(d) of the tax code specifies that qualified tuition reductions are not taxable. To be qualified, however, certain conditions must be met. These include the following:

- The tuition reduction is provided to an employee of "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."
- If the tuition reduction is for education below the graduate level, (1) the recipient is an employee of the eligible educational institution; (2) the recipient no longer is an employee of the eligible educational institution due to retirement or disability; (3) the recipient is a widow or widower of an individual who died while an employee of the eligible educational institution or who retired or left on disability; (4) the recipient is the dependent child or spouse of an individual described in (1) through (3) above.
- A tuition reduction for graduate education is qualified, and therefore tax-free, if both of the following requirements are met: (1) it is provided by an eligible educational institution, and (2) the recipient is a graduate student who performs teaching or research activities for the educational institution. A recipient must include in income any other tuition reductions for graduate education.
- "Highly compensated employees" cannot exclude qualified tuition reductions from their gross income unless the same benefit "is available on substantially similar terms" to non-highly compensated employees. For 2018 the term *highly compensated employee* refers to any employee whose annual compensation for the "look-back" year of 2017 exceeded \$120,000. The fact that a highly compensated employee must report the value of a tuition reduction in his or her income for tax reporting purposes does not affect the right of employees who are not highly compensated to exclude the value of tuition reductions from their income.

The House bill would have repealed the exclusion for qualified tuition reductions, but the final version of the Act retains it.

**Example.** *A church operates a K-12 school, and charges annual tuition of \$4,000. The children of school employees receive a 50 percent reduction in tuition. These reductions represent taxable income to the employees.*

#### **4. Expansion of the "section 529" deduction to private church schools**

A "section 529 plan" (also known as a "qualified tuition plan") is a plan operated by a state or educational institution with tax advantages and potentially other incentives to make it easier to save for college and other post-secondary training for a designated beneficiary, such as a child or grandchild.

The main tax advantage of a 529 plan is that earnings are not subject to federal tax and generally are not subject to state tax when used for the qualified education expenses of the designated beneficiary, such as tuition, fees, books, as well as room and board. Contributions to a 529 plan, however, are not deductible.

Contributions to a 529 plan cannot exceed the amount necessary to provide for the qualified education expenses of the beneficiary. If you contribute to a 529 plan, however, be aware that there may be gift tax consequences if your contributions, plus any other gifts, to a particular beneficiary exceed \$15,000 during the year.

The Tax Cuts and Jobs Act modifies section 529 plans to allow such plans to distribute *not more than \$10,000* in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, *private or religious elementary or secondary school*. This limitation applies on a per-student basis, rather than a per-account basis. Thus, although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of \$10,000 in distributions free of tax, regardless of whether the funds are distributed from multiple accounts. Any excess distributions received by the individual would be treated as a distribution subject to tax under the general rules of section 529.

The House bill further modified the definition of higher education expenses to include certain expenses incurred in connection with a *homeschool*, including:

- curriculum and curricular materials;
- books or other instructional materials;
- online educational materials;
- tuition for tutoring or educational classes outside of the home (but only if the tutor or instructor is not related to the student);
- dual enrollment in an institution of higher education; and
- educational therapies for students with disabilities.

The extension of section 529 plans to homeschools was not included in the final version of the Tax Cuts and Jobs Act.

**Key point.** *Church leaders should note an important modification to section 529 plans after 2017: 529 accounts can distribute up to \$10,000 for tuition incurred during the year in connection with the enrollment or attendance of a designated beneficiary at a religious elementary or secondary school.*

**Key point.** *Even if a 529 plan is used to finance a student's education, the student or the student's parents still may be eligible to claim the American opportunity credit or the lifetime learning credit.*

## **5. Repeal of the "Pease limit" on itemized deductions**

In the past, the total amount of most itemized deductions was limited for certain upper-income taxpayers by the so-called "Pease limit" (named after the congressman who proposed it). In general, the total amount of itemized deductions was reduced by three percent of the amount by which the taxpayer's adjusted gross income exceeded a threshold amount.

For 2017, the threshold amounts were \$261,500 for single taxpayers, \$287,650 for heads of household, \$313,800 for married couples filing jointly, and \$156,900 for

married taxpayers filing separately. These threshold amounts were indexed for inflation. The otherwise allowable itemized deductions could not be reduced by more than 80 percent by reason of the overall limit on itemized deductions.

The Tax Cuts and Jobs Act repeals the overall limitation on itemized deductions. The provision is effective for taxable years beginning after December 31, 2017, will not apply to taxable years beginning after December 31, 2025, unless extended by Congress.

**Example.** *A married couple with adjusted gross income of \$400,000 in 2017 makes charitable contributions to their church of \$50,000. Based on these facts alone, the couple's deduction would be reduced by \$2,436 (three percent of the amount by which their AGI exceeds the \$313,800 threshold amount for married couples filing a joint return). As a result, the couple's charitable contribution deduction would be \$47,564 (\$50,000 less \$2,436).*

**Example.** *Same facts as the previous example, except that the couple makes their contribution in 2018. The Pease limit no longer applies, and so the couple's \$50,000 donation is not reduced by three percent of the amount by which their AGI exceeds a threshold.*

**Example.** *A single person with adjusted gross income of \$500,000 in 2017 made charitable contributions to his church of \$75,000. Based on these facts alone, the donor's deduction would be reduced by \$7,155 (three percent of the amount by which his AGI exceeds the \$261,500 threshold amount for single persons). As a result, the donor's charitable contribution deduction would be reduced from \$75,000 to \$67,845.*

**Example.** *Same facts as the previous example, except that the taxpayer makes his contribution in 2018. The Pease limit no longer applies, and so his \$75,000 donation is not reduced by three percent of the amount by which the couple's AGI exceeds a threshold.*

## **6. New withholding tables**

The House-Senate Conference Committee addressed the new law's effect on withholding and tax forms as follows:

The IRS will need to adjust its wage withholding tables to reflect the repeal of personal exemptions. Because revised wage withholding will occur within the first month of 2018, this would require employers to switch to new withholding tables somewhat quickly, which can be expected to result in a one-time additional burden for employers (or potential additional costs for employers that rely on a bookkeeping or payroll service).

The IRS will need to modify its forms and publications. The temporary nature of [some] provisions will necessitate that the IRS do this again once the temporary provisions expire.

Some taxpayers who currently itemize deductions may respond . . . by claiming the increased standard deduction in lieu of itemizing. According to estimates by the staff of the Joint Committee on Taxation, approximately 94-percent of taxpayers will claim the standard deduction under the bill, up from

approximately 70-percent under present law. These taxpayers will no longer have to file Schedule A to Form 1040, a significant number of which will no longer need to engage in the record keeping inherent in itemizing below-the-line deductions. Moreover, by claiming the standard deduction, such taxpayers may qualify to use simpler versions of the Form 1040 (i.e., Form 1040EZ or Form 1040A) that are not available to individuals who itemize their deductions. These forms simplify the return preparation process by eliminating from the Form 1040 those items that do not apply to particular taxpayers. This reduction in complexity and record keeping also may result in a decline in the number of individuals using a tax preparation service, or tax preparation software, or a decline in the cost of such service or software. The provision also should reduce the number of disputes between taxpayers and the IRS regarding the substantiation of itemized deductions.

In January, the IRS announced that:

The IRS is working to develop withholding guidance to implement the tax reform bill signed into law on December 22. We anticipate issuing the initial withholding guidance in January, and employers and payroll service providers will be encouraged to implement the changes in February. The IRS emphasizes this information will be designed to work with the existing Forms W-4 that employees have already filed, and no further action by taxpayers is needed at this time.

Use of the new 2018 withholding guidelines will allow taxpayers to begin seeing the changes in their paychecks as early as February. In the meantime, employers and payroll service providers should continue to use the existing 2017 withholding tables and systems.

**Key point.** *The IRS published new withholding tables on January 13, 2018.*

#### **SIDEBAR: Forms W-4 and 1040-ES**

In January, the IRS announced that it anticipates issuing withholding guidance later that month, and employers and payroll service providers are encouraged to implement the changes in February. The IRS noted that this information will be designed to work with the existing W-4 forms that employees have already filed, and no further action by taxpayers is needed at this time. The IRS also noted that use of the new 2018 withholding guidelines will allow taxpayers to begin seeing the changes in their paychecks as early as February. In the meantime, employers and payroll service providers should continue to use the existing 2017 withholding tables and systems.

In addition, many employees will be paying less taxes as a result of the recent tax law, and this will provide an opportunity to have less federal income taxes withheld from their wages. Of course, wages paid to ministers for the performance of ministerial duties are exempt from income tax withholding and are not affected. But, ministers who have not elected voluntary withholding should review their estimated tax liability computed on Form 1040-ES to see if any adjustments in their quarterly payments are warranted.

## 7. Moving Expenses

In the past, if you moved due to a change in your job or business location, or because you started a new job or business, you could deduct your reasonable moving expenses (excluding meals). Deductible moving expenses had to meet both a distance test and time test. The distance test was met if the new job location was at least 50 miles farther from the employee's old home than the old job location was. The time test was met if the employee worked at least 39 weeks during the first 12 months after arriving in the general area of the new job location.

Deductible moving expenses included the reasonable expenses of:

- Moving household goods and personal effects from the former home to the new home, and
- Traveling (including lodging) from the former home to the new home.

**Key point.** *In the past, the value of the moving expense deduction was enhanced by the fact that it was an "above the line" deduction, meaning that it could be claimed whether a taxpayer was able to itemize deductions or not.*

In addition, an employer's reimbursement of an employee's qualified moving expenses was a nontaxable fringe benefit if the arrangement was accountable. This applies to reimbursements paid in 2018 even if the moving expenses were incurred in 2017.

The Tax Cuts and Jobs Act repeals both the moving expense deduction, and the exclusion of employer reimbursements of moving expenses under an accountable arrangement--except in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order.

This provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

**Example.** *A church hires an associate pastor in 2017, and reimburses \$7,500 in expenses the pastor incurs in moving to the new assignment. So long as the requirements summarized above are met, and the church only reimburses expenses pursuant to an accountable arrangement, the \$7,500 is nontaxable.*

**Example.** *Same facts as the previous example, except that the move occurs in 2018. With the elimination of the exclusion for employer reimbursements of qualified moving expenses, the \$7,500 must be added to the pastor's W-2.*

## 8. Elimination of Shared Responsibility Payment for Individuals Failing to Maintain Minimal Essential Health Coverage

Under the Affordable Care Act (Obamacare) individuals must be covered by a health plan that provides at least minimum essential coverage or be subject to a tax (also referred to as a penalty) for failure to maintain the coverage (commonly referred to as the "individual mandate"). Minimum essential coverage includes government-sponsored programs (including Medicare, Medicaid, and CHIP, among others), eligible

employer-sponsored plans, plans in the individual market, grandfathered group health plans and grandfathered health insurance coverage, and other coverage as recognized by the Secretary of Health and Human Services. The tax is imposed for any month that an individual does not have minimum essential coverage unless the individual qualifies for an exemption.

The tax for any calendar month is one-twelfth of the tax calculated as an annual amount. The annual amount is equal to the greater of a flat dollar amount or an excess income amount. The flat dollar amount is the lesser of (1) the sum of the individual annual dollar amounts for the members of the taxpayer's family and (2) 300 percent of the adult individual dollar amount. The individual adult annual dollar amount is \$695 for 2017 and 2018. For an individual who has not attained age 18, the individual annual dollar amount is one half of the adult amount. The excess income amount is 2.5 percent of the excess of the taxpayer's household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return. The total annual household payment may not exceed the national average annual premium for bronze level health plans for the applicable family size offered through Exchanges that year.

Exemptions from the requirement to maintain minimum essential coverage are provided for the following:

- an individual for whom coverage is unaffordable because the required contribution exceeds 8.16 percent of household income;
- an individual with household income below the income tax return filing threshold;
- a member of an Indian tribe;
- a member of certain recognized religious sects or a health sharing ministry;
- an individual with a coverage gap for a continuous period of less than three months; and
- an individual who is determined by the Secretary of HHS to have suffered a hardship with respect to the capability to obtain coverage.

The Tax Cuts and Jobs Act reduces the amount of the ACA's individual responsibility payment to zero with respect to health coverage status for months beginning after December 31, 2018.

## **Part 2: Education**

The Tax Cuts and Jobs Act contains a number of provisions pertaining to education. One of these have been addressed above (expansion of "529 plans" to religious elementary and secondary schools). Other provisions pertaining to education are summarized below.

### **9. American Opportunity Tax Credit**

The American Opportunity Tax Credit provides individuals with a tax credit of up to \$2,500 per eligible student per year for qualified tuition and related expenses (including course materials) paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses, and 25 percent on the next \$2,000 of qualified tuition and related expenses.

The American Opportunity Tax Credit is phased out ratably for taxpayers with modified AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing a joint return). Forty percent of a taxpayer's otherwise allowable modified credit is refundable. A refundable credit is a credit which, if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

No credit is allowed to a taxpayer who fails to include the taxpayer identification number of the student to whom the qualified tuition and related expenses relate.

The Tax Cuts and Jobs Act does not affect the American Opportunity Tax Credit.

### **10. Lifetime Learner Credit**

Individual taxpayers may be eligible to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. Up to \$10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (*i.e.*, the maximum credit per taxpayer return is \$2,000).

In contrast to the American Opportunity credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the American Opportunity credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family—that is, the American Opportunity credit is computed on a per-student basis while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$56,000 and \$66,000 (\$112,000 and \$132,000 for married taxpayers filing a joint return) in 2017.

The House version of the Tax Cuts and Jobs Act of 2017 repealed the Lifetime Learning Credit, but it was retained in the final version of the Act.

### **11. Scholarships**

The tax code's exclusion of qualified scholarships from the definition of taxable income is not changed.

### **12. Tuition and Fees Deduction Expires**

For taxable years beginning before January 1, 2017, an individual was allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year. Qualified tuition included tuition and fees required for the enrollment or attendance by the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction. The expenses had to be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year.

The deduction was not available for tuition and related expenses paid for elementary or secondary education. The maximum deduction was \$4,000 for an individual whose AGI for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose AGI does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction was allowed for an individual whose AGI exceeded the relevant AGI limitations, for a married individual who did not file a joint return, or for an individual with respect to whom a personal exemption deduction could be claimed by another taxpayer for the taxable year.

This deduction expired for taxable years beginning after December 31, 2016, and was not extended by the Tax Cuts and Jobs Act.

### **13. Education Exception to IRA Distribution Penalty**

Even if you are under age 59 1/2, if you paid expenses for higher education during the year, part (or all) of any IRA distribution may not be subject to the 10% additional tax on early distributions. The part not subject to the tax is generally the amount that is not more than the qualified higher education expenses for the year for education furnished at an eligible educational institution. The education must be for you, your spouse, or the children or grandchildren.

Qualified higher education expenses are tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible educational institution. They also include expenses for special needs services incurred by or for special needs students in connection with their enrollment or attendance. In addition, if the individual is at least a half-time student, room and board are qualified higher education expenses.

The Tax Cuts and Jobs Act of 2017 does not modify or repeal the exemption of traditional IRA distributions to pay qualified education expenses from the 10% additional tax penalty on early distributions.

### **14. Work-related Educational Expenses**

In the past, employees could deduct expenses incurred for education, such as tuition, books, supplies, correspondence courses, and certain travel and transportation expenses, even though the education could lead to a degree, if the education

- was required by your employer, or by law or regulation, to keep your salary, status, or job, or
- maintained or improved skills required in your present work.

However, employees could not deduct expenses incurred for education, even if one or both of the above-mentioned requirements was met, if the education

- was required in order to meet the minimum educational requirements to qualify you in your trade or business, or
- was part of a program of study that would lead to qualifying you in a new trade or business, even if you did not intend to enter that trade or business.

You can deduct the costs of qualifying, work-related education as a business expense even if the education could lead to a degree.

The Tax Cuts and Jobs Act eliminates any deduction for unreimbursed employee business expenses, including education.

**Key point.** *Self-employed taxpayers may continue to deduct work-related education expenses.*

**Key point.** *Employees may be eligible for American Opportunity Tax Credit or Lifetime Learner credit, summarized above.*

### **Part 3: Other Tax Law Changes**

#### **15. Repeal of Deduction for Personal Exemptions**

Under prior law, in determining taxable income, an individual reduced AGI by any personal exemption deductions and either the applicable standard deduction or itemized deductions. Personal exemptions generally were allowed for the taxpayer, the taxpayer's spouse, and any dependents.

For 2017, the amount deductible for each personal exemption was \$4,050. This amount is indexed annually for inflation, and would have been \$4,150 for 2018. The personal exemption amount was phased out in the case of an individual with AGI in excess of \$313,800 for married taxpayers filing jointly, \$287,650 for heads of household, \$156,900 for married taxpayers filing separately, and \$261,500 for all other filers. In addition, no personal exemption was allowed in the case of a dependent if a deduction was allowed to another taxpayer.

##### *Withholding rules*

Under prior law, the amount of tax required to be withheld by employers from an employee's wages was based in part on the number of withholding allowances an employee claimed on his or her Form W-4 (Withholding Allowance Certificate). The number of allowances was based in part on the number of personal exemptions a taxpayer expected to claim on his or her federal tax return. Personal exemptions were allowed for the employee (unless the employee could be claimed as a dependent of another person) and each of the employee's dependents.

##### *Filing requirements*

For 2017, unmarried individuals were required to file a federal tax return if their gross income exceeded \$10,400 (the personal exemption amount of \$4,050 plus the standard deduction of \$6,350 for unmarried taxpayers). These amounts were increased by \$1,550 for taxpayers age 65 or older, or blind.

A married couple was required to file a tax return for 2017 if their gross income exceeded \$20,800 (the personal exemption amount of \$4,050 for both spouses plus the standard deduction of \$12,700 for married taxpayers filing a joint return). These amounts were increased by \$1,250 for taxpayers age 65 or older, or blind.

##### *The Tax Cuts and Jobs Act*

The House version of the Tax Cuts and Jobs Act repealed the deduction for personal exemptions, and modified the requirements for those who are required to file a tax return. For 2018, single taxpayers would have been required to file a tax return if their

gross income exceeded the applicable standard deduction (\$6,500) and would not be increased by the personal exemption amount (\$4,150). Married individuals would have been required to file a return if their gross income, when combined with their spouse's gross income, was more than the standard deduction applicable to a joint return (\$13,000) and would not be increased by the personal exemption amount (\$4,150) for each spouse.

The House bill directed the Secretary of the Treasury to develop rules to determine the amount of tax required to be withheld by employers from a taxpayer's wages.

The Senate followed the House bill in modifying the requirements for those who are required to file a tax return. Further, the provision did not apply to taxable years beginning after December 31, 2025.

The conference agreement followed the Senate amendment and suspends the deduction for personal exemptions. The suspension does not apply to taxable years beginning after December 31, 2025, unless extended by Congress. The conference agreement generally follows the House bill in modifying the withholding rules to reflect that taxpayers no longer claim personal exemptions under the conference agreement.

The repeal of the personal exemption is effective for taxable years beginning after December 31, 2017. The conference agreement provides that the Secretary of the Treasury may administer the tax withholding rules for taxable years beginning before January 1, 2019, without regard to the amendments made under this provision. Thus, at the Secretary's discretion, wage withholding rules may remain the same as under present law for 2018.

**Key point.** *As noted above, the new law's substantial increase in the standard deduction will necessitate new tax withholding tables. The elimination of personal exemptions has the same effect. The House-Senate Conference Committee addressed the new law's effect on withholding as follows: "The IRS will need to adjust its wage withholding tables to reflect the repeal of personal exemptions. Because revised wage withholding will occur within the first month of 2018, this would require employers to switch to new withholding tables somewhat quickly, which can be expected to result in a one-time additional burden for employers (or potential additional costs for employers that rely on a bookkeeping or payroll service)."*

## **16. Tax brackets**

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2017, there were seven separate tax brackets based on income, with tax rates of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.

The individual income tax rate schedules for single persons and married couples filing jointly for 2017 are set forth in Tables 1 and 2.

### **TABLE 1.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2017:**

**SINGLE PERSONS**

<b>if taxable income is:</b>	<b>then income tax equals:</b>
not over \$9,325	10% of taxable income
over \$9,325 but not over \$37,950	\$932.50 plus 15% of the excess over \$9,325
over \$37,950 but not over \$91,900	\$5,226.25 plus 25% of the excess over \$37,950
over \$91,900 but not over \$191,650	\$18,713.75 plus 28% of the excess over \$91,900
over \$191,650 but not over \$416,700	\$46,643.75 plus 33% of the excess over \$191,650
over \$416,700 but not over \$418,400	\$120,910.25 plus 35% of the excess over \$416,700
over \$418,400	\$121,505.25 plus 39.6% of the excess over \$418,400

**TABLE 2.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2017: MARRIED PERSONS FILING JOINT RETURNS**

<b>if taxable income is:</b>	<b>then income tax equals:</b>
not over \$18,650	10% of taxable income
over \$18,650 but not over \$75,900	\$1,865 plus 15% of the excess over \$18,650
over \$75,900 but not over \$153,100	\$10,452.50 plus 25% of the excess over \$75,900
over \$153,100 but not over \$233,350	\$29,752.50 plus 28% of the excess over \$153,100
over \$233,350 but not over \$416,700	\$52,222.50 plus 33% of the excess over \$233,350
over \$416,700 but not over \$470,700	\$112,728 plus 35% of the excess over \$416,700
over \$470,700	\$131,628 plus 39.6% of the excess over \$470,700

Beginning with 2018, the Tax Cuts and Jobs Act retains seven income tax brackets, but reduces the income tax percentages to 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The new rates, and income ranges, for both single and married taxpayers are summarized in Tables 3 and 4. The new rates "sunset" (i.e., are repealed) for tax years beginning after December 31, 2025, and at that time the rates revert to those in effect in 2017 unless extended by Congress.

**Key point.** *The new rates sunset for tax years beginning after December 31, 2025.*

**TABLE 3.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2018: SINGLE PERSONS**

<b>if taxable income is:</b>	<b>then income tax equals:</b>
not over \$9,525	10% of taxable income
over \$9,525 but not over \$38,700	\$952.50 plus 12% of the excess over \$9,525
over \$38,700 but not over \$82,500	\$4,453.50 plus 22% of the excess over \$38,700
over \$82,500 but not over \$157,500	\$14,089.50 plus 24% of the excess over \$82,500

over \$157,500 but not over \$200,000	\$32,089.50 plus 32% of the excess over \$157,500
over \$200,000 but not over \$500,000	\$45,689.50 plus 35% of the excess over \$200,000
over \$500,000	\$150,689.50 plus 37% of the excess over \$500,000

**TABLE 4.—FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2018: MARRIED PERSONS FILING JOINT RETURNS**

<b>if taxable income is:</b>	<b>then income tax equals:</b>
not over \$19,050	10% of taxable income
over \$19,050 but not over \$77,400	\$1,905 plus 12% of the excess over \$19,050
over \$77,400 but not over \$165,000	\$8,907 plus 22% of the excess over \$77,400
over \$165,000 but not over \$315,000	\$28,179 plus 24% of the excess over \$165,000
over \$315,000 but not over \$400,000	\$64,179 plus 32% of the excess over \$315,000
over \$400,000 but not over \$600,000	\$91,379 plus 35% of the excess over \$400,000
over \$600,000	\$161,379 plus 37% of the excess over \$600,000

**Key point.** Beginning with 2018, the Tax Cuts and Jobs Act retains seven income tax brackets, but reduces the income tax percentages from 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%, to 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Note that one's tax liability is not computed by taking the top marginal tax rate times total income. Rather, tax is computed by multiplying income in each bracket times the applicable percentage, as illustrated by the following example.

**Example.** A married couple has combined taxable income of \$100,000 in 2018. Their tax is not their top marginal tax rate of 22 percent multiplied times their taxable income of \$100,000 (i.e., \$22,000). Rather, they pay 10 percent of their first \$19,050 of taxable income, 12 percent of income above \$19,050 but below \$77,400, and 22 percent of the remaining income above \$77,400. This results in a tax liability of \$13,879, and an effective tax rate of 13.8 percent. These calculations are built into the tax tables by computing the couple's tax as "\$8,907 plus 22 percent of income over \$77,400." How does this compare with the couple's tax liability for 2017? Under the tax tables in effect prior to the passage of the Tax Cuts and Jobs Act of 2017, the couple's tax liability would have been "\$10,452.50 plus 25% of the excess over \$75,900," or \$16,477, for an effective rate of 16.4 percent. The bottom line is that the new law provided tax savings of \$2,598 to this couple.

Note, however, that the actual computation of tax savings is more complex. For example, if the couple has two dependent children then the loss of (1) four personal exemptions in 2018 ( $\$4,150 \times 4 = \$16,660$ ) and (2) the standard deduction for a married couple filing a joint return that would have applied if the Tax Cuts and Jobs Act of 2017 had not been enacted (\$13,000), would have resulted in tax-free income of \$29,600. With the new tax law, only the

enhanced standard deduction of \$24,000 of income is tax-free, resulting in an increase of \$5,600 in taxable income.

**Example.** Pastor Jon has taxable income (gross income less exclusions, including a housing allowance) of \$50,000. His wife does not work outside the home and serves as the primary caregiver for their two preschool children. The couple's tax liability is not their top marginal tax rate of 12 percent multiplied times their taxable income of \$50,000 (i.e., \$6,000). Rather, they pay 10 percent of their first \$19,050 of taxable income, and 12 percent of income above \$19,050. This results in a tax liability of \$3,714, and an effective tax rate of 7.48 percent. These calculations are built into the tax tables by computing the couple's tax as "\$1,905 plus 12% of the excess over \$19,050." How does this compare with the couple's tax liability for 2017? Under the tax tables in effect prior to the passage of the Tax Cuts and Jobs Act of 2017, the couple's tax liability would have been "\$1,865 plus 15% of the excess over \$18,650," or \$4,702, for an effective rate of 9.4 percent. The bottom line is that the new law provided tax savings of \$988 to this couple.

As in the previous example, the actual computation of tax savings is more complex. For example, if the couple has two dependent children then the loss of (1) four personal exemptions in 2018 ( $\$4,150 \times 4 = \$16,660$ ) and (2) the standard deduction for a married couple filing a joint return that would have applied if the Tax Cuts and Jobs Act of 2017 had not been enacted ( $\$13,000$ ), would have resulted in tax-free income of \$29,600. With the new tax law, only the enhanced standard deduction of \$24,000 of income is tax-free, resulting in an increase of \$5,600 in taxable income.

**Key point.** The Act retains present-law maximum rates on net capital gains and qualified dividends.

## **17. Repeal of the Miscellaneous Deductions Subject to the Two-Percent AGI Floor**

Under prior law, individuals could claim itemized deductions for certain miscellaneous expenses. Certain of these expenses were not deductible unless, in aggregate, they exceeded two percent of the taxpayer's adjusted gross income. The deductions described below are subject to the aggregate two-percent floor:

- Appraisal fees for a casualty loss or charitable contribution;
- Casualty and theft losses from property used in performing services as an employee;
- Clerical help and office rent in caring for investments;
- Hobby expenses, but generally not more than hobby income;
- Investment fees and expenses;
- Safe deposit box rental fees, except for storing jewelry and other personal effects;
- Trustee's fees for an IRA, if separately billed and paid;
- Tax preparation expenses;
- Unreimbursed employee business expenses (see below);
- Job search expenses in the taxpayer's present occupation;
- Licenses and regulatory fees;
- Passport fees for a business trip;
- Tools and supplies used in the taxpayer's work;

Unreimbursed employee business expenses subject to the 2 percent AGI floor include such items as:

- overnight out-of-town travel;
- local transportation;
- meals (subject to a 50 percent AGI floor);
- entertainment (subject to a 50 percent AGI floor);
- home office expenses;
- business gifts;
- dues to professional societies;
- work-related education;
- work clothes and uniforms if required and not suitable for everyday use;
- malpractice insurance;
- subscriptions to professional journals and trade magazines related to the taxpayer's work; and
- equipment and supplies used in the taxpayer's work.

The Tax Cuts and Jobs Act suspends all miscellaneous itemized deductions that are subject to the 2 percent floor under present law. As a result, taxpayers may not claim the above-listed items as itemized deductions for the taxable years to which the suspension applies.

This provision is effective for taxable years beginning after December 31, 2017, but does not apply for taxable years beginning after December 31, 2025 unless extended by Congress.

**Example.** *Pastor Karen incurs \$4,000 in unreimbursed employee business expenses in 2017 for transportation and education. Pastor Karen could deduct these expenses as a miscellaneous expense on line 21 of Schedule A (Form 1040) subject to a 2 percent of AGI floor.*

**Example.** *Same facts as the previous example, except that these expenses were incurred in 2018. The Tax Cuts and Jobs Act of 2017 makes employee business expenses nondeductible. Pastor Karen may be able to benefit from the American Opportunity and Lifetime Learner Tax Credits for her education expenses.*

**Key point.** *This example illustrates the costs and benefits of tax reform. The substantial increase in the standard deduction, plus other favorable tax provisions, had to be paid for, and eliminating most itemized deductions was one way this was done.*

### **A Possible Workaround?**

The elimination of an itemized deduction for most expenses, including unreimbursed employee business expenses, will hit some clergy hard. Some have suggested the following "workaround" to ease the impact:

(i) Churches could reimburse employees' business expenses under an accountable expense reimbursement arrangement. To be accountable, a church's reimbursement arrangement must comply with all four of the following rules:

- Expenses must have a business connection—that is, the reimbursed expenses must represent expenses incurred by an employee while performing services for the employer.
- Employees are only reimbursed for expenses for which they provide an adequate accounting within a reasonable period of time (not more than 60 days after an expense is incurred).
- Employees must return any excess reimbursement or allowance within a reasonable period of time (not more than 120 days after an excess reimbursement is paid).
- The income tax regulations caution that in order for an employer's reimbursement arrangement to be accountable, it must meet a "reimbursement requirement" in addition to the three requirements summarized above. The reimbursement requirement means that an employer's reimbursements of an employee's business expenses come out of the employer's funds and not by reducing the employee's salary.

The basis for this workaround is the fact that while the Tax Cuts and Jobs Act eliminated "all miscellaneous itemized deductions that are subject to the 2 percent floor under present law" (including unreimbursed employee business expenses), it did not modify or repeal section 62(a)(2)(A) of the tax code, which excludes from tax employer reimbursements of employee business expenses under an accountable plan (defined above).

**Example.** *In 2017, Pastor Bob incurs \$5,000 in unreimbursed business expenses for business-related travel, entertainment, and education. If Pastor Bob was able to itemize deductions using Schedule A (Form 1040), he could deduct these expenses to the extent they exceeded 2 percent of his AGI. If his AGI was \$40,000, then his deduction would be limited to \$4,200 (\$5,000 less 2 percent of AGI).*

**Example.** *Same facts, except the expenses were incurred in 2018. Pastor Bob receives no deduction for unreimbursed employee business expenses since the Tax Cuts and Jobs Act repealed this deduction after 2017. However, if the church adopts an accountable reimbursement plan agreeing to reimburse the pastor's substantiated business expenses, the church's reimbursements would not constitute taxable income to the pastor. This is because while Congress eliminated an itemized tax deduction for unreimbursed business expenses, it did not modify or repeal the tax code's long-standing exclusion of employer reimbursements of an employee's substantiated business expenses under an accountable plan from the employee's taxable income.*

**Key point.** *Church leaders should consider adopting an accountable expense reimbursement arrangement to relieve employees of the burden of paying for their out-of-pocket church-related business expenses without the benefit of a tax deduction.*

(ii) Another idea is for churches to treat clergy and lay staff as self-employed rather than as employees for income tax reporting, enabling them to deduct their unreimbursed business expenses on Schedule C. While it is true that self-employed workers may continue to deduct their work expenses, this strategy should not be implemented without the approval of a tax professional, for two reasons. First, most clergy and lay staff would be employees rather than self-employed under the prevailing tests used by the IRS and Tax Court. Second, the IRS can assess penalties under

section 3509 of the tax code against employers that treat a worker as self-employed whom the IRS later reclassifies as an employee.

## **18. Enhancement of Child Tax Credit and New Family Credit**

Under prior law, an individual could claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child was \$1,000. The aggregate amount of child credits that may be claimed was phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit was reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns.

To the extent the child credit exceeded the taxpayer's tax liability, the taxpayer was eligible for a refundable credit (the "additional child tax credit") equal to 15 percent of earned income in excess of \$3,000. Families with three or more children could determine the additional child tax credit using an alternative formula if this resulted in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equaled the amount by which the taxpayer's Social Security taxes exceeded the taxpayer's earned income credit (EIC).

Earned income was defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings.

**Key point.** *The additional child tax credit was based only on earned income to the extent it was included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and as a result are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.*

The Tax Cuts and Jobs Act temporarily increases the child tax credit to \$2,000 per qualifying child. The credit is further modified to temporarily provide for a \$500 nonrefundable credit for qualifying dependents other than qualifying children (such as aging parents). The provision generally retains the present-law definition of *dependent*.

**Key point.** *The child tax credit is doubled, from \$1,000 to \$2,000 per qualifying child, beginning in 2018, and a new credit of \$500 is established for "non-child" dependents, such as an aging parent.*

**Key point.** *The new child tax credit is "refundable" up to \$1,400, meaning that to the extent the credit exceeds a taxpayer's tax liability (i.e., there are no taxes to reduce), the excess is refunded to the taxpayer.*

Under the conference agreement, the maximum amount refundable may not exceed \$1,400 per qualifying child. Additionally, the conference agreement provides that, in order to receive the child tax credit (i.e., both the refundable and non-refundable portion) a taxpayer must include a Social Security number for each qualifying child for whom the credit is claimed on the tax return. For these purposes, a Social Security number must be issued before the due date for the filing of the return for the taxable

year. This requirement does not apply to a non-child dependent for whom the \$500 nonrefundable credit is claimed.

Further, the conference agreement retains the present-law age limit for a qualifying child. As a result, a qualifying child is an individual who has not attained age 17 during the taxable year. Finally, the conference agreement modifies the adjusted gross income phaseout thresholds. Under the conference agreement, the credit begins to phase out for taxpayers with adjusted gross income in excess of \$400,000 (in the case of married taxpayers filing a joint return) and \$200,000 (for all other taxpayers). These phaseout thresholds are not indexed for inflation.

These new provisions are effective for taxable years beginning after December 31, 2017, and expire for taxable years beginning after December 31, 2025, unless extended by Congress.

**Key point.** *Note that a tax credit is more valuable than a tax deduction, since it represents a dollar for dollar reduction in actual taxes rather than in taxable income. To illustrate, consider a taxpayer in the 22 percent tax bracket. A tax credit of \$1,000 will reduce this person's actual tax liability by \$1,000. But a tax deduction will reduce taxable income, and the tax savings will depend on one's tax bracket. This means that a person in the 22 percent tax bracket will see taxes reduced by 22 percent, or \$220 in this example—much less valuable than a \$1,000 credit that reduces taxes by \$1,000.*

### **19. Deduction for State and Local Taxes (the "SALT deduction")**

Under current law, individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes are:

- State and local real property taxes,
- State and local personal property taxes, and
- State and local income taxes.

At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes. This provision was added to address the unequal treatment of taxpayers in the seven states that do not have an income tax. Taxpayers in these states cannot take advantage of the itemized deduction for state income taxes. Allowing them to deduct sales taxes helps offset this disadvantage.

The Tax Cuts and Jobs Act allows taxpayers to claim an itemized deduction of up to \$10,000 (\$5,000 for married taxpayer filing a separate return) for the aggregate of:

- State and local property taxes, and
- State and local income taxes (or sales taxes in lieu of income taxes) paid or accrued in the taxable year.

The new rules apply to taxable years beginning after December 31, 2017, and beginning before January 1, 2026.

**Key point.** *Some claim that the greatest impact of the new limits on the itemized deduction for state and local taxes will be on high-income taxpayers in left-leaning high-tax states whose state and local tax deduction will be significantly reduced to*

*finance tax cuts in more conservative states. For example, New York Democratic Governor Andrew Cuomo has argued that "this tax provision hits the blue states by eliminating the state and local tax deductibility and uses that money to finance the tax cut in the red states."*

**Key point.** *Some tax analysts are predicting a dip in home values in high-tax states due to the \$10,000 cap on the itemized deduction for state and local taxes and the reduced limit on the deductibility of home mortgage interest (see below).*

## **20. Home mortgage interest**

As a general matter, personal interest is not deductible. Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations. Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and which secures the residence. The maximum amount treated as acquisition indebtedness is \$1 million (\$500,000 in the case of a married person filing a separate return). Acquisition indebtedness also includes indebtedness from the refinancing of other acquisition indebtedness but only to the extent of the amount (and term) of the refinanced indebtedness. For example, if the taxpayer incurs \$200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to \$150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above \$150,000 (except by indebtedness incurred to substantially improve the residence).

Home equity indebtedness is indebtedness (other than acquisition indebtedness) secured by a qualified residence. The amount of home equity indebtedness may not exceed \$100,000 (\$50,000 in the case of a married individual filing a separate return) and may not exceed the fair market value of the residence reduced by the acquisition indebtedness.

The Tax Cuts and Jobs Act provides that, in the case of taxable years beginning after December 31, 2017, and beginning before January 1, 2026, a taxpayer may treat no more than \$750,000 as acquisition indebtedness (\$375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred before December 15, 2017, this limitation is \$1,000,000 (\$500,000 in the case of married taxpayers filing separately).

**Key point.** *For taxable years beginning after December 31, 2025, the previous rules are restored and taxpayers may treat up to \$1,000,000 (\$500,000 in the case of married taxpayers filing separately) of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred. This assumes, however, that Congress does not extend the new rules adopted by the Tax Cuts and Jobs Act of 2017.*

Additionally, the Act suspends the deduction for interest on home equity indebtedness. As a result, for taxable years beginning after December 31, 2017, a taxpayer may not

claim a deduction for interest on home equity indebtedness. The suspension ends for taxable years beginning after December 31, 2025.

## **21. Repeal of casualty and theft deduction**

Under prior law, a taxpayer could claim an itemized deduction for any loss sustained during the taxable year, not compensated by insurance or otherwise. For individual taxpayers, deductible losses had to be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses were deductible only if they exceeded \$100 per casualty or theft. In addition, aggregate net casualty and theft losses were deductible only to the extent they exceeded 10 percent of an individual taxpayer's adjusted gross income.

The Tax Cuts and Jobs Act temporarily modifies the deduction for personal casualty and theft losses. Under the provision, a taxpayer may claim a personal casualty loss (subject to the limitations described above) only if such loss was attributable to a disaster declared by the President under the Disaster Relief and Emergency Assistance Act.

The above-described limitation is effective for losses incurred in taxable years beginning after December 31, 2017, but does not apply with respect to losses incurred after December 31, 2025.

***Example.** A pastor's home is broken into while she is conducting a funeral service for a deceased member of the congregation. Several items are stolen with a value of \$5,000. The loss is not covered under the pastor's home insurance policy. Prior to the enactment of the Tax Cuts and Jobs Act the pastor could have claimed an itemized deduction in the amount of the adjusted basis of the stolen property. But, in 2018, no deduction is allowed.*

## **22. Reinstatement of 7.5% AGI floor for Medical Expenses for All Taxpayers**

Under prior law, individuals could claim an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceeded 10 percent of adjusted gross income. For taxable years beginning before January 1, 2017, the 10 percent threshold was reduced to 7.5 percent in the case of taxpayers who had attained the age of 65 before the close of the taxable year. In the case of married taxpayers, the 7.5 percent threshold applied if either spouse had attained the age of 65 before the close of the taxable year.

The Tax Cuts and Jobs Act provides that, for taxable years beginning after December 31, 2016 and ending before January 1, 2019 (i.e., for 2017 and 2018) the threshold for deducting medical expenses shall be 7.5 percent for all taxpayers.

## **23. The exclusion of gain on the sale of a principal residence**

A taxpayer who is an individual may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the date of the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change

of place of employment, health, or (to the extent provided under regulations) unforeseen circumstances, is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. The exclusion under this provision may not be claimed for more than one sale or exchange during any two-year period.

The House bill would have modified this exclusion in the following ways:

- The exclusion would be available only if a taxpayer owned and used the residence as a principal residence for at least five of the eight years;
- The exclusion could not apply to more than one sale or exchange during any five-year period.
- The exclusion would be phased out by one dollar for every dollar a taxpayer's AGI exceeds \$250,000 (\$500,000 if married filing a joint return).

The final text of the Act rejected the changes proposed in the House bill.

#### **24. Alternative minimum tax**

An alternative minimum tax (AMT) is imposed on an individual in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. For taxable years beginning in 2017, the tentative minimum tax was the sum of (1) 26 percent of so much of the taxable excess as did not exceed \$187,800 (\$93,900 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The breakpoints were indexed for inflation. The taxable excess is so much of the alternative minimum taxable income (AMTI) as exceeded the exemption amount.

The exemption amounts for taxable years beginning in 2017 were: (1) \$84,500 in the case of married individuals filing a joint return, and surviving spouses; (2) \$54,300 in the case of other unmarried individuals; and (3) \$42,250 in the case of married individuals filing separate returns. For taxable years beginning in 2017, the exemption amounts were phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeded (1) \$160,900 in the case of married individuals filing a joint return and surviving spouses, (2) \$120,700 in the case of other unmarried individuals, and (3) \$80,450 in the case of married individuals filing separate returns or an estate or a trust. The amounts are indexed for inflation. AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The Tax Cuts and Jobs Act of 2017 temporarily increases both the exemption amount and the exemption amount phaseout thresholds for the individual AMT. Under the provision, for taxable years beginning after December 31, 2017, and beginning before January 1, 2026, the AMT exemption amount is increased to \$109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), and \$70,300 for all other taxpayers. The phaseout thresholds are increased to \$1,000,000 for married taxpayers filing a joint return, and \$500,000 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.

**Key point.** *The AMT was enacted by Congress in 1969 in response to public outrage over the disclosure that 155 wealthy Americans paid no federal income*

*taxes. From its humble beginnings a half century ago, affecting a handful of taxpayers, the AMT steadily captured more and more Americans. According to the Tax Foundation, 9.7 million Americans had to do the AMT calculations last year, and of these, 3.9 million owed additional taxes. The modifications contained in the recent tax reform legislation do not repeal the AMT, but insure that very few taxpayers will be impacted by it.*

## **25. Estate Tax**

The Tax Cuts and Jobs Act doubles the estate and gift tax exemption for estates of decedents dying after December 31, 2017, and before January 1, 2026. This is accomplished by increasing the basic exclusion amount provided in section 2010(c)(3) of the tax code from \$5 million to \$10 million. The \$10 million amount is indexed for inflation occurring after 2011, and for 2018 is \$11.2 million. This amount can be doubled to \$22.4 million for married couples who establish a marital deduction trust or qualified terminable interest property trust ("QTIP" trust)

### **Conclusion**

In conclusion, consider two points:

First, there are many other provisions in the 1,097-page tax reform legislation that are beyond the scope of this presentation. I have attempted to highlight those having the greatest relevance to churches and church staff. I have written a much more detailed analysis of the new law that you can access on my website, [churchlawandtax.com](http://churchlawandtax.com).

Second, it is impossible to draw generalizations about the impact of the new law in individual cases. It depends on all the unique facts and circumstances of each case. But generally, items that likely will reduce tax liability include:

- the lower tax brackets and thresholds;
- the lower tax rates;
- the substantial increase in the standard deduction;
- expansion of the 529 plan rules to allow distributions of up to \$10,000 for a student attending an elementary or secondary church school;
- repeal of the Affordable Care Act's individual responsibility penalty for failure to maintain minimum essential coverage; and,
- the doubling of the child tax credit and a new credit of \$500 for non-child dependents.

And, if you incur any out-of-pocket unreimbursed employee business expenses, be sure that your church adopts an accountable expense reimbursement arrangement to relieve employees of the burden of paying their out-of-pocket church-related business expenses without the benefit of a tax deduction.

Since most of the new law's provisions will not apply until your 2018 tax return, most of us will have to await until April 15, 2019, to see if we are better off, and if so, by how much.