2019

U.S. Tax Reform: Considerations for Service Members [notes]

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U.S. Tax Reform

Considerations for Service Members

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Introduction

On 22 December 2017, the president signed into law P.L. 115-97 (the "Act").[1] The Act represents the largest overhaul of the U.S. Internal Revenue Code since the Tax Reform Act of 1986.[2] Specifically, the Act lowers individual tax rates and increases the standard deductions, while modifying or repealing a number of other previously available deductions, generally effective 1 January 2018. Absent further Congressional action, since the Act was passed under the Senate "budget reconciliation" rules, most of the individual provisions are scheduled to sunset after 2025. This article summarizes the most important changes affecting service members.

Reduction in Individual Tax Rates

The Act retains the current seven-bracket individual tax rate structure but temporarily lowers tax rates and modifies income levels for some brackets.[3] Over time, however, taxpayers will gradually find themselves in higher tax brackets due to a newly adopted "chained" Consumer Price Index (CPI) approach, which will not sunset after 2025.[4] The Act also modifies the individual Alternative Minimum Tax.[5]

Exclusions from Gross

Income Alimony Payments

Prior to the Act, alimony payments and certain separate maintenance payments were available for an above-the-line deduction by a payor spouse, while receipt of such payments was includable as gross income by a payee spouse.[6] For divorces effective after 31 December 2018, however, the Act provides that alimony payments will neither be deductible by a payor spouse,[7] nor includible by a payee spouse. This provision will not sunset after 2025.

Exclusion for Employer Moving Expense Reimbursement

Prior to the Act, qualified moving expense reimbursements provided by an employer to an employee were excluded from the employee's gross income.[8] For service members, moving and storage reimbursements and allowances were similarly excluded.[9] While the Act suspends the exclusion of such moving expense reimbursements for civilians until after 31 December 2025, the exclusion is preserved for reimbursements and allowances received by service members.[10]

Out-of-Pocket Moving Expenses

Prior to the Act, qualified moving expenses not covered by an employer's reimbursement generally were allowed as an above-the-line deduction from an employee's gross income if certain distance and employment status requirements were met.[11] The Act suspends the deduction for moving expenses for civilian employees until after 31 December 2025. However, the suspension does not apply to service members.[12] Consequently, service members may be able to deduct out-of-pocket expenses related to a permanent change of station (PCS) if certain requirements are met.[13]

Deductions

Standard Deduction

An individual who does not itemize deductions may reduce his or her adjusted gross income by taking a standard deduction.[14] In 2017, the amount of the standard deduction was $12,700 for married individuals filing a joint return, $6,350 for individual filers, and $9,350 for single filers with at least one qualifying child.[15] The Act increases the standard deduction to $24,000 for married individuals filing a joint return, $12,000 for individual filers and married individuals filing separately, and $18,000 for single filers with at least one qualifying child.[16] Due to the increased standard deductions and the reduction of available itemized deductions discussed below, fewer taxpayers will itemize their deductions. In addition, those who itemize their deductions may find it useful to "bunch" their itemized deductions in one year, such as making two years of charitable contributions in one year, and then taking the standard deduction in the following year.

Itemized Deductions

State and Local Tax Deductions

One of the biggest changes that will affect service members concerns the itemized deduction for state and local taxes not incurred in a trade or business. Prior to the Act, the Code generally permitted taxpayers to deduct state and local income, property, and sales taxes.[17] The Act limits the deduction of state and local taxes to a combined total of $10,000.[18] As a result, state and local taxes in excess of $10,000 are not deductible, unless the deduction relates to a trade or business.[19] Service members from high income tax states such as California, Massachusetts, and New York are likely to be significantly affected by this change.

Mortgage Interest Deduction

Prior to the Act, individuals could deduct mortgage interest expenses related to a qualified residence for mortgage debt up to $1 million for married taxpayers or $500,000 for single taxpayers.[20] The Act reduced the amount of interest expense deductible under the Code.[21] Specifically, interest for indebtedness related to a mortgage incurred after 14 December 2017, is only deductible for mortgage debt up to $750,000 for taxpayers who are married filing jointly and $375,000 for those who are single.[22] Existing mortgages as of 14 December 2017, continue to be subject to the prior $1 million limitation. In addition, the Act repeals the prior separate deduction for interest paid on home equity loans.[23]

Miscellaneous Itemized Deductions

Prior to the Act, individual taxpayers could claim an itemized deduction for certain miscellaneous expenses as long as the total of such expenses exceeded two percent of the individual taxpayer's adjusted gross income.[24] One commonly used miscellaneous itemized deduction applied to National Guard and reserve component members who did not receive expense reimbursement for travel 100 miles or less to their duty station.[25] Common expenses included costs for traveling to and from the destination, meals and lodging while away from home, baggage charges, and laundry expenses. Travel, if unreimbursed, generally was permitted as a miscellaneous itemized deduction.[26] The Act repeals all the miscellaneous itemized deductions.[27] As a result, National Guard and reserve component members can no longer deduct these.[28]

Increase of the Child Tax Credit

Prior to the Act, taxpayers generally received a $1,000 child tax credit per qualifying child.[29] In general, the Act increases the child tax credit to $2,000 per child subject to certain limitations for each qualifying child.[30] In addition, the Act increases the phaseout gross income level limitation for claiming the credit from $110,000 to $400,000 for married taxpayers filing jointly and from $75,000 to $200,000 for single filers.

Individuals performing services in the Sinai Peninsula of Egypt

In general, service members receive numerous tax benefits if they serve in combat zones, qualified hazardous duty areas, or areas in direct support of military operations in combat zones or qualified hazardous duty areas. Prior to the Act, service members serving in the Sinai Peninsula of Egypt did not receive these benefits. The Act, however, designated the Sinai Peninsula as a qualified hazardous duty area retroactive to 9 June 2015.[31] As a result, service members serving in the Sinai now qualify for benefits such as the exclusion of certain military pay from their gross income and extensions of time for filing their tax returns.[32]

Spousal Residency

In addition to the changes made by the Act, Section 302 of the Veterans Benefits and Transition Act of 2018 allows for military spouses to elect to use the same legal residence as the Servicemember during any taxable year of the marriage beginning with the 2018 tax year. In short, it will allow a military spouse to elect the residence of the Servicemember even if the spouse might not otherwise have the requisite connections with the state where the Servicemember has legal residence or domicile. **TAL**

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Notes

1. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

2. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

3. Tax Cuts and Jobs Act § 11001.

4. Tax Cuts and Jobs Act § 11002. *See generally* Sho Chandra, *What You Need to Know About Chained CPI*, Bloomberg (Nov. 20, 2017), https://www.bloomberg.com/news/articles/2017-11-20/why-chained-cpi-has-links-to-u-s-tax-debate-quicktake-q-a. For example, in 2017 "the threshold at which a single filer move[d] from a 25 percent tax bracket to a 28 percent bracket [was] $91,900. [In 2016,] it was $91,150. It gets adjusted upward to account for inflation, to spare taxpayers from what's known as bracket creep. If chained CPI were used to calculate the next adjustment, rather than traditional CPI, the 28 percent rate might kick in just a tiny bit earlier–say, at $92,600 of income, instead of $92,700." *Id.*

5. Tax Cuts and Jobs Act § 12003.

6. *See* I.R.C. § 61(a)(8) (2012) (including alimony and separate maintenance payments as gross income of the payee spouse); I.R.C. §§ 62(a)(10), 215(a) (excluding those payments from the payor spouse's gross income in the form of an above-the-line deduction).

7. Tax Cuts and Jobs Act § 11051.

8. *See* I.R.C. § 132(g) (2012) (permitting an itemized deduction for moving expenses paid or incurred in connection with the commencement of work by the individual taxpayer as an employee or as a self-employed individual at a new principal place of work).

9. *See generally* Internal Revenue Service, Armed Forces' Tax Guide, publication 3 (Feb. 20, 2018).

10. Tax Cuts and Jobs Act § 11048.

11. I.R.C. §§ 62(a)(15), 217 (2012).

12. Tax Cuts and Jobs Act § 11049.

13. Internal Revenue Service, Armed Forces' Tax Guide, publication 3 (Feb. 20, 2018).

14. I.R.C. § 63 (2012).

15. Internal Revenue Service, Itemize or Choose the Standard Deduction (Feb. 21, 2017), https://www.irs.gov/newsroom/itemize-or-choose-the-standard-deduction.

16. Tax Cuts and Jobs Act § 11021. *See also* H.R. Rep. No. 115-466, at 201 (2017) (outlining the difference between the House and Senate versions of the Tax Cuts and Jobs Act, in which the House version proposed to increase the standard deduction to $24,400 for married individuals filing a joint return, $12,200 for individual filers, and $18,300 for single filers with at least one qualifying child).

17. I.R.C. § 164 (2012).

18. Tax Cuts and Jobs Act § 11042.

19. *See generally* I.R.C. § 212 (2012) (permitting an itemized deduction for an individual if such expense relates to the production of income, or the management or maintenance of property held for the production of income).

20. I.R.C. §§ 163(h)(2)(D), (h)(3) (2012).

21. Tax Cuts and Jobs Act § 11043.

22. H.R. Rep. No. 115-466, at 258 (2017).

23. Tax Cuts and Jobs Act § 11043. *See also Interest on Home Equity Loans Often Still Deductible Under New Law*, Internal Revenue Service (last visited Sept. 1, 2018), https://www.irs.gov/newsroom/interest-on-home-equity-loans-often-still-deductible-under-new-law.

24. I.R.C. § 67(a) (2012).

25. *See generally* Internal Revenue Service, Publication 529, Miscellaneous Deductions (Jan. 26, 2018) (noting the difference between travel expenses and travel in excess of 100 miles provided by military reserve component members, which is treated as an above-the-line deduction or adjustment under Internal Revenue Code section 62(a)(2)(E)).

26. Internal Revenue Service, Publication 529, Miscellaneous Deductions (Jan. 26, 2018) (noting an employee that has an ordinary and necessary business-related expense for travel away from home may be deductible as a miscellaneous itemized expense so long as the travel does not relate to an indefinite work assignment).

27. Tax Cuts and Jobs Act § 11045.

28. *See id.* For clarification, National Guard and military reserve component members who travel in excess of 100 miles to their duty station may still utilize adjustments provided under Internal Revenue Code section 62(a)(2)(E).

29. *See generally* I.R.C. § 24 (2012) (defining a qualifying child to meet the following requirements: (i) must be under the age of seventeen years old by the end of the tax year; (ii) must be the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of these individuals, including the taxpayer's grandchild, niece, or nephew; (iii) must have more than half of the support provided by the taxpayer; (iv) must be claimed as a dependent on the taxpayer's tax return; (v) must be a U.S. citizen, U.S. national, or U.S. resident alien; and (vi) must have lived with the taxpayer for more than half of the tax year). Other limitations apply, such as a reduction in the child tax credit by $50 for each $1,000 of modified adjusted gross income that exceeds $110,000 for married taxpayers filing jointly or $75,000 for single individual taxpayers.

30. Tax Cuts and Jobs Act § 11022.

31. *Id.* § 11026.

32. *Id.*