

Can taxes impact social behaviors?

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ABSTRACT

House of Representatives Bill 1 of the 115th Congress, also known as the Tax Cut and Jobs Act of 2017 (the “Act”) changed many well-known tax deductions. Deductions for home equity loans, mortgage interest, moving expenses, and miscellaneous job expenses were changed by the Act. Tax preparation fees and many other miscellaneous deductions will be eliminated beginning in 2018, including investment fees and expenses. One of the biggest changes to the current tax code eliminates all personal exemptions and nearly doubles the current standard deduction for taxpayers. With the decrease in allowable deductions and the marked increase in the standard deduction, more taxpayers will use the standard deduction because it will be higher and more beneficial than any itemized deductions. With more taxpayers using the standard deduction, and not keeping track of their itemized deductions, will charitable donations still be made if they are not necessary to reduce a taxpayer’s tax burden? Will people continue to purchase houses or use home equity loans for purchases if not all of the interest is deductible? Will this tax bill affect social behaviors as well as taxable income? This paper will explore possible intended and perhaps unintended consequences of some of these changes.

Keywords taxes, social behaviors, deductions, new tax act

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INTRODUCTION

The Tax Cuts and Jobs Act of 2017 was passed by the House of Representatives on November 16, 2017, passed by the Senate on December 2, 2017, and then returned to a joint conference committee for changes agreed to by the Senate on December 20, 2017 and the House of Representatives on December 19, 2017. The Act was signed into law by President Trump on December 22, 2017 (Tax Act, 2). The Act was the first major revision to the Internal Revenue Code since 1986. The Act's focus was to simplify filing for taxpayers with a goal that taxpayers could file on a postcard. This simplification led to some major changes – such as eliminating personal exemptions, substantial increases to the standard deduction, and major changes to the deductibility of traditional Schedule A deductions. (Caplinger, 2).

A review of tax data produced by the Internal Revenue Service and listed Individual Statistical Tables by Size of Adjusted Gross Income shows 45,153,109 taxpayer returns claimed itemized deductions on 2016 tax filings. (Dept of Treasury, Stat Tables, 1). According to irs.gov, approximately 150,272,157 tax returns were actually filed during that same time frame. These numbers show that thirty percent of tax filers itemized deductions prior to the new Act. Interestingly, the group with the largest number of itemized filers was taxpayers making \$100,000 to \$200,000 per year. However, the groups with the largest percentage of itemized filers were the groups making \$200,000 - \$500,000; \$500 - \$1M and over \$1M. Each group shows taxpayers taking itemized deductions at over 90%. This paper will focus on those households making over \$50,000 since the number of itemizers in those households are substantial and measureable.

A taxpayer who itemizes has many choices of deductions to take. A review of the 2017 Form Schedule A, an attachment for taxpayers to use with their Form 1040 as they file taxes, shows that the major deductions most taxpayers seek are medical expenses, state and local taxes, home mortgage interest, gifts to charity and unreimbursed employee expenses. This form changed in 2018 to exclude unreimbursed employee expenses and limit some of the additional itemized deductions previously allows. The question remains will these changes promulgated by the Act change taxpayers' social behaviors when these payments are no longer motivated by tax savings? This paper will investigate changes to the itemized deductions of mortgage interest deductions, miscellaneous deductions which include unreimbursed employee expenses, and charitable deductions as well as review the above the line deduction of moving expenses.

MORTGAGE INTEREST

Mortgage Interest Deduction

According to the data set forth by the Internal Revenue Service, approximately 35 to 73 percent of all households making over \$50,000 a year claimed a mortgage interest deduction. (Dept of Treasury, Stat Tables, 2). IRS publication 936 outlines the mortgage interest deduction afforded to all taxpayers prior to the Act. Generally, deductible home mortgage interest is any interest paid by individuals on a loan secured by their home – this can be either their main residence or a second home. The loan may be a mortgage to buy a home, a second mortgage, a line of credit, or a home equity loan. (Dept of Treasury, Pub 936, 3). Prior to the Act, a taxpayer could deduct mortgage interest on first \$1,000,000 of home equity debt. New provisions under

the Act state taxpayer can only deduct interest on up to \$750,000 of qualified residence loans. This reduction in the amount of debt allowed will necessitate a reduction in the amount of interest deducted. This \$750,000 threshold total is a combined total, meaning the interested on all types of loans taken together can only be deducted up to the loans totaling \$750,000. (Tax Act, 34).

The IRS outlines an example showing that a taxpayer who uses a \$500,000 loan to purchase their primary residence and then additionally secures a \$500,000 loan to purchase a vacation home will be limited on the interest they may deduct. Since the loan total is \$1,000,000 and the threshold is \$750,000, the taxpayer in question will only be able to deduction $\frac{3}{4}$ of the interest generated on these loans. This deduction percentage is calculated by taking the \$750,000 allowance for deduction and dividing it by the \$1,000,000 actual loan balance. Because the total amount of both mortgages exceeds \$750,000, not all of the interest paid on the mortgages is deductible. (Dept of Treasury, Pub 936, 9). The social question to ask is will this change have a “chilling effect” on the purchase of real estate, particularly in areas where real estate carries a high value? Will purchasers wait to purchase real estate until a time when they can provide a higher down payment and thus a lower mortgage balance? If so, this change to mortgage interest deductions will slow the purchasing of higher-valued real estate.

Home Equity Lines of Credit

An additional change to the mortgage interest deduction was made to the treatment of home equity lines of credit. A home equity line of credit is a loan in which a homeowner borrows against the equity created in a personal residence. This loan comes in the form of cash to the taxpayer. Prior to 2018, a deduction allowance was made for loans up to \$100,000 secured by the taxpayer’s primary residence as long as loans were within the \$1,000,000 deductibility threshold. The Act suspended deduction for interest paid on home equity lines of credit unless the loan was used to “buy, build or substantially improve” the taxpayer’s home that secures the loan. (Tax Act, 34). This change necessitates that interest paid on home equity lines of credit that are not used directly for home improvement are not deductible.

Cavanaugh in her report for the U.S. Census stated that only 45% of home equity loans were used to repair property. Additional reasons for taking these loans were to consolidate debts, purchase automobiles, make investments or pay educational or other medical expenses. (Cavanaugh, 1). After changes to the Tax Act, interest paid on home equity loans taken for these reasons will no longer be deductible. A review of home equity loans show they have been very popular in recent years. Davidson in his article “Home equity credit lines boom 20% in 2015 borrowing binge” show that from 2014 to 2015, home equity lines of credit increased from a total of approximately 120M to 146M. (Davidson, 2) Since the interest on these loans will not be deductible unless these loans are used specifically for home improvement, the logical draw from that is that taxpayers will have to find other sources to fund these non-homeowner expenses previously paid for by home equity loans and home equity loans will lose popularity.

MISCELLANEOUS EXPENSES

Miscellaneous Expenses are not claimed by taxpayers as frequently as other itemized deductions. These expenses are harder to claim because prior to 2018, in order to deduct these expenses, many of the expenses to claim must meet the “2% floor threshold”. This threshold

means that in order to deduct these miscellaneous expenses, a taxpayer must add together all expenses, and then review their adjusted gross income from Line 37 of Form 1040. (Dept of Treasury, Pub 529, 3) The taxpayer must then multiply their adjusted gross income by 2% and then may only deduct the amount of expenses above the 2% of adjusted gross income. For example, if a taxpayer has \$5000 of miscellaneous expenses and \$100,000 of adjusted gross income then they must multiply their \$100,000 of adjusted gross income times the 2% threshold. This \$2,000 is the taxpayer's miscellaneous expense deduction "floor" and they may only deduct any miscellaneous expenses above that floor. Therefore, in this case, the taxpayer who has \$5,000 of miscellaneous deductions can only deduct \$3,000 of said expenses (\$5,000 expenses minus \$2,000 floor). Although these expenses are harder to claim due to this threshold, according to data produced by the Internal Revenue Service, based on income levels, approximately 25% of filers claim these expenses. (Dept of Treasury, Stat Tables, 2).

The Act made some drastic changes to miscellaneous deductions. Section 11045 of the Act suspends "All miscellaneous itemized deductions that are subject to the 2% floor." Therefore, many miscellaneous deductions are no longer reportable. (Tax Act, 36). Some popular miscellaneous deductions are unreimbursed employee expenses that average approximately \$6000 per year for the people claiming them. (Lowrey, 5). These expenses are generated when employees purchase or pay for items necessary for work and are not reimbursed by their employer. Examples of these expenses are scrubs for nurses or travel and cell phones expenses for salesmen. Additional popular miscellaneous expenses are tax preparation fees, fees for safety deposit boxes and investment fees. All miscellaneous expenses combined are subject to the 2% floor. Will social behaviors change with the non-deductibility of these expenses? Will taxpayers stop using CPA's for help filing tax returns or will they stop seeing an investment advisors for retirement planning? Additionally, will the burden to pay these employees expenses be shifted as employees ask and expect employers to pay for these expenses that are no longer deductible by employees?

An interesting twist to miscellaneous expenses is that although the Act suspended all miscellaneous itemized deductions subject to the 2% floor, it did not suspend other miscellaneous deductions not subject to the 2% floor. One of the most popular deductions found in this section is gambling losses. In the past, gambling losses were limited and could only be deducted to the extent the taxpayer had gambling income. Thus, a taxpayer who won \$1,000 and lost \$2,000 could only claim \$1,000 of losses as an "Other Miscellaneous Deduction Not Subject to the 2% Floor" because of this limitation. Section 11050 of the Act modified the law that limits the deduction for gambling losses only to the extent that the taxpayer has gambling income. The new Act states that "losses from wagering transactions" are generally deductible and may include otherwise deductible expenses incurred in "carrying out a wagering transaction" - these expenses are expenses for traveling to or from a casino to place a bet. (Tax Act, 37) The question that must be asked is will taxpayers now be able to deduct the expenses related to their gambling vacations? Legally it appears that the answer to this question is yes!

CHARITABLE DEDUCTIONS

Charitable Deductions are the most widely taken tax deduction, with over 50% of filers taking this deduction across the tax brackets. (Dept of Treasury, Stat Tables, 2). Under 2017 tax law, cash donations are usually allowed up to 50% of the taxpayer's adjusted gross income. This means that a taxpayer with \$100,000 in adjusted gross income would be able to deduction up to

\$50,000 in charitable donations because that is 50% of his adjusted gross income. If taxpayers donate more than what is allowed as a deduction under this law, the taxpayer was allowed a carryover of this deduction for five years in the future. A carryover means that the taxpayer was allowed to carry this deduction onto his next return for a period of five years, to determine if the deduction could be taken based on his adjusted gross income in future years. For example, if a taxpayer with \$100,000 of adjusted gross income donated \$60,000 to a qualified charity, the taxpayer would be limited to a \$50,000 deduction because that is 50% of his adjusted gross income. The remaining \$10,000 that was not deducted in the current year would be carried forward to the next year where the taxpayer could deduct it as long as the carry forward plus the current charitable contributions with below 50% of adjusted gross income. (Dept of Treasury, Pub 526, 3).

Under the new Act, these charitable deductions are now allowed up to 60% of the taxpayer's adjusted gross income. (Tax Act, 22). Therefore, using the example above of a taxpayer with \$100,000 of adjusted gross income and a \$60,000 contribution to a qualified charity shows that under the new Tax Act the taxpayer in this example would be able to deduct all \$60,000 of contributions in the current year. This change benefits taxpayers because they can take a higher deduction based on the amount of charitable donations given. The carry over period for any amount not deducted in a current year will still be allowed a carryover of five years. This change will reduce the tax burden for taxpayers and will also be a benefit to the charitable programs receiving these donations. Charitable deductions will continue to be made at the current level or may even increase based on the increased level of their deductibility.

MOVING EXPENSES

According to "The Average American's Tax Deductions -- how do yours compare?" by Frankel, only about 2.5% of all households claim moving expenses and the average deduction is about \$4000. (Frankel, 2). Prior to the change in tax law, moving expenses were allowed for any employee who moved more than fifty miles for their job. Expenses for moving vans, packing materials, movers, and even hotel stays were deductible. (Dept of Treasury, Pub 521, 7). These expense were considered "Above the Line" deductions, meaning for years 2017 and before, the taxpayers reported these expenses on page 1 of the Form 1040 and deducted these expenses from income to calculate adjusted gross income. Thus, the moving expenses reduced adjusted gross income and many deductibility thresholds that relied on a percentage of adjusted gross income.

Prior to any change, moving expenses were filed on Form 3903 and are limited by any reimbursement received by the employer. The new Tax Act does not provide for any deductibility of moving expenses. This is a deduction that is simply lost. (Tax Act, 36). With this deduction no longer available, will employees be less willing to take new jobs or transfer locations? It may be that employees will not be willing to transfer locations or change jobs without a reimbursement of these expenses from their employers, shifting the burden of these payments from the moving employee to the new employer.

CONCLUSION

H.R.1 also known as the Tax Cut and Jobs Act of 2017 changed many well-known tax deductions. The Act was an effort to simplify the U.S. Tax Code as well as reduce the tax burden for many American taxpayers. This Act will not only change the way taxpayers itemize their

deductions, but will also have some lasting social impacts to home ownership, charitable deductions, employee expenses and moving expenses. Although these effects may be unintended, there is no doubt that tax law drives social behavior of taxpayers.

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