Tax Tune-Up

What's New in the Tax Cuts and Jobs Act of 2017

BY SAM SCHMITT

On Dec. 22, 2017, President Donald Trump signed the final version of House Resolution 1 (known as H.R, 1), which amends various sections of the Internal Revenue Code of 1986. Also known as the Tax Cut and Jobs Act of 2017, the 185-page law makes several changes to the tax provisions summarized in the AFSA 2017 Tax Guide, published in the January-February *Foreign Service Journal,* two of which will immediately affect AFSA members whose taxes are due this month. The remaining amendments, which generally take effect in 2018 (for filing in April 2019), center on a reduction in the corporate income tax rate and repatriating foreign profits currently sheltered from tax overseas.

The new tax law makes wide-ranging changes that will affect both individuals and businesses, with many changes to the individual tax laws sun-setting in 2026. For the individual taxpayer, the new law cuts the marginal tax rates, consolidates the personal exemption with the standard deduction, eliminates some deductions while increasing others and effectively eliminates the individual mandate of the Affordable Care Act. The net effect of the changes can reasonably be expected to emphasize private-sector investment and require increased public-sector efficiency.

This article summarizes those portions of the tax law that are most significant generally, as well as those that are most important to the Foreign Service community. A particular emphasis will be placed on changes to the provisions reviewed in the AFSA 2017 Tax Guide. The article simplifies the most significant portions of the new law. There is no substitute for reading the statutes themselves and retaining the services of a tax professional before applying the new rules in an income tax return. It is also important to note that changes to the law and its interpretation (possibly even corrective legislation) should be expected as its effects and meaning become clear over the year.

Changes That Take Effect Immediately

Amendments to some of the laws we summarized in the AFSA 2017 Tax Guide have already taken effect. Filers need to be aware that these changes must be accounted for in their 2017 tax returns due in April 2018.

- **7.5 percent floor for medical and dental expenses, applicable to 2017 taxes (filed in April 2018)**

The amended tax law allows taxpayers who itemize to deduct medical expenses to the extent they exceed 7.5 percent of the adjusted gross income (AGI). Without the amendments, this floor would have increased to 10 percent for 2017 taxes (filed in April 2018). The 7.5 percent floor will remain in effect for 2018 (filed in April 2019).

- **Estate tax planning, gifts and retirement contributions**

The new law also increases the lifetime gift and estate exclusion to the first $10 million ($11.2 million adjusted for inflation) gifted or bequeathed in 2018. It is important to understand that gift and estate taxes are connected. The use of this exemption on one's taxable lifetime gifts reduces the total exemption allowed for bequests at death. Any unused portion of one's lifetime exemption may be transferred to a surviving spouse with a portability election on the decedent's final tax return. If gifts of less than $15,000 per person per year ($30,000 for joint gifts split between spouses) or gifts otherwise exempt from the gift tax regime (such as gifts between spouses) are the only gifts made during a taxpayer's life, the surviving spouse may then exclude up to $22.4 million from the federal gift and estate tax.

Changes to Tax Laws Applicable to the 2018 Tax Year (filed in April 2019)

The amendments to some of the laws we summarized in the AFSA 2017 Tax Guide will not affect members' tax returns until they file 2018 taxes in April 2019.

Individual Taxes

H.R. 1 made significant changes to individual income tax provisions, most of which sunset at the end of 2025 as a condition of budget reconciliation rules that were required to pass the law with fewer than 60 votes in the Senate. The reduction in each marginal tax rate and increase in the dollar limits for each corresponding income bracket were chief among those changes. The number of tax brackets remains the same despite significant political debate about consolidating some (see chart). The long-term capital gains rates of 0 percent, 15 percent and 20 percent, and their associated income brackets, were not changed other than to adjust for inflation.

New Tax Brackets for 2018

- **Increased standard deduction and eliminated personal exemption**

H.R. 1 effectively combined the personal exemption ($4,050 in 2017) with an increased standard deduction for

Comparison of 2017 and 2018 Individual Income Tax Brackets & Rates					
	2017 Marginal Rates & Brackets		2018 Marginal Rates & Brackets		
2017	**Unmarried Individuals**				**2018**
	Lower Limit	Upper Limit	Lower Limit	Upper Limit	
10%	$0	$9,325	$0	$9,525	10%
15%	$9,326	$37,950	$9,526	$38,700	12%
25%	$37,951	$91,900	$38,701	$82,500	22%
28%	$91,901	$191,650	$82,501	$157,500	24%
33%	$191,651	$416,700	$157,501	$200,000	32%
35%	$416,701	$418,400	$200,001	$500,000	35%
39.60%	$418,401	Unlimited	$500,001	Unlimited	37%
2017	**Married Filing Jointly**				**2018**
	Lower Limit	Upper Limit	Lower Limit	Upper Limit	
10%	$0	$18,650	$0	$19,050	10%
15%	$18,651	$75,900	$19,051	$77,400	12%
25%	$75,901	$153,100	$77,401	$165,000	22%
28%	$153,101	$233,350	$165,001	$315,000	24%
33%	$233,351	$416,700	$315,001	$400,000	32%
35%	$416,701	$470,700	$400,001	$600,000	35%
39.60%	$470,701	Unlimited	$600,001	Unlimited	37%
2017	**Head of Household**				**2018**
	Lower Limit	Upper Limit	Lower Limit	Upper Limit	
10%	$0	$13,350	$0	$13,600	10%
15%	$13,351	$50,800	$13,601	$51,800	12%
25%	$50,801	$131,200	$51,801	$82,500	22%
28%	$131,201	$212,500	$82,501	$157,500	24%
33%	$212,501	$416,700	$157,501	$200,000	32%
35%	$416,701	$444,550	$200,001	$500,000	35%
39.60%	$444,551	Unlimited	$500,001	Unlimited	37%

a single tax benefit of $12,000 in 2018 ($24,000 married filing jointly). This simplification should be considered along with the new brackets, increased child tax credit (increasing to $2,000 for each child, with a non-refundable deduction of $500 for non-child dependents in 2018), and suspension of miscellaneous itemized deductions to fairly gauge the effect of the new law on one's tax return.

- **Suspension of miscellaneous itemized deductions**

H.R. 1 suspends miscellaneous itemized deductions until the end of 2025. This broad deduction previously allowed itemizers to deduct unreimbursed employee expenses (business liability insurance premiums, depreciation of a personal computer used to produce income, dues to professional societies, educator expenses and much more); tax preparation fees; and "other expenses," including appraisal fees for casualty losses and charitable contributions, hobby expenses to the extent of hobby income, investment fees and expenses, safe deposit box rentals and more. Members of the Foreign Service who itemized deductions in 2017 should consult a tax professional about other options for deducting expenses incurred for home leave, unreimbursed representational expenses and unreimbursed moving expenses in 2018. The 2016 version of IRS Publication 529 contains a more inclusive list of expenses taxpayers may have once deducted as miscellaneous itemized deductions but that should not be deducted again until after 2025.

Several members have expressed concern that some reimbursed or employer-paid employee expenses (like Permanent Change of Station moving expenses) might become taxable with the suspension of the IRC Section 217 deduction for moving expenses paid by an employer. However, H.R 1 did not touch the IRC Section 912 exclusion for civilian officers and employees for "allowances or otherwise (but not amounts received as post differentials)" paid by the Secretary under the Foreign Service Act. Such allowances include department payments (and reimbursements) of

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costs and expenses incurred for:

(1) Travel to and from post;

(2) Authorized or required home leave;

(3) Family members to accompany a member on temporary duty;

(4) Representational travel within the host country to which a member is assigned;

(5) Obtaining necessary medical care for an illness, injury or medical condition while abroad under certain circumstances;

(6) R&R travel of family members;

(7) Removal of family members, furniture and household and personal effects (including automobiles) from post where there is imminent danger;

(8) Trips by a member of the Service, and members of his or her family, for purposes of family visitation in certain situations;

(9) Transporting the furniture, household and personal effects of a member of the Service (and of his or her family) to successive posts of duty and, on separation of a member from the Service, to the place where the member will reside;

(10) Packing and unpacking, transporting to and from a place of storage, and storing the furniture and household and personal effects of a member of the Service (and of his or her family);

(11) Transporting, for or on behalf of a member of the Service, a privately owned motor vehicle under certain conditions;

(12) Travel and relocation of members of the Service, and members of their families, assigned to or within the United States and some territories;

(13) A round-trip to post each year for each child who is under 21; and

(14) Several other expenses.

AFSA recommends reading IRC Section 912 in its entirety for full details on each of these expenses, which have been simplified here.

AFSA requested additional input from Charleston General Financial Services on this issue. Based on an unofficial opinion from the IRS, CGFS confirms that all travel authorized under Section 901 of the Foreign Service Act, which includes Permanent Change of Station (PCS), R&R, emergency visitation travel, medevacs, etc., is exempt from taxation under the terms of IRC Section 912.

There were no changes to the exclusion of lodging benefits furnished to employees for the convenience of the employer despite an earlier House proposal to limit this benefit.

• Deduction for state and local taxes capped at $10,000

A new $10,000 limit ($5,000 married filing separately, not indexed for inflation) on the deduction for state and local taxes is one of the more controversial elements of H.R. 1. Prior to the amendment, which expires at the end of 2025, there was no aggregate limit to the deduction allowed for state, local and foreign real property taxes; state and local personal property taxes; state, local and foreign income taxes; and state and local sales taxes (in lieu of income taxes). Foreign real property taxes may no longer be deducted, though foreign income tax is still deductible. Foreign value added taxes (VAT) have never been deductible under this provision.

• Home mortgage interest deduction

Somewhat unexpectedly, the new law reins in the deduction for home mortgage interest. For all acquisition indebtedness incurred after Dec. 15, 2017, a taxpayer may only deduct the mortgage interest on up to $750,000 of acquisition debt ($350,000 married filing separately). The interest on home equity loans is no longer deductible.

Both the House and Senate versions of H.R. 1 would have extended the amount of time homeowners had to own and occupy their principal residences to exclude up to $250,000 ($500,000 married filing jointly), but the conference committee dropped the change.

No changes were made to the definition of a residence that qualifies for the home mortgage interest deduction. The mortgage interest deduction may be applied to a principal residence and up to one other residence that is also used by a taxpayer as a residence during the year.

• 1031s apply to domestic real estate only

The new law places new limits on Section 1031 like-kind exchanges. Only exchanges of like-kind real property held for the production of income may be traded without recognizing gain. Property within the United States may not be exchanged for property in another country. The new rules apply beginning in 2018, but exchanges already underway are grandfathered in with transition rules.

Other Changes to Tax Law Applicable to the 2018 Tax Year (filed in April 2019)

Below we highlight other changes to the Internal Revenue Code that will affect fewer Foreign Service members but which are nevertheless important to keep in mind for financial decisions in 2018 and beyond. As always, we encourage readers to consult a tax professional for more details on their specific situation.

Business Taxes

Cuts for businesses were central to the new law. Among these, the C corporation income tax rate was reduced from 35 percent to a 21 percent flat tax, which does not sunset like most changes to the individual tax laws. Few members of the Foreign Service community operate small businesses as C corporations, but this cut may affect future business structuring choices. Those with smaller taxable incomes should note that the 15 percent corporate tax bracket for corporations with less than $50,000 of taxable income has been eliminated.

More germane to all business owners, the tax cut permits "bonus" depreciation of capital assets subject to wear and tear (e.g., vehicles, computers and office equipment) of up to 100 percent in the first year. In other words, businesses can write off the entire cost of depreciable assets they acquire the same year they are purchased. Note that this property must be used by a trade or business or held for the production of income. This rule will fully phase out by the end of 2026.

A third high-priority business tax cut includes a deduction of up to 20 percent of "combined qualifying business income" for businesses that are not corporations and that own an interest in some kinds of pass-through entities like partnerships, S corporations and sole proprietorships. This concept is highly complex and includes many limits. It appears that businesses with large amounts of real estate held in a C corporation and those operating like merchants (as opposed to rendering professional services such as legal advice) will benefit most from this. In any case, this incentive is further complicated by additional layers of complex definitions. You should retain a tax professional for assistance claiming this deduction if you believe you may be able to benefit from it.

Briefly, some amendments act to increase corporate tax liability to balance loss of revenue from the above cuts. The most relevant of these include reduced deductibility of business entertainment expenses and limiting net carryover losses to 80 percent of taxable income. Net business interest expense deductions are also capped at 30 percent of adjusted taxable income.

Individual Taxes

• Alimony/spousal support no longer deductible by payor

Payments of alimony (also known as spousal support or separate maintenance) have been deductible to the payor and included in the income of the recipient since the 1950s. The tax cut eliminates the deduction for payors and the requirement that recipients of such payments include them in their taxable income. This provision applies only to divorces entered into and modifications of support beginning in 2019.

H.R 1 did not touch the IRC Section 912 exclusion for civilian officers and employees for "allowances or otherwise (but not amounts received as post differentials)" paid by the Secretary under the Foreign Service Act.

• 529 Funds for elementary and secondary education

Up to $10,000 of a taxpayer's 529 plan may now be used to pay for elementary and secondary education. Funds may be used for private and religious education as well as public options.

• Some charitable contributions deductible up to 60 percent

The tax cut increases the percent by which charitable donations to public charities and private foundations are deductible, from 50 percent to 60 percent of a taxpayer's "contribution base," which is often the same as AGI.

Some Proposed Changes Were Not Made

Earlier versions of H.R. 1 included modifications of many tax laws that did not make it to the president's desk. Reducing the number of marginal tax brackets, capping the exclusion for employer-provided housing and modifying the ownership requirements for excluding the gain on the sale of a principal residence are among the rejected proposals already summarized above. In addition, the $250 deduction for educator expenses and the $5,250 exclusion for employer-provided educational assistance for employees and their dependents were not touched by the new law.

Conclusion

The Tax Cut and Jobs Act of 2017 is a broad, detailed set of amendments to the existing Internal Revenue Code. It accomplishes much for businesses and individuals, the net effect of which, as estimated by the Joint Committee on Taxation, will be to increase the Gross Domestic Product by about 0.7 percent over a 10-year budget window. That growth is expected to soften the blow to federal revenue, which is forecast to decrease by $1 trillion over the same period.

Although each individual and corporate taxpayer will see different results based on their particular circumstances, members of the Foreign Service community will generally benefit from the lower marginal brackets, increased standard deduction, increased child tax credit and reduced need to itemize. Retirees' deductions for medical expenses over the 7.5 percent AGI floor have been preserved a bit

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longer. Conversely, those looking to finance an expensive new home, live in high-tax states, and who had previously claimed a large number of miscellaneous itemized deductions may see little or no actual tax cut. Ultimately, the new law is intended to incentivize private-sector growth and investment and set the stage for a leaner public sector.

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AFSA Meets with Global Ties Participants

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AFSA Outreach Specialist Allan Saunders (right) speaks with an attendee at the 2018 Global Ties U.S. National Meeting held from Feb. 7-10.

Global Ties works with the U.S. Department of State to bring future leaders from around the world to participate in a professional development program sponsored and funded by the Office of International Visitors, part of the Bureau of Educational and Cultural Affairs.

AFSA participated in the conference to promote our publications and outreach programs, particularly the Speakers Bureau and the National High School Essay Contest.