Federal Reporting Requirements for Churches

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INTRODUCTION

The most important federal reporting obligation for most churches is the withholding and reporting of employee income taxes and Social Security taxes. These payroll reporting requirements apply, in whole or in part, to almost every church. Yet many churches do not fully comply with them for various reasons, including the following:

- The church treasurer is elected by the congregation and does not remain in office long enough to understand the application of the payroll tax reporting rules to churches.
- Church leaders assume that churches are exempt from the payroll tax reporting requirements. This is a false assumption. The courts have rejected the argument that the application of the payroll tax reporting rules to churches violates the constitutional guaranty of religious freedom.
- There are a number of special payroll tax reporting rules that apply to churches, and these often are not clearly understood by church staff members. These special rules include the following:
    - While most ministers are employees for federal income tax reporting, they are self-employed for Social Security with respect to compensation they receive for ministerial services. This means that they pay the "self-employment tax" (SECA) rather than the employee's share of Social Security and Medicare taxes (FICA)—even if they report their federal income taxes as a church employee. It is a common mistake for churches to treat ministers as employees for Social Security and to withhold the employee's share of Social Security and Medicare taxes from their wages.
    - Wages paid to a minister as compensation for ministerial services are exempt from income tax withholding whether the minister reports income taxes as an employee or as self-employed. Ministers use the estimated tax procedure to pay their federal taxes, unless they have entered into a voluntary withholding agreement with their employing church (explained below).
    - Some churches are exempt from the employer's share of Social Security and Medicare taxes because they filed a timely exemption application. For most churches, this exemption had to be filed before October 31, 1984. The exemption does not excuse the church from income tax withholding, filing Form 941, or issuing W-2 forms to church employees. The nonminister employees of a church that filed this exemption application are treated as self-

employed for Social Security, and must pay the self-employment tax (SECA) if they are paid $108.28 or more during the year.

WARNING Federal law specifies that any corporate officer, director, or employee who is responsible for withholding taxes and paying them over to the government may be liable for a penalty in the amount of 100 percent of such taxes if they are either not withheld or not paid over to the government. This penalty is of special relevance to church leaders, given the high rate of noncompliance by churches with the payroll reporting procedures.

MAXIMIZING TAX BENEFITS FOR YOUR MINISTER

Housing allowance (and parsonage allowance)

CAUTION The housing allowance is being challenged in federal court as an unconstitutional preference for religion. See the discussion of this case, including its possible impact, in a special section at the beginning of the companion booklet on ministers' tax preparation.

The most important tax benefit available to ministers who own or rent their home is the housing allowance exclusion. Unfortunately, many churches fail to designate a portion of their minister's compensation as a housing allowance, and thereby deprive the minister of an important tax benefit.

A housing allowance is simply a portion of a minister's compensation that is so designated in advance by the minister's employing church. For example, in December of 2017 a church agrees to pay its pastor "total compensation" of $45,000 for 2018, and designates $15,000 of this amount as a housing allowance (the remaining $30,000 is salary). This costs the church nothing. It is simply a matter of designating part of a minister's salary as a housing allowance.

The tax code specifies that the housing allowance of a minister who owns or rents a home is nontaxable in computing federal income taxes to the extent that it is (1) declared in advance, (2) used for housing expenses, and (3) does not exceed the fair rental value of the minister's home (furnished, plus utilities).

KEY POINT Under no circumstances can a church designate a housing allowance retroactively.

KEY POINT Although repayments of principal and interest on a home mortgage loan qualify as a housing expense to which a housing allowance can be applied, costs associated with refinancing a principal residence or a home equity loan qualify only if the proceeds are used for housing expenses.

Ministers who live in a church-owned parsonage that is provided "rent-free" as compensation for ministerial services do not include the annual fair rental value of the parsonage as income in computing their federal income taxes. The annual fair rental value is not "deducted" from the minister's income. Rather, it is not reported as additional income on Form 1040 (as it generally would be by non-clergy workers). Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents compensation for ministerial services and is used to pay parsonage-related expenses such as utilities, repairs, and furnishings.

Note that the housing allowance and fair rental value of a parsonage are nontaxable only when computing federal income taxes. Ministers must include their housing allowance and rental value of a parsonage as taxable income when computing their self-employment taxes (except for retired ministers). In addition, any housing provided to a minister that is excludable from taxable income pursuant to IRC §119 (relating to housing provided on an employer's premises "for the convenience of the employer") also must be included in a minister's taxable income when computing self-employment income.

KEY POINT Be sure that the designation of a housing allowance for the following year is on the agenda of the church or church board for its last meeting of the current year. The designation should be an official action, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations in employment contracts and budget line items—assuming that the church duly adopted the designation and it is reflected in a written document.

Accountable reimbursements

The best way for ministers to handle their ministry-related business expenses is to have their employing church adopt an *accountable* expense reimbursement arrangement. An accountable arrangement is one that meets the following four requirements: (1) only

business expenses are reimbursed; (2) no reimbursement without an adequate accounting of expenses within a reasonable period of time (not more than 60 days after an expense is incurred); (3) any excess reimbursement or allowance must be returned to the employer within a reasonable period of time (not more than 120 days after an excess reimbursement is paid); (4) an employer's reimbursements must come out of the employer's funds and not by reducing the employee's salary. Under an accountable plan, an employee reports to the church rather than to the IRS. The reimbursements are not reported as taxable income to the employee, and the employee does not claim any deductions. This is the best way for churches to handle reimbursements of business expenses.

> **KEY POINT** Reimbursements of business expenses under an accountable arrangement are not reported as taxable income on an employee's Form W-2 or Form 1040, and there are no deductions to claim. In effect, the employee is reporting to the church rather than to the IRS. This often translates into significant tax savings for the employee.

An *accountable* reimbursement arrangement should be established by the church board or congregation in an appropriate resolution. In adopting a resolution, pay special attention to the following rules:

- Condition the reimbursement of any expense on adequate substantiation. This will include written evidence for all expenses and receipts for expenses of $75 or more. For most expenses, the evidence must substantiate the amount, date, place, and business nature of each expense. The key point is this: A church must require the same degree of substantiation as would be required for a deduction on the minister's income tax return.
- Expenses must be substantiated, and excess reimbursements returned to the church, within a reasonable time. Expenses will be deemed substantiated within a reasonable time if they are substantiated within 60 days. Excess reimbursements will be deemed to be returned to the employer within a reasonable time if they are returned within 120 days.

Churches occasionally reimburse ministers for *nonbusiness* expenses. Such reimbursements, though they require an accounting, ordinarily must be included in the minister's wages for income tax reporting purposes, and they are not deductible by the minister. Instead, the entire amount of these reimbursements must be reported as taxable income on the minister's Form W-2 and Form 1040.

Flexible spending accounts

A health flexible spending arrangement (FSA) allows employees to be reimbursed for medical expenses. FSAs are usually funded through voluntary salary reduction agreements with one's employer. No payroll taxes are deducted from employee contributions. The employer also may contribute.

> **KEY POINT** Unlike health spending arrangements which must be reported on Form 1040, FSA contributions are not reported on the employee's Form 1040.

FSAs have several benefits, including the following: (1) employer contributions can be nontaxable; (2) no payroll taxes are deducted from employee contributions; (3) withdrawals may be tax-free if used to pay qualified medical expenses; (4) employees can withdraw funds from an FSA to pay qualified medical expenses even if they have not placed the funds in the account.

Generally, distributions from a health FSA must be paid to reimburse the employee for qualified medical expenses. Qualified medical expenses are those incurred by an employee, or the employee's spouse and certain dependents (including a child under age 27 at the end of the year).

Employees must be able to receive the total amount they have elected to contribute for the year at any time during the year, regardless of the amount they have actually contributed.

FSAs are "use-it-or-lose-it" plans. This means that amounts in the account at the end of the plan year cannot be carried over to the next year. However, the plan can provide for a grace period of up to 2 ½ months after the end of the plan year. If there is a grace period, any qualified medical expenses incurred in that period can be paid from any amounts left in the account at the end of the previous year. An employer is not permitted to refund any part of the balance to the employee.

> **KEY POINT** An employer, at its option, may amend its cafeteria plan document to provide for the carryover to the immediately following plan year of up to $500 of any amount remaining unused as of the end of the plan year in a health FSA. The carryover of up to $500 may be used to pay or reimburse medical expenses under the health FSA incurred during the entire plan year to which it is carried over. For this purpose, the amount remaining unused as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan's run-out period for the plan year. In addition to the unused amounts of up to $500 that a plan may permit an individual to carry over to the next year, the plan

may permit the individual to also elect up to the maximum allowed salary reduction amount ($2,600 for 2017). Thus, the carryover of up to $500 does not count against or otherwise affect the $2,600 salary reduction limit applicable to each plan year. Although the maximum unused amount allowed to be carried over in any plan year is $500, the plan may specify a lower amount as the permissible maximum (and the plan sponsor has the option of not permitting any carryover at all).

A plan adopting this carryover provision is not permitted to also provide a grace period with respect to health FSAs.

The maximum amount available for reimbursement of incurred medical expenses of an employee and the employee's dependents under a health FSA cannot exceed $2,600 for 2017 or $2,650 for 2018.

Note that the Affordable Care Act prohibits employers from using an FSA to pay for, or reimburse, the cost of individually-owned health insurance policies with pre-tax dollars.

KEY POINT Non-prescription medicines (other than insulin) do not qualify as an expense for FSA purposes

Section 403(b) plans

A 403(b) plan, also known as a tax-sheltered annuity or retirement income account, is a retirement plan for certain employees of churches and other tax-exempt organizations. These plans have the following tax benefits: (1) Employees do not pay income tax on allowable contributions until they begin making withdrawals from the plan, usually after they retire. Note, however, that lay employees must pay Social Security and Medicare tax on their contributions to a 403(b) plan, including those made under a salary reduction agreement. (2) Earnings and gains on amounts in an employee's 403(b) account are not taxed until they are withdrawn. (3) Employees may be eligible to claim the retirement savings contributions credit ("saver's credit") for elective deferrals contributed to a 403(b) account.

There are limits on the amount of contributions that can be made to a 403(b) account each year. If contributions made to a 403(b) account are more than these contribution limits, penalties may apply. Generally, annual contributions to a 403(b) plan cannot exceed either the limit on annual additions or the limit on elective deferrals. See IRS Publication 571 for details.

COMPLYING WITH FEDERAL PAYROLL TAX REPORTING OBLIGATIONS

Step 1. Obtain an employer identification number (EIN) from the federal government if this has not been done.

This number must be recited on some of the returns listed below and is used to reconcile a church's deposits of withheld taxes with the W-2 forms it issues to employees. The EIN is a nine-digit number that looks like this: 00-0246810. If your church does not have an EIN, you may apply for one online. Go to the IRS website at irs.gov for information. You may also apply for an EIN by calling 1-800-829-4933, or you can fax or mail Form SS-4 to the IRS. You should have only one EIN.

> **KEY POINT** An employer identification number is not a "tax exemption number" and has no relation to your nonprofit corporation status. It merely identifies you as an employer subject to tax withholding and reporting and ensures that your church receives proper credit for payments of withheld taxes. You can obtain an EIN by submitting a Form SS-4 to the IRS.

Step 2. Determine whether each church worker is an employee or self-employed.

In some cases, it is difficult to determine whether a particular worker is an employee or is self-employed. If in doubt, churches should treat a worker as an employee, since substantial penalties can be assessed against a church for treating a worker as self-employed whom the IRS later reclassifies as an employee. In general, a self-employed worker is one who is not subject to the control of an employer with respect to how a job is to be done. Further, a self-employed person typically is engaged in a specific trade or business and offers his or her services to the general public.

The IRS and the courts have applied various tests to assist in classifying a worker as an employee or self-employed. Factors that tend to indicate employee status include the following:

- The worker is required to follow an employer's instructions regarding when, where, and how to work.
- The worker receives "on-the-job" training from an experienced employee.
- The worker is expected to perform the services personally, and not use a substitute.
- The employer rather than the worker hires and pays any assistants.
- The worker has a continuing working relationship with the employer.
- The employer establishes set hours of work.
- The worker is guaranteed a regular wage amount for an hourly, weekly, or other period of time.
- The worker is expected to work full time.
- The work is done on the employer's premises.
- The worker must submit regular oral or written reports to the employer.
- The worker's business expenses are reimbursed by the employer.
- The employer furnishes the worker's tools, supplies, and equipment.
- The worker does not work for other employers.
- The worker does not advertise his or her services to the general public.

Not all of these factors must be present for a worker to be an employee. But if most of them apply, the worker is an employee. Once again: If in doubt, treat the worker as an employee.

> **KEY POINT** For 2018 churches must withhold 28 percent of the compensation paid to a self-employed person who fails to provide his or her Social Security number to the church. This is referred to as "backup withholding" and is designed to promote the reporting of taxable income.

> **KEY POINT** Some fringe benefits are nontaxable only when received by employees.

Step 3. Obtain the Social Security number for each worker.

After determining whether a worker is an employee or self-employed, you must obtain the worker's Social Security number. A worker who does not have a Social Security number can obtain one by filing Form SS-5. This is a Social Security Administration form, not an IRS form. If a self-employed worker performs services for your church (and earns at least $600 for the year), but fails to provide you with his or her Social Security number, then the church is required by law to withhold a specified percentage of compensation as backup withholding. The backup withholding rate is 28 percent for 2018.

A self-employed person can stop backup withholding by providing the church with a correct Social Security number.

The church will need the correct number to complete the worker's Form 1099-MISC (discussed later).

Churches can be penalized if the Social Security number they report on a Form 1099-MISC is incorrect, unless they have exercised "due diligence." A church will be deemed to have exercised due diligence if it has self-employed persons provide their Social Security numbers using Form W-9. It is a good idea for churches to present self-employed workers (e.g., guest speakers, contract laborers) with a Form W-9, and to backup withhold unless the worker returns the form. The church should retain each Form W-9 to demonstrate its due diligence.

All taxes withheld through backup withholding must be reported to the IRS on Form 945. The Form 945 for 2017 must be filed with the IRS by January 31, 2018. However, if you made deposits on time in full payment of the taxes for the year, you may file the return by February 12, 2018.

Step 4. Have each employee complete a Form W-4.

These forms are used by employees to claim withholding allowances. A church will need to know how many withholding allowances each nonminister employee claims in order to withhold the correct amount of federal income tax. Ministers need not file a Form W-4 unless they enter into a voluntary withholding arrangement with their employing church. A withholding allowance lowers the amount of tax that will be withheld from an employee's wages. Allowances generally are available for the employee, the employee's spouse, each of the employee's dependents, and in some cases for itemized deductions.

Ask all new employees to give you a signed Form W-4 when they start work. If an employee does not complete such a form, then the church must treat the employee as a

single person without any withholding allowances or exemptions. Employers must put into effect any Form W-4 that replaces an existing certificate no later than the start of the first payroll period ending on or after the 30th day after the day on which you received the replacement Form W-4. Of course, you can put a Form W-4 into effect sooner, if you wish. Employers are not responsible for verifying the withholding allowances that employees claim.

> **TIP** The "Withholding Calculator" found on the IRS website (irs.gov) can help employees determine the proper amount of federal income tax withholding.

Step 5. Compute each employee's taxable wages.

The amount of taxes that a church should withhold from an employee's wages depends on the amount of the employee's wages and the information contained on his or her Form W-4. A church must determine the wages of each employee that are subject to withholding. Wages subject to federal withholding include pay given to an employee for service performed. The pay may be in cash or in other forms. Measure pay that is not in money (such as property) by its fair market value. Wages often include a number of items in addition to salary. (There is a comprehensive list of examples in Step 10.)

Step 6. Determine the amount of income tax to withhold from each employee's wages.

The amount of federal income tax the employer should withhold from an employee's wages may be computed in a number of ways. The most common methods are the wage bracket method and the percentage method.

Wage bracket method. Under the wage bracket method, the employer simply locates an employee's taxable wages for the applicable payroll period (that is, weekly, biweekly, monthly) on the wage bracket withholding tables in IRS Publication 15 ("Circular E"), and determines the tax to be withheld by using the column headed by the number of withholding allowances claimed by the employee. You can obtain a copy of IRS Publication 15 at any IRS office or by downloading a copy from the IRS website (irs.gov).

Percentage method. Under the percentage method, the employer multiplies the value of one withholding allowance (derived from a table contained in Publication 15) by the number of allowances an employee claims on Form W-4, subtracts the total from the

employee’s wages, and determines the amount to be withheld from another table. This method works for any number of withholding allowances an employee claims and any amount of wages.

> **RECOMMENDATION** Be sure to obtain a new IRS Publication 15 in January of 2018. It will contain updated tables for computing the amount of income taxes to withhold from employees’ 2018 wages and other helpful information.

Both of these methods are explained in detail in IRS Publication 15. Each year, a church should obtain a copy of Publication 15 to ensure that the correct amount of taxes is being withheld.

Wages paid to a minister as compensation for ministerial services are exempt from income tax withholding. However, ministers who report their income taxes as employees can enter into a voluntary withholding arrangement with their church. Under such an arrangement, the church withholds federal income taxes from the minister’s wages as if the minister’s wages are not exempt from withholding. Some ministers find voluntary withholding attractive since it avoids the often difficult task of budgeting for four significant tax payments.

A minister initiates voluntary withholding by providing the church with a completed IRS Form W-4 (Employee’s Withholding Allowance Certificate). The filing of this form is deemed to be a request for voluntary withholding.

Voluntary withholding arrangements may be terminated at any time by either the church or minister, or by mutual consent.

The tax code specifies that ministers are self-employed for Social Security with respect to services performed in the exercise of ministry. Therefore, a church whose minister elects voluntary withholding is only obligated to withhold the minister’s federal income taxes. The minister is still required to use the estimated tax procedure to report and prepay self-employment taxes. However, ministers electing voluntary withholding can indicate on line 6 of Form W-4 that they want an additional amount of income taxes to be withheld from each pay period that will be sufficient to pay the estimated self-employment tax liability by the end of the year. This additional withholding of income taxes becomes a credit that can be applied against a minister’s self-employment taxes on Form 1040. It is reported by the church as additional income taxes withheld on its quarterly Form 941. Many churches incorrectly report these additional withholdings as Social Security and Medicare taxes.

Since any tax paid by voluntary withholding is deemed to be timely paid, a minister who pays self-employment taxes using this procedure will not be liable for any underpayment penalty (assuming that a sufficient amount of taxes are withheld).

Step 7. Withhold Social Security and Medicare taxes from nonminister employees' wages.

Employees and employers each pay Social Security and Medicare taxes (FICA) equal to 7.65 percent of an employee's wages. The 7.65 percent tax rate is comprised of two components: (1) a Medicare hospital insurance tax of 1.45 percent, and (2) an "old age, survivor and disability" (Social Security) tax of 6.2 percent. There is no maximum amount of wages subject to the Medicare tax. For 2017, the maximum wages subject to the Social Security tax (the 6.2 percent amount) was $118,500. It increases to $127,200 for 2018.

Beginning in 2013, the Affordable Care Act increases the employee portion of the Medicare (HI) tax by an additional tax of 0.9 percent on wages received in excess of a threshold amount. However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, and $200,000 for single persons. The $250,000 and $200,000 amounts are not adjusted for inflation and remain the same for 2018.

The Social Security tax rates for 2017 and 2018 are shown in the following table:

Year	Tax on Employee	Tax on Employer	Combined Tax
2017	7.65%	7.65%	15.3%
2018	7.65%	7.65%	15.3%

KEY POINT Federal law allowed churches that had nonminister employees as of July 1984 to exempt themselves from the employer's share of Social Security and Medicare taxes by filing a Form 8274 with the IRS by October 30, 1984. Many churches did so. The exemption was available only to those churches that were opposed for religious reasons to the payment of Social Security taxes. The effect of such an exemption is to treat all nonminister church employees as self-employed for Social

Security purposes. Such employees must pay the self-employment tax (SECA) if they are paid $108.28 or more for the year. Churches hiring their first nonminister employee after 1984 have until the day before the due date for their first quarterly 941 form to file the exemption application. Churches can revoke their exemption by filing a Form 941 accompanied by full payment of Social Security and Medicare taxes for that quarter. Many churches have done so, often inadvertently.

Step 8. The church must deposit the taxes it withholds.

Churches accumulate three kinds of federal payroll taxes:

- income taxes withheld from employees' wages,
- the employees' share of Social Security and Medicare taxes (withheld from employees' wages), and
- the employer's share of Social Security and Medicare taxes.

Most employers must deposit payroll taxes on a monthly or semiweekly basis. An employer's deposit status is determined by the total taxes reported in a four-quarter "lookback" period. For 2018, the lookback period will be July 1, 2016 through June 30, 2017.

Monthly depositor rule. Churches that reported payroll taxes of $50,000 or less in the lookback period will deposit their withheld taxes for 2018 on a monthly basis. Payroll taxes withheld during each calendar month, along with the employer's share of FICA taxes, must be deposited by the 15th day of the following month.

Semiweekly depositor rule. Churches that reported payroll taxes of more than $50,000 in the lookback period must deposit their withheld taxes on a semiweekly basis. This means that for paydays falling on Wednesday, Thursday, or Friday, the payroll taxes must be deposited on or by the following Wednesday. For all other paydays, the payroll taxes must be deposited on the Friday following the payday.

Payment with return rule. If you accumulate less than a $2,500 tax liability during the current or previous quarter, you may make a payment with Form 941 instead of depositing monthly. See IRS Publication 15 for more information.

KEY POINT All deposits must be made using the Electronic Federal Tax Payment System (EFTPS). There are penalties for depositing late, or

for mailing payments directly to the IRS that are required to be deposited, unless you have reasonable cause for doing so. To enroll in EFTPS, call 800-555-4477, or to enroll online, visit eftps.gov. If you do not want to use EFTPS, you can arrange for your tax professional, financial institution, payroll service, or other trusted third party to make deposits on your behalf.

Step 9. All employers subject to income tax withholding, Social Security and Medicare taxes, or both, must file Form 941 quarterly.

Form 941 reports the number of employees and amount of Social Security and Medicare taxes and withheld income taxes that are payable. Form 941 is due on the last day of the month following the end of each calendar quarter.

Quarter	Ending	Due date of Form 941
1st (Jan.–Mar.)	March 31	April 30
2nd (April–June)	June 30	July 31
3rd (July–Sept.)	September 30	October 31
4th (Oct.–Dec.)	December 31	January 31

If any due date for filing shown above falls on a Saturday, Sunday, or legal holiday, you may file your return on the next business day.

Form 941 may be filed electronically. For more information, visit the IRS website at irs.gov or call 1-866-255-0654.

KEY POINT Form 944 replaces Form 941 for eligible small employers. The purpose of new Form 944 is to reduce burden on the smallest employers by allowing them to file their employment tax returns annually, and in most cases pay the employment tax due with their return. Generally, you are eligible to file this form only if your payroll taxes for

the year are $1,000 or less. Do not file Form 944 unless the IRS has sent you a notice telling you to file it.

Step 10. Prepare a Form W-2 for every employee, including ministers employed by the church.

KEY POINT Congress has enacted legislation requiring that Forms W-2, W-3, 1099-MISC, and 1096, be filed by January 31, and eliminating the extended due date (March 31) for electronically filed Forms W-3 and 1096.

A church reports each employee's taxable income and withheld income taxes as well as Social Security and Medicare taxes on this form. A church should furnish copies B, C, and 2 of the 2017 Form W-2 to each employee by January 31, 2018. File Copy A with the Social Security Administration by January 31, 2018. Send all Copies A with Form W-3, Transmittal of Wage and Tax Statements. If you file electronically the due date remains January 31, 2018.

KEY POINT Be sure to add cents to all amounts. Make all dollar entries without a dollar sign and comma, but with a decimal point and cents. For example, $1,000 should read "1000.00." Government scanning equipment assumes that the last two figures of any amount are cents. If you report $40,000 of income as "40000," the scanning equipment would interpret this as 400.00 ($400)!

You may need some assistance with some of the boxes on the Form W-2. Consider the following:

Box a. Report the employee's Social Security number. Insert "applied for" if an employee does not have a Social Security number but has applied for one. If you do not provide the correct employee name and Social Security number on Form W-2, you may owe a penalty unless you have reasonable cause.

Box b. Insert your church's federal employer identification number (EIN). This is a nine-digit number that is assigned by the IRS. If you do not have one, you can obtain one by submitting a completed Form SS-4 to the IRS. Some churches have more than one EIN (for example, some churches that operate a private school have a number for both the church and the school). Be sure that the EIN listed on an employee's Form W-2 is the one associated with the employee's actual employer.

Box c. Enter your church's name, address, and ZIP Code. This should be the same address reported on your Form 941.

Box d. You may use this box to identify individual W-2 forms. You are not required to use this box.

Box e. Enter the employee's name.

Box f. Enter the employee's address and ZIP Code.

Box 1. Report all wages paid to workers who are treated as employees for federal income tax reporting purposes. This includes:

- Salary, bonuses, prizes, and awards.
- Taxable fringe benefits (including cost of employer-provided group term life insurance coverage that exceeds $50,000).
- The value of the personal use of an employer-provided car.
- Most Christmas, birthday, anniversary, and other special occasion gifts paid by the church.
- Business expense reimbursements paid under a nonaccountable plan (one that does not require substantiation of business expenses within a reasonable time, or does not require excess reimbursements to be returned to the church, or reimburses expenses out of salary reductions). Also note that such reimbursements are subject to income tax and Social Security withholding if paid to nonminister employees.
- If you reimburse employee travel expenses under an accountable plan using a per diem rate, include in Box 1 the amount by which your per diem rate reimbursements for the year exceed the IRS-approved per diem rates. Also note that such excess reimbursements are subject to income tax and Social Security withholding if paid to nonminister employees or ministers who have elected voluntary tax withholding. Use code L in Box 12 to report the amount equal to the IRS-approved rates.
- If you reimburse employee travel expenses under an accountable plan using a standard business mileage rate in excess of the IRS-approved rate (53.5 cents per mile for 2017) include in Box 1 the amount by which your mileage rate reimbursements for the year exceed the IRS-approved rates. Also note that such excess reimbursements are subject to income tax and Social Security withholding if paid to nonminister employees or ministers who have elected voluntary tax withholding. Use code L in Box 12 to report the amount equal to the IRS-approved rates.

- Employer reimbursements of an employee’s nonqualified (nondeductible) moving expenses.
- Any portion of a minister’s self-employment taxes paid by the church.
- Amounts includible in income under a nonqualified deferred compensation plan because of section 409A.
- Designated Roth contributions made under a section 403(b) salary reduction agreement.
- Church reimbursements of a spouse’s travel expenses incurred while accompanying a minister on a business trip represent income to the minister unless the spouse’s presence serves a legitimate and necessary business purpose and the spouse’s expenses are reimbursed by the church under an accountable plan.
- Churches that make a “below-market loan” to a minister of at least $10,000 create taxable income to the minister (some exceptions apply). A below market loan is a loan on which no interest is charged, or on which interest is charged at a rate below the applicable federal rate.
- Churches that forgive a minister’s debt to the church create taxable income to the minister.
- Severance pay.
- Payment of a minister’s personal expenses by the church.
- Employee contributions to a health savings account (HSA).
- Employer contributions to an HSA if includable in the income of the employee.
- “Love gifts” from the church to a pastor.

For ministers who report their income taxes as employees, do not report in box 1 the annual fair rental value of a parsonage or any portion of a minister’s compensation that was designated (in advance) as a housing allowance by the church. Also, some contributions made to certain retirement plans out of an employee’s wages are not reported.

> **CAUTION** Taxable fringe benefits not reported as income in box 1 may constitute an automatic excess benefit transaction exposing the recipient and members of the church board to intermediate sanctions in the form of substantial excise taxes.

> **KEY POINT** Churches should not include in box 1 the annual fair rental value of a parsonage or a housing allowance provided to a minister as compensation for ministerial services.

Box 2. List all federal income taxes that you withheld from the employee's wages. The amounts reported in this box (for all employees) should correspond to the amount of withheld income taxes reported on your four 941 forms.

Box 3. Report an employee's wages subject to the "Social Security" component (the 6.2 percent rate for 2017) of FICA taxes. Box 3 should not list more than the maximum wage base for the "Social Security" component of FICA taxes ($127,200 for 2017, $128,700 for 2018). This box usually will be the same as Box 1, but not always. For example, certain retirement contributions are included in Box 3 that are not included in Box 1. To illustrate, contributions to a 403(b) plan by salary reduction agreement may be excludable from income and not reportable in Box 1, but they are subject to FICA taxes and accordingly they represent Social Security and Medicare wages for nonminister employees.

> **KEY POINT** Remember that ministers (including those who report their income taxes as employees) are self-employed for Social Security with respect to their ministerial services, and so they pay self-employment taxes rather than the employee's share of Social Security and Medicare taxes.

Churches that filed a timely Form 8274 exempting themselves from the employer's share of FICA taxes do not report the wages of nonminister employees in this box since such employees are considered self-employed for Social Security purposes.

Box 4. Report the "Social Security" component (6.2 percent) of Social Security and Medicare taxes that you withheld from a nonminister employee's wages. This tax is imposed on all wages up to a maximum of $128,700 for 2018. Do not report the church's portion (the "employer's share") of Social Security and Medicare taxes. Ministers who report their income taxes as employees are still treated as self-employed for Social Security with respect to compensation from the performance of ministerial services. For ministers, this box should be left blank.

Box 5. Report a nonminister employee's current and deferred (if any) wages subject to the Medicare component (1.45 percent) of FICA taxes. This will be an employee's entire wages regardless of amount. There is no ceiling. For persons earning less than the annual maximum earnings subject to the 6.2 percent Social Security tax ($128,700 for 2018) Boxes 3 and 5 should show the same amount. If you pay more than $128,700 to a nonminister employee in 2018, Box 3 should show $128,700 and Box 5 should show the full amount of wages paid.

Box 6. Report the Medicare component of FICA taxes that you withheld from the nonminister employee's wages. This tax is imposed on all wages, current and deferred (if any), regardless of amount.

Box 10. Show the total dependent care benefits under a dependent care assistance program (section 129) paid or incurred by you for your employee. Include the fair market value of employer-provided daycare facilities and amounts paid or incurred for dependent care assistance in a section 125 cafeteria plan. Report all amounts paid or incurred including those in excess of the $5,000 exclusion. Include any amounts over $5,000 in Boxes 1, 3, and 5. For more information, see IRS Publication 15-B.

Box 11. The purpose of box 11 is for the Social Security Administration (SSA) to determine if any part of the amount reported in box 1 or boxes 3 or 5 was earned in a prior year. The SSA uses this information to verify that they have properly applied the Social Security earnings test and paid the correct amount of benefits. Report distributions to an employee from a nonqualified plan in box 11. Also report these distributions in box 1. Under nonqualified plans, deferred amounts that are no longer subject to a substantial risk of forfeiture are taxable even if not distributed. Report these amounts in boxes 3 (up to the Social Security wage base) and 5. Do not report in box 11 deferrals included in boxes 3 or 5 and deferrals for current year services (such as those with no risk of forfeiture).

If you made distributions and also are reporting any deferrals in boxes 3 or 5, do not complete box 11. See IRS Publication 957.

Unlike qualified plans, nonqualified plans do not meet the qualification requirements for tax-favored status. Nonqualified plans include those arrangements traditionally viewed as deferring the receipt of current compensation, such as a rabbi trust. Welfare benefit plans and plans providing termination pay, or early retirement pay, are not generally nonqualified plans.

For additional information, see IRS Publications 15 and 957.

Box 12. Insert the appropriate code and dollar amount in this box. Insert the code letter followed by a space and then insert the dollar amount on the same line within the box. Do not enter more than three codes in this box. If more are needed, use another Form W-2. Use capital letters for the codes, and remember not to use dollar signs or commas. For example, to report a $3,000 contribution to a section 403(b) tax-sheltered annuity, you would report "E 3000.00" in this box. The codes are as follows:

A—This will not apply to church employees.

B—This will not apply to church employees.

C—You (the church) provided your employee with more than $50,000 of group term life insurance. Report the cost of coverage in excess of $50,000. It should also be included in Box 1 (and in Boxes 3 and 5 for nonminister employees). See page 12 for additional information.

D—Generally not applicable to churches.

E—The church made contributions to a 403(b) plan pursuant to a "salary reduction agreement" on behalf of the employee. Report the amount of the contributions. While this amount ordinarily is not reported in Box 1, it is included in Boxes 3 and 5 for nonminister employees since it is subject to Social Security and Medicare taxes with respect to such workers.

F—Generally not applicable to churches.

G—Generally not applicable to churches.

H—Generally not applicable to churches.

J—You (the church) are reporting sick pay. Show the amount of any sick pay that is not includable in the employee's income because he or she contributed to the sick pay plan.

K—Generally not applicable to churches.

L—You (the church) reimbursed the employee for employee business expenses using the standard mileage rate or the per diem rates, and the amount you reimbursed exceeds the amounts allowed under these methods. Enter code "L" in Box 12, followed by the amount of the reimbursements that equal the allowable standard mileage or per diem rates. Any excess should be included in Box 1. For nonminister employees, report the excess in Boxes 3 (up to the Social Security wage base) and 5 as well. Do not include any per diem or mileage allowance reimbursements for employee business expenses in Box 12 if the total reimbursements are less than or equal to the amount deemed substantiated under the IRS-approved standard mileage rate or per diem rates.

M, N—Generally not applicable to churches.

P—You (the church) paid qualified moving expenses reimbursements directly to an employee. Report the amount of these reimbursements but only if they were made under a nonaccountable arrangement. Do not report reimbursements of qualified moving expenses that you paid directly to a third party on behalf of the employee (for example, to a moving company), or the employee under an accountable arrangement.

Q—Generally not applicable to churches.

R—Report employer contributions to a medical savings account on behalf of the employee. Any portion that is not excluded from the employee's income also should be included in Box 1.

S—Report employee salary reduction contributions to a Simple retirement account. However, if the Simple account is part of a 401(k) plan, use code D.

T—Report amounts paid (or expenses incurred) by an employer for qualified adoption expenses furnished to an employee under an adoption assistance program.

V—Generally not applicable to churches.

W—Report employer contributions to a health savings account (HSA). Include amounts the employee elected to contribute using a cafeteria plan.

Y—It is no longer necessary to report deferrals under a section 409A nonqualified deferred compensation plan in Box 12 using code Y.

Z—Report all amounts deferred (including earnings on deferrals) under a nonqualified deferred compensation plan that are included in income under section 409A of the tax code because the NQDC fails to satisfy the requirements of section 409A. Do not include amounts properly reported on Forms 1099-MISC or W-2 for a prior year. Also, do not include amounts considered to be subject to a substantial risk of forfeiture for purposes of section 409A. The amount reported in box 12 using code Z is also reported in box 1.

AA—Generally not applicable to churches.

BB—Report designated Roth contributions under a section 403(b) salary reduction agreement. Do not use this code to report elective deferrals under code E.

DD—The Affordable Care Act requires employers to report the cost of coverage under an employer-sponsored group health plan. IRS Notice 2011-28 provided relief for smaller employers filing fewer than 250 W-2 forms by making the reporting requirement optional for them until further guidance is issued by the IRS. The reporting under this provision is for information only; the amounts reported are not included in taxable wages and are not subject to new taxes.

EE—Generally not applicable to churches.

Box 13. Check the appropriate box.

statutory employee. Churches rarely if ever have statutory employees. These include certain drivers, insurance agents, and salespersons.

retirement plan. Mark this checkbox if the employee was an active participant (for any part of the year) in any of the following: (1) a qualified pension, profit-sharing, or stock bonus plan described in section 401(a) (including a 401(k) plan); (2) an annuity contract or custodial account described in section 403(b); (3) a simplified employee pension (SEP) plan; or (4) a SIMPLE retirement account.

third party sick pay. Churches generally will not check this box.

Box 14. This box is optional. Use it to provide information to an employee. Some churches report a church-designated housing allowance in this box. The IRS uses Box 14 for this purpose in a comprehensive minister tax example in the current edition of its Publication 517, but this is not a requirement.

> **TAX TIP** The IRS has provided the following suggestions to reduce the discrepancies between amounts reported on Forms W-2, W-3, and Form 941: First, be sure the amounts on Form W-3 are the total amounts from Forms W-2. Second, reconcile Form W-3 with your four quarterly Forms 941 by comparing amounts reported for: (1) Income tax withholding (Box 2). (2) Social Security and Medicare wages (Boxes 3, 5, and 7). (3) Social Security and Medicare taxes (Boxes 4 and 6). Amounts reported on Forms W-2, W-3, and 941 may not match for valid reasons. If they do not match, you should determine that the reasons are valid.

Step 11. Prepare a Form 1099MISC for every self-employed person receiving nonemployee compensation of $600 or more.

By January 31, 2018, churches must furnish Copy B of Form 1099-MISC (“statement for recipient of miscellaneous income”) to any self-employed person to whom the church paid nonemployee compensation of $600 or more in 2017. This form (rather than a W-2) should be provided to clergy who report their federal income taxes as self-employed, since the Tax Court and the IRS have both ruled that a worker who receives a W-2 rather than a 1099-MISC is presumed to be an employee rather than self-employed. Other persons to whom churches may be required to issue a 1099-MISC include evangelists, guest speakers, contractors, and part-time custodians.

Churches must send Copy A of Forms 1099-MISC, along with Form 1096, to the IRS by January 31, 2018, if nonemployee compensation is reported in box 7. If you file electronically, the due date for filing Copy A with the IRS is also January 31, 2018, if

you are reporting nonemployee compensation box 7. Otherwise the deadline is February 28 if you file on paper, or April 2 if you file electronically.

Form 1099-MISC is designed to induce self-employed persons to report their full taxable income.

Self-employment earnings include compensation paid to any individual other than an employee. Examples include ministers who report their income as self-employed for income tax reporting purposes, some part-time custodians, and certain self-employed persons who perform miscellaneous services for the church (plumbers, carpenters, lawn maintenance providers, etc.) and who are not incorporated.

To illustrate, if a guest speaker visited a church in 2017 and received compensation from the church in an amount of $600 or more (net of any housing allowance or travel expenses reimbursed under an accountable plan) then the church must issue the person Copy B of Form 1099MISC by January 31, 2018.

Exceptions apply. For example, a church need not issue a 1099MISC to a corporation, or to a person who will be receiving a Form W-2 for services rendered to the church. Also, travel expense reimbursements paid to a self-employed person under an accountable reimbursement plan do not count toward the $600 figure.

To complete Form 1099MISC the church will need to obtain the recipient's name, address, and Social Security number. Churches should obtain this information at the time of the person's visit, since it often can be difficult to obtain the necessary information at a later date. IRS Form W-9 can be used to obtain this information. If a self-employed person who is paid $600 or more during the course of a year by a church refuses to provide a Social Security number, then the church is required to withhold a percentage of the person's total compensation as "backup withholding." See "Step 2," above. The backup withholding rate is 28 percent for 2018.

OTHER IMPORTANT REQUIREMENTS FOR CHURCHES

Reporting group term life insurance

You must include in the income of employees an imputed cost of employer-provided group term life insurance coverage (including death benefits under the Benefits Plan) that

exceeds $50,000. You must also include the imputed cost of all employer-provided group term life insurance on the life of a spouse or dependent if the coverage provided exceeds $2,000. The imputed cost can be determined according to the following table.

Cost per $1,000 of protection for 1-month period			
Age Brackets	**Cost**	**Age Brackets**	**Cost**
Under 25	5 cents	25 to 29	6 cents
30 to 34	8 cents	35 to 39	9 cents
40 to 44	10 cents	45 to 49	15 cents
50 to 54	23 cents	55 to 59	43 cents
60 to 64	66 cents	65 to 69	$1.27
70 and above	$2.06		

EXAMPLE Church A pays the premiums on a $70,000 group term insurance policy on the life of Pastor B with B's wife as beneficiary. Pastor B is 29 years old. Church A also pays the premium on a $5,000 group term policy which covers Pastor B's wife who is 30 years old. The church would have to report $21.90 as the imputed cost of the insurance provided to Pastor B and his wife. This amount is computed as follows: (1) For Pastor B, the table shows the "cost" per month for each $1,000 of group term life insurance in excess of $50,000. To compute the cost for Pastor B, take 6 cents x 12 months = 72 cents x 20 (corresponding to $20,000 of group term insurance in excess of $50,000) = $14.40. (2) In addition, the cost of the entire $5,000 of insurance provided to Pastor B's wife would have to be computed. Take 8 cents x 12 months = 96 cents x 5 = $4.80. Combine this amount with the cost of Pastor B's excess insurance to obtain the taxable amount of $19.20. Church A should include this amount with wages in Box 1 of Form W-2. This amount should also be reported in Box 12 and labeled code C. Any includable amount is subject to income tax as well as Social Security and Medicare withholding for nonminister church employees.

Form I-9

All employers are responsible for verifying the identity and eligibility of employees to work in the United States. As employers, churches must complete an Employment Eligibility Verification form for each new employee. This form is better known as Form I-9.

Form I-9 is not an IRS form and is not filed with any government agency. However, it is important for churches to be familiar with this form because they can be assessed fines for failing to comply with the requirements summarized below.

Churches should:

- Ensure that each new employee completes Section 1 of the Form I-9 on or before his or her first day of compensated work. Review the employee's documents and fully complete Section 2 of the Form I-9 within 3 business days of the hire. Collect a Form I-9 for all employees, including ministers, hired after November 6, 1986, even if the church has no doubt that someone is a U.S. citizen. An employee signs part of the form and the employer signs part of the form. The form's instructions list documents employees may show to verify their identity and eligibility to work in the United States.
- Review the United States Citizenship and Immigration Services website (uscis.gov) for instructions that will assist you in completing the Form I-9. You can also download Form I-9 from the USCIS website.
- Collect forms from new employees only, not from all applicants. When extending job offers, churches should clarify that employment is conditioned on completion of a Form I-9. Employers should remind new employees to bring their documents the first day of work. Forms should be completed no later than the end of the employee's third day at work.
- Accept documents that appear to be genuine and relate to the employee. If churches act reasonably when deciding that a document is genuine, they will not be held responsible for a mistake. Churches may keep photocopies of original identification and verification documents with each employee form. This is not required by law but may be helpful in case there is ever a question about whether a document was genuine.
- Employers must retain an employee's completed Form I-9 for as long as the individual works for the employer. Once the individual's employment has terminated, the employer must determine how long after termination the Form I-9 must be retained, which is either three years after the date of hire, or one year after

the date employment is terminated, whichever is later. Forms I-9 can be retained either on paper or microform, or electronically.

- Upon request, show completed forms to authorized officials of the Department of Homeland Security (DHS), Department of Labor, or the Justice Department's Office of Special Counsel for Unfair Immigration-Related Employment Practices (OSC). Officials will give a minimum of three days' notice before inspection.
- Churches, like any employer, can be penalized for failing to comply with the I-9 requirement. If you fail to complete, retain, or make available for inspection a Form I-9 as required by law, you may face a civil penalty for each violation. There are additional penalties for knowingly hiring unauthorized aliens.
- Providing an employee's Social Security number on Form I-9 is voluntary for all employees unless an employer participates in the USCIS "E-Verify" program.

CAUTION In 2016 USCIS approved a new Form I-9 (dated November 14, 2016). After January 21, 2017, all previous versions of Form I-9 are invalid.

Annual certification of racial nondiscrimination

Churches and other religious organizations that operate, supervise, or control a private school must file a certificate of racial nondiscrimination (Form 5578) each year with the IRS. The certificate is due by the 15th day of the 5th month following the end of the organization's fiscal year. This is May 15 of the following year for organizations that operate on a calendar year basis. For example, the Form 5578 for 2017 is due May 15, 2018.

A private school is defined as an educational organization that 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 conducted. The term includes primary, secondary, preparatory, or high schools; and colleges and universities, whether operated as a separate legal entity or an activity of a church.

KEY POINT The term "school" also includes preschools, and this is what makes the reporting requirement relevant for many churches. As many as 25 percent of all churches operate a preschool program.

KEY POINT Independent religious schools that are not affiliated with a church or denomination, and that file Form 990, do not file Form 5578.

Instead, they make their annual certification of racial nondiscrimination directly on Form 990.

Form 5578 is easy to complete. A church official simply identifies the church and the school and certifies that the school has "satisfied the applicable requirements of sections 4.01 through 4.05 of Revenue Procedure 75-50." This reference is to the following requirements:

- The school has a statement in its charter, bylaws, or other governing instrument, or in a resolution of its governing body, that it has a racially nondiscriminatory policy toward students.
- The school has a statement of its racially nondiscriminatory policy toward students in all its brochures and catalogs dealing with student admissions, programs, and scholarships.
- The school makes its racially nondiscriminatory policy known to all segments of the general community served by the school through the publication of a notice of its racially nondiscriminatory policy at least annually in a newspaper of general circulation or through utilization of the broadcast media. However, such notice is not required if one or more exceptions apply. These include the following: (1) During the preceding three years, the enrollment consists of students at least 75 percent of whom are members of the sponsoring church or religious denomination, and the school publicizes its nondiscriminatory policy in religious periodicals distributed in the community. (2) The school draws its students from local communities and follows a racially nondiscriminatory policy toward students and demonstrates that it follows a racially nondiscriminatory policy by showing that it currently enrolls students of racial minority groups in meaningful numbers.
- The school can demonstrate that all scholarships or other comparable benefits are offered on a racially nondiscriminatory basis.

Filing the certificate of racial nondiscrimination is one of the most commonly ignored federal reporting requirements. Churches that operate a private school (including a preschool), as well as independent schools, may obtain Form 5578 from the IRS website (irs.gov) or by calling the IRS forms number (1-800-829-3676).

Charitable contribution substantiation rules

Several important rules apply to the substantiation of charitable contributions, including the following:

Cash contributions. All cash contributions, regardless of amount, must be substantiated by either a bank record (such as a cancelled check) or a written communication from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution. The recordkeeping requirements *may not be satisfied by maintaining other written records*. In the past, donors could substantiate cash contributions of less than $250 with "other reliable written records showing the name of the charity, the date of the contribution, and the amount of the contribution" if no cancelled check or receipt was available. This is no longer allowed. As noted below, additional substantiation requirements apply to contributions (of cash or property) of $250 or more, and these must be satisfied as well.

Substantiation of contributions of $250 or more. Donors will not be allowed a tax deduction for any individual cash (or property) contribution of $250 or more unless they receive a written acknowledgment from the church containing the following information:

- Name of the church.
- Name of the donor (a Social Security number is not required).
- Date of the contribution.
- Amount of any cash contribution.
- For contributions of property (not including cash) valued by the donor at $250 or more, the receipt must describe the property. No value should be stated.
- The receipt must contain one of the following: (1) a statement that no goods or services were provided by the church in return for the contribution; (2) a statement that goods or services that a church provided in return for the contribution consisted entirely of intangible religious benefits; or (3) a description and good faith estimate of the value of goods or services other than intangible religious benefits that the church provided in return for the contribution.
- The church may either provide separate acknowledgements for each single contribution of $250 or more or one acknowledgement to substantiate several single contributions of $250 or more. Separate contributions are not aggregated for purposes of measuring the $250 threshold.
- The written acknowledgment must be received by the donor on or before the earlier of the following two dates: (1) the date the donor files a tax return claiming a deduction for the contribution, or (2) the due date (including extensions) for filing the return.

Quid pro quo contributions of more than $75. If a donor makes a "quid pro quo" contribution of more than $75 (that is, a payment that is partly a contribution and partly a payment for goods or services received in exchange), the church must provide a written statement to the donor that satisfies two conditions:

The statement must inform the donor that the amount of the contribution that is tax-deductible is limited to the excess of the amount of any money (or the value of any property other than money) contributed by the donor over the value of any goods or services provided by the church or other charity in return. The statement must provide the donor with a good faith estimate of the value of the goods or services furnished to the donor.

A written statement need not be issued if only "token" goods or services are provided to the donor. For 2017, token goods or services were those having a value not exceeding the lesser of $107 or 2 percent of the amount of the contribution. This amount is adjusted annually for inflation. In addition, the rules do not apply to contributions in return for which the donor receives solely an intangible religious benefit that generally is not sold in a commercial context outside the donative context.

Gifts of property. Several additional rules apply to the substantiation of contributions of noncash property valued by the donor at $500 or more. Donors who claim a deduction over $500 but not over $5,000 for a noncash charitable contribution must retain certain records and complete the front side (Section A, Part I, and Part II if applicable) of IRS Form 8283 and enclose the completed form with the Form 1040 on which the charitable contribution is claimed.

Special rules apply to donations of cars, boats, and planes valued by the donor at more than $500. The church must provide the donor with a written acknowledgment, and send a Form 1098-C to the IRS containing required information about the donation. Form 1098-C can be used as the written acknowledgment that must be issued to a donor. See the instructions to Form 1098-C for more information.

For contributions of noncash property valued at more than $5,000 ($10,000 for privately held stock), a donor must obtain a qualified appraisal of the donated property from a qualified appraiser and complete a qualified appraisal summary (Section B of Form 8283) and have the summary signed by the appraiser and a church representative. The completed Form 8283 is then enclosed with the Form 1040 on which the charitable contribution deduction is claimed. The appraisal must be enclosed for contributions of property (other than inventory and publicly traded securities) in excess of $500,000.

Affordable Care Act reporting

The ACA imposes the most significant reporting obligations since the introduction of Form W-2 in 1943. In fact, the new reporting obligations are similar to Form W-2 in that there are forms that must be issued to individual employees, and a "transmittal" form that is sent to the IRS along with copies of all the forms issued to employees. And, as with Form W-2, the IRS can assess penalties for failure to comply with the new reporting obligations. Because of the similarities of the new reporting requirements to Form W-2, some are calling them the "Health Care W-2s." Of course, the analogy is not perfect. The W-2 form reports compensation and tax withholding, while the new forms report health insurance information. The reporting requirements consist of the following forms:

- Providers of minimum essential coverage are required to file Forms 1094-B and 1095-B. These forms are used to report certain information to the IRS and to employees about individuals who are covered by minimum essential coverage and therefore aren't liable for the individual shared responsibility payment penalty. These forms must be filed by February 28, 2018 (April 2, 2018 if filed electronically).
- Applicable Large Employers, generally employers with 50 or more full-time employees (including full-time equivalent employees) in the previous year, must file one or more Forms 1094-C (including a Form 1094-C designated as the Authoritative Transmittal, whether or not filing multiple Forms 1094-C), and must file a Form 1095-C for each employee who was a full-time employee of the employer for any month of the calendar year. Generally, the employer is required to furnish a copy of the Form 1095-C (or a substitute form) to the employee. These forms must be filed by February 28, 2018 (April 2, 2018 if filed electronically). The information reported on Forms 1094-C and 1095-C is used to determine whether an employer owes a payment under the employer shared responsibility provisions of the ACA (the "employer mandate" or "play or pay" provisions).

See the instructions to these forms on the IRS website (irs.gov) for more information.

> **KEY POINT** Churches with fewer than 50 full-time employees, and an insured group health plan, generally have no reporting obligation. They are not required to file Forms 1094-C and 1095-C since they have fewer than 50 employees, and their group plan insurer files the Forms 1094-B and 1095-B.

APPENDIX: 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

if taxable income is:	**then income tax equals:**
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

if taxable income is:	then income tax equals:
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

if taxable income is:	then income tax equals:
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

if taxable income is:	then income tax equals:
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 x 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 x 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 that 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.

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.

HELPFUL NUMBERS AND RESOURCES

To request IRS forms 800-TAX-FORM or 800-829-3676

IRS home page irs.gov

ChurchLawandTax.com—A Christianity Today website featuring Richard Hammar and a host of other professionals who provide information on church law, tax, finance, and risk management

ChurchLawAndTaxStore.com—Christianity Today's online store with church management resources to keep your church safe, legal, and financially sound

Church & Clergy Tax Guide—Richard Hammar's comprehensive tax guide published annually by Christianity Today International