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White Paper

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Highlights

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Tax Cuts and Jobs Act Will Present Retirement, Benefits, Executive Compensation and Payroll Professionals With New Challenges in 2018

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). The Act represents the most sweeping tax legislation in 30 years and will affect nearly every individual, business owner, and corporate taxpayer in the United States. While the primary focus of the Act is on the personal and corporate income tax rates, and the law does not uproot pension and benefits arrangements as radically as past legislation, the new rules will present employers, employees, and tax and benefits professionals with potentially difficult decisions in the areas of retirement planning, employee benefits management, executive compensation, and payroll administration.

Among the changes demanding immediate attention, the Act: repeals the rule permitting Roth IRA recharacterizations, imposes an excise tax on the excess compensation of executives of tax-exempt organizations, provides a new income deferral election for qualified equity grants, limits application of the $1 million deduction limit on executive compensation by removing the exclusion for performance based compensation, expands the contribution options under 529 plans, repeals the limited employer deduction for certain fringe benefits (such as entertainment), eliminates the deduction for qualified transportation fringe benefits, suspends the income exclusion for moving expenses reimbursements, eliminates the individual mandate penalty enacted under the Affordable Care Act, provides a temporary employer credit for paid family and medical leave, substantially alters the personal income tax rates, (which will lead to significant modification of the applicable income tax withholding rates), and radically changes the standard deduction and personal exemptions allowed under pre-2018 law.

While the scope of the Act is vast, one of the more surprising aspects of the legislation as enacted, from a retirement plan and executive compensation perspective, is the limited nature of the changes, especially when compared to proposed reforms that had been included in previous incarnations of the Act. For example, the Act does not curtail the 401(k) deferral and contribution limits or impose excise taxes on high income retirement savers. In addition the tax-favored status available to qualified and nonqualified stock options has been retained. However, while the rules governing retirement plans may not be directly affected by the law, the modification and expansion of the deduction for pass-through income could have a serious effect on currently maintained retirement plans. Pursuant to the law of unintended consequences, the new pass-through rules could effectively function as a disincentive to small employers to the establishment and continued maintenance of qualified plans.

A Roth IRA conversion may no longer be recharacterized or reversed after 2017

The impact of the Tax Cuts and Jobs Act on retirement plans, executive compensation, employee benefits, and payroll administration is detailed below. Professional Insights provided by leading practitioners highlight the immediate impact of the pending changes.

RETIREMENT BENEFIT PLANS

By: Glenn Sulzer, J.D.

The Act: repeals the rule permitting the recharacterization of Roth IRA conversions; provides an extended rollover period for plan loan offset amounts; furnishes relief from the early distribution penalty tax to taxpayers living in "2016 Disaster Areas;" and modifies the rules governing length of service awards under 457 plans. In addition, the Act significantly modifies the pass-through deduction rules, which may potentially discourage small employers from continuing to maintain qualified plans.

REPEAL OF RULE PERMITTING RECHARACTERIZATION OF ROTH CONVERSIONS

Prior to 2018, if an individual makes a contribution to an IRA for a tax year and then transfers the contribution (or a portion of the contribution) to another IRA in a trustee-to-trustee transfer, the individual can elect to treat the contribution as having been made to the transferee IRA and not to the transferor IRA. Thus, a taxpayer who converts an IRA into a Roth IRA may, within a stipulated time period, recharacterize the Roth IRA as a traditional IRA. The transfer must be made on or before the federal income tax due date (including extensions) for the tax year for which the original contribution was made, and must include allocable net income on the contribution. In addition, no deduction is permitted for the contribution to the transferor IRA.

Such "recharacterizations" are intended to provide tax relief to individuals who erroneously convert traditional IRAs into Roth IRAs or who otherwise wish to change the nature of an IRA contribution (e.g., in response to a decline in the value of the Roth IRA after conversion). Although recharacterizations are generally corrective measures, a taxpayer may recharacterize an IRA contribution for any reason. As a result, taxpayers typically employ the recharacterization strategy when they incur losses in a traditional IRA between the time it was converted and the due date of the taxes on the conversion.

New Law. The Act, effective for tax years beginning after December 31, 2017 repeals the special rule permitting the recharacterization of Roth conversions. Thus, while taxpayers may still convert traditional IRAs to Roth IRAs, a Roth IRA conversion may no longer be recharacterized or reversed after 2017 (Code Sec. 408A(d)(6)(B)(iii), as added by Act Sec. 13611).

> **Comment:** *Recharacterization remains an option with respect to other contributions. Accordingly, taxpayers who have made contributions for a year to a Roth IRA may (prior to due date of their individual income tax return for the year) recharacterize it as a contribution to a traditional IRA (Conference Committee Report).*

EXTENDED ROLLOVER PERIOD FOR PLAN LOAN OFFSET AMOUNTS

A qualified plan may allow a loan to be offset against the participant's accrued benefits in order to repay the loan. A loan offset typically occurs when the plan terms require that, in the event of an employee's termination or request for distribution, the loan be repaid immediately or treated as in default. Loan offset also arises when the plan terms require the loan to be cancelled upon an employee's termination or within a specified period thereafter.

In the event a plan offsets the distribution of a terminating participant's account balance by the amount of the outstanding loan balance, the distribution must include the loan balance at the time of the offset. However, the amount of the account balance that is offset against the loan is an actual distribution, and not a deemed distribution.

As an actual distribution, the amount of the loan offset is an eligible rollover distribution. Accordingly, an amount equal to the plan loan offset amount may be rolled over by the employee (or spousal distributee) to an eligible retirement plan (typically, an IRA). However, the rollover must occur within the 60-day period required under Code Sec. 402(c)(3).

New Law. The period during which a qualified loan offset amount must be rolled over to an eligible retirement plan has been extended, effective for tax years beginning after December 31, 2017, to the due date (including extensions) for filing the income tax return for the year in which the loan offset occurs (i.e., the tax year in which the amount is treated as distributed from a qualified plan (Code Sec. 402(c)(3)(C), as added by Act Sec. 13613(a) and (c)).

Qualified loan offset. For purposes of the extension of the rollover period, a qualified plan offset will be treated as a loan offset amount that is treated as distributed from a qualified plan (including a 403(b) or 457(b) governmental plan) to a participant or beneficiary solely because of: (1) the termination of the plan, or (2) the failure to meet the payment terms of the loan because of the participant's severance from employment (Code Sec. 402(c)(3)(C)(ii), as added by Act Sec. 13613(a)).

Loan offset amount. The amount of a qualified plan loan offset will remain the amount by which the participant's accrued plan benefit is reduced in order to repay the loan (Code Sec. 402(c)(3)(C)(iii), as added by Act Sec. 13613(a)).

RELIEF FOR 2016 DISASTER AREAS

A 10 percent penalty tax is imposed on an individual under age 59 ½ who receives a distribution from a plan qualified under Code Sec. 401(a) or from an individual retirement arrangement. The tax applies to the amount of the distribution includible in income. However, in addition to other exceptions enumerated under Code Sec. 72(t), the 10 percent early distribution penalty does not apply to "qualified hurricane distributions."

Congress has periodically provided relief allowing taxpayers affected by major hurricanes to take distributions from their retirement plans without incurring the additional tax. Specifically, Code Sec. 1400Q, added by the Gulf Opportunity Zone Act of 2005 (P.L. 109-135), expanded relief first enacted under the Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) to cover victims of Hurricanes Rita and Wilma. Subsequently, the Heartland, Habitat, Harvest, and Horticulture Act of 2008 (P.L. 110-246), extended the Code Sec. 1400Q relief to victims of tornadoes and storms that hit the Greensboro, Kansas area in May 2007. Most recently, The Disaster Tax Relief and Airport and Airway Extension Act of 2017 (P.L. 115-63), extended the relief to qualified individuals affected by Hurricanes Harvey, Irma, and Maria in 2017.

Under the currently authorized relief: the aggregate amount of distributions received by an individual that may be treated as qualified hurricane distributions cannot exceed the excess (if any) of $100,000 over any qualified hurricane distributions received for prior tax years; the portion of a qualified hurricane distribution that is includible in income may be reported ratably over three years, beginning with the year in which the distribution is received; and an individual who receives qualified hurricane distributions may recontribute up to the amount of those distributions to an eligible retirement plan within three years of receiving them.

The law further authorizes a temporary increase in the available dollar amount of a plan loan for qualified individuals affected by specified hurricanes. In addition, the due dates for the repayment of loans made available to qualified individuals affected by designated hurricanes may be delayed for one year.

Itemized deduction for casualty losses. A taxpayer may generally claim a deduction for any loss sustained during the taxable year that is not compensated by insurance or otherwise. For individual taxpayers, deductible losses must 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 are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

New Law. The Act extends the relief from the 10 percent penalty tax for "qualified 2016 disaster distributions" from qualified plans, 403(b) plans and IRAs of up to $100,000. The provisions essentially mirror the relief provided under Code Sec. 1400Q. Thus, income attributable to a qualified 2016 disaster distribution may be included in income ratably over three years, and the amount of a qualified 2016 disaster distribution may be recontributed to an eligible retirement plan within three years (Act Sec. 11028). However, the Act does not incorporate the loan options under Code Sec. 1400Q(c).

A qualified distribution recontributed within the three-year period is treated as a rollover and is not includible in income.

Qualified 2016 disaster distribution requires loss. A qualified 2016 disaster distribution is a distribution from an eligible retirement plan made on or after January 1, 2016, and before January 1, 2018, to an individual whose principal place of abode at any time during calendar year 2016 was located in a 2016 disaster area (as declared by the President under the Robert T. Stafford Disaster Relief and Emergency Assistance Act). In addition, however, the individual must have sustained an economic loss by reason of the events giving rise to the disaster declaration (Act Sec. 11028(b)(1)(D)).

Recontribution of qualified disaster distribution. Any portion of a qualified 2016 disaster distribution may, at any time during the three-year period beginning the day after the date on which the distribution was received, be recontributed to an eligible retirement plan to which a rollover can be made. An amount recontributed within the three-year period is treated as a rollover and is not includible in income. Thus, if an individual receives a qualified 2016 disaster distribution in 2016, that amount is included in income, generally ratably over the year of the distribution and the following two years, but is not subject to the 10 percent early withdrawal tax. Moreover, if the amount of the qualified 2016 disaster distribution is recontributed to an eligible retirement plan in 2018, the individual may file an amended return to claim a refund of the tax attributable to the amount previously included in income (Act Sec. 11028(b)(1)(E)).

Retroactive plan amendments. The Act allows a plan amendment made pursuant to the provision (or a regulation issued thereunder) to be retroactively effective. The amendment must be made on or before the last day of the first plan year beginning after December 31, 2018 (or in the case of a governmental plan, December 31, 2020), or a later date prescribed by the Secretary (Act Sec. 11028(b)(2)).

Deduction of casualty losses related to 2016 disaster. The Act authorizes a deduction for personal casualty losses arising in a 2016 disaster area in tax years beginning after December 31, 2015 and before January 1, 2018. The losses must be attributable to the events giving rise to the declared disaster.

The law allows losses to be deducted without regard to whether aggregate net losses exceed 10 percent of a taxpayer's adjusted gross income. However, in order to be deductible, the losses must exceed $500 per casualty (Act Sec. 11028(c)) .

MODIFICATION OF RULES APPLICABLE TO LENGTH OF SERVICE AWARDS

Code Sec. 457 plans are limited to agreements or arrangements between eligible employers (state and local governments and tax-exempt entities) and participants (including individual employment agreements) that provide for the deferral of the payment of compensation. However, specifically identified plans are either not subject to the restrictions of Code Sec. 457 or are treated as not providing for the deferral of compensation, for purposes of Code Sec. 457, even if the payment of compensation is deferred under the plan.

Among the authorized exceptions are plans that pay awards based solely on length of service, to "bona fide volunteers," such as firefighters, emergency medical and ambulance service personnel, or their beneficiaries. Such plans do not defer compensation and, thus, are not eligible 457 plans.

Bona fide volunteers may not receive any compensation for their services except for (1) reimbursement or a reasonable allowance for expenses incurred in performing their volunteer services, or (2) reasonable benefits (including length of service awards) and nominal fees for these services customarily paid by tax-exempt employers or governments. In addition, a length of service award will not qualify for this special treatment if the total amount of length of service awards for any year for any bona fide volunteer exceeds $3,000.

New law. The Act, effective for tax years beginning after December 31, 2017, increases the aggregate amount of length of service awards that may accrue for a bona fide volunteer with respect to any year of service from $3,000 to $6,000. In addition, the Act authorizes an adjustment to the maximum deferral amount in $500 increments to reflect changes in the cost-of-living for years after 2018 (Code Sec. 457(e)(11)(B), as amended by Act Sec. 13612(a) and (b)).

Application of limitation on accruals for defined benefit plans. A special rule applies to defined benefit plans. Under such circumstances, the limit will apply to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service (Code Sec. 457(e)(11)(B)(iv), as added by Act Sec. 13612(c)).

Actuarial present value is to be calculated using reasonable actuarial assumptions and methods. The method must assume payment will be made under the most valuable form of payment under the plan, commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation.

IMPACT OF REVISED PASS-THROUGH DEDUCTION RULES

An individual who receives business income from a pass-through entity—such as a partnership, an S corporation, or a sole proprietorship—is taxed on that income at the regular individual income tax rates. For businesses where the taxpayer's income from a pass through entity is the result of the personal services of the taxpayer, a reasonable amount of the income passed through is required to be treated as compensation. In the case of partnerships, certain LLC's, and proprietorships, this compensation is reported on Schedule SE and is subject to self- employment taxes. For S Corporations, this compensation is treated as wages and reported on a W2.

Under current law, owners of S Corporations will typically divide their income between pass through business income and wages. Wages are subject to Social Security taxes up to the taxable wage base ($127,200 for 2017 and $128,400 in 2018). All wages are also subject to Medicare taxes. Pass-through income, reported to the owner on Form K1, is not subject to either of these taxes. This creates an incentive to reduce wages and increase K1 income.

> **Comment:** *Small business owners in pass-through entities have traditionally adopted retirement plans (e.g., cash balance plans) to allow them to provide for the retirement needs of themselves (and their employees), rather than pay taxes on business income at the high individual "pass-through" rate.*

New Law. The Act, for the tax years 2018 through 2025, allows noncorporate taxpayers to deduct up to 20 percent of domestic qualified business income from a partnership, S corporation, or sole proprietorship (Code Sec. 199A, as added by Act Sec. 11011). The deduction is generally limited to the greater of (1) 50 percent of W-2 wages paid by the business, or (2) the sum of 25 percent of the W-2 wages paid plus 2.5 percent of the unadjusted basis of certain property the business uses to produce qualified business income. This limit may be phased-in or eliminated if the taxpayer's taxable income meets certain threshold requirements.

> **Comment:** *The law effectively allows companies that pay a large amount of W-2 wages to take a greater deduction than a smaller company with fewer employees.*

The deduction is generally not allowed for certain service trades or businesses. However, this restriction is phased-in for taxpayers whose taxable income meets certain threshold requirements.

Professional Insight: The concern raised by the revised rules has been that small business owners may now elect to pay tax on income at the lower pass-through rate, rather than contribute the income to a qualified plan. Thus, ftwilliam.com (a provider of cloud-based employee benefits software, including state of the art plan documents, forms, and compliance systems) cautions that the Act effectively may remove the monetary incentive to incur the cost and administrative burden of sponsoring and maintaining a qualified plan.

The combined effect of the pass-through changes may discourage employer contributions to qualified plans.

As further highlighted by the American Retirement Association, the Act by, allowing small business owners with qualified income to apply income tax at the lower marginal rate, will disincent the direction of income to maintain contributions to a retirement plan, which will be subject to higher tax rate upon distribution. Accordingly, instead of taking the deduction afforded by the retirement plan contribution, the owner could have a personal financial incentive, especially over the long-term, to take the income and pay the resultant tax at the lower pass-through rate.

The following example, provided by Richard Perlin, J.D., CPC and President of E.R.I.S.A. Inc., in Skokie, Illinois, neatly illustrates the potential impact of the revised pass through rule as: (1) an incentive for employers to take income as business income rather than wages or other earned income and (2) a disincentive for companies to fund qualified retirement plans with employer money.

Example: Individual A owns 100% of S corporation T. In 2016, T had $150,000 of net earnings. A took $100,000 as salary and $50,000 as an S corporation dividend. In 2017, T has $200,000 of earnings. If A takes $130,000 of salary in 2017, the incremental Social Security and Medicare taxes, on both the employer and employee side, would be $4,242.80. If A decides to leave her salary unchanged the incremental taxes will be zero (although some states impose a small "pick-up" tax on S corporation dividends). The existing system creates an incentive for the owner to characterize income as S corporation dividends rather than wages.

In addition, assume Company T maintained a 401(k) profit sharing plan in which A received a profit sharing contribution of 15% of pay ($15,000 based on $100,000 of wages) and a common law employee, B received a contribution equal to 5% of wages, plus the opportunity to defer wages into the 401(k). Assume A is in a 24% marginal tax bracket (2018) and is able to receive the full deduction for the S corporation dividend of 20%. If A contributes the $15,000 to the plan for herself, she will receive a tax savings of about $2,880 (80% of 24% of $15,000). Under 2017 rates this tax savings would have been about $4,200 (28% of $15,000). The tax savings are much lower in 2018.

Further, the retirement money A accumulates in the qualified plan will be taxed at ordinary income rates, with no reduction, once distributed. In other words, if A took the money out in the same year it was contributed to the plan (unlikely, but intended to highlight the disparity), A would have federal income taxes due of $3,600 (24% of $15,000). But A (as the owner of S corporation T) only received a tax savings of $2,880 in making the contribution. The effect of this tax "penalty" will only compound over the years.

Consequently, the combined effect of these changes can discourage employer contributions to qualified plans.

EXECUTIVE COMPENSATION

By: Glenn Sulzer, J.D.

The Act: imposes an excise tax on tax-exempt organizations for excess compensation paid to designated executives; provides certain high income qualified employees with a new option to elect to defer the inclusion of income from qualified stock transfers; modifies application of the $1 million limitation on the deductibility of executive compensation by removing the exclusion for performance based compensation; and increases the excise tax assessed on the stock compensation of insiders in expatriated corporations.

EXCISE TAX ON EXCESS TAX-EXEMPT ORGANIZATION EXECUTIVE COMPENSATION

The rules restricting a publicly held corporation from deducting more than $1 million of compensation in a taxable year for "covered employees" or "excess parachute payments" do not apply to compensation paid to employees of a tax-exempt organization. Thus, while compensation to an executive employee must be reasonable, payments in excess of $1 million to a covered employee are not subject to any excise tax.

New Law. The Act, effective for tax years beginning after December 31, 2017, imposes an excise tax on tax-exempt organizations of 21 percent (the newly enacted corporate tax rate) on the sum of: (1) remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee by the tax-exempt organization for the tax year, and (2) any excess parachute payment paid by the tax-exempt organization to a covered employee (Code Sec. 4960(a), as added by Act Sec. 13602).

Covered employee. A covered employee triggering the tax would be an employee (including any former employee) of an applicable tax-exempt organization who: (1) is one of the five highest compensated employees of the organization for the taxable year, or (2) was a covered employee of the organization (or a predecessor) for any preceding taxable year beginning after December 31, 2016 (Code Sec. 4960(c)(2), as added by Act Sec. 13602).

Remuneration. Remuneration subject to the excise tax includes wages, as defined under Code Sec. 3401(a) for income tax withholding purposes, but does not encompass any designated Roth contribution (Code Sec. 4960(c)(3)(A), as added by Act Sec. 13602). However, compensation attributable to medical services of certain qualified medical professionals is excluded from the definitions of remuneration and parachute payments. Similarly, in determining an individual's status as a covered employee, remuneration paid to a licensed medical professional (e.g., doctor, nurse, or veterinarian) which is directly related to the performance of medical or veterinary services by such professional is not taken into account (Code Sec. 4960(c)(3)(B), as added by Act Sec. 13602).

Remuneration paid when no substantial risk of forfeiture. Remuneration is treated as paid when there is no substantial risk of forfeiture (as defined under Code Sec. 457(f)(3)(B)) of the rights to such remuneration (Code Sec. 4960(a) added by Act Sec. 13602).

> **Comment:** *The Conference Report cautions that the excise tax may be imposed on the value of remuneration that is vested (and any increases in such value or vested remuneration), even if it is not yet received.*

Employer liable for excise tax. The employer of the covered employee is liable for the excise tax (Code Sec. 4960(b), as added by Act Sec. 13602). In the event remuneration of a covered employee from more than one employer is taken into account in determining the excise tax, each employer will be liable for the tax in an amount that bears the same ratio to the total tax as the remuneration paid by that employer bears to the remuneration paid by all employers to the covered employee (Code Sec. 4960(c)(4)(C), as added by Act Sec. 13602).

TREATMENT OF QUALIFIED EQUITY GRANTS: NEW DEFERRAL ELECTION OPTION

The tax treatment of transfers of stock to an employee in connection with the performance of services is governed by specific rules under Code Sec. 83. Generally, an employee must recognize income in the tax year in which the employee's right to the stock is transferable or, if earlier, is not subject to a substantial risk of forfeiture (i.e., substantially vested). Accordingly, if an employee's right to the stock is substantially vested when the stock is transferred, the employee will recognize income in the tax year of the transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). However, if, at the time the stock is transferred, the employee is not substantially vested (i.e., nonvested), the employee will not recognize income attributable to the stock transfer until the tax year in which the employee's right becomes substantially vested. Under such circumstances, the amount includible in the employee's income will be the fair market value of the stock as of the date that the employee's right to the stock is substantially vested (less any amount paid for the stock). However, if the employee's right to the stock is nonvested at the time the stock is transferred to employee, the employee has the option under Code Sec. 83(b) to elect within 30 days of transfer to recognize income in the tax year of the transfer (i.e., an "83(b) election").

The election to defer income for up to 5 years is not available to certain executives, highly compensated employees, and 1 percent owners.

The employer making the transfer of stock is entitled, under Code Sec. 83(h), to a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount included in the employee's income as a result of transfer of the stock. The deduction applies to the tax year in which or with which ends the tax year of the employee when the amount was included and reported in the employee's income.

New Law. The Act, generally effective with respect to stock attributable to options exercised or restricted stock units (RSUs) settled after December 31, 2017, provides a "qualified employee" with a new option to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to "qualified stock" transferred to the employee by the employer (Code Sec. 83(i), as added by Act Sec. 13603(a)). The election to defer income for up to 5 years, however, is not available to certain executives, highly compensated employees, and 1-percent owners.

Timeframe for inclusion deferral election. The election to defer income inclusion with respect to qualified stock must be made no later than 30 days after the first date the employee's rights to the stock are transferable or are subject to substantial risk of forfeiture (Code Sec. 83(i)(4)(A), as added by Act Sec. 13603(a)).

Tax year of inclusion. Under an election to defer income inclusion, the income must be included in the employee's income for the tax year that includes the earliest of: (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer; (2) the date the employee first becomes an "excluded employee;" (3) the first date on which any stock of the employer becomes readily tradable on an established securities market; (4) the date five years after the first date the employee's right to the stock becomes substantially vested; or (5) the date on which the employee revokes the inclusion deferral election (Code Sec. 83(i)(1)(B), as added by Act Sec. 13603(a)).

Comment: *The effect of an inclusion deferral election is that the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee's tax liability with respect to such stock).*

Limitation on election following employer stock purchase. An employee generally may not make an inclusion deferral election for a year with respect to qualified stock if, in the preceding calendar year, the corporation purchased any of its outstanding stock. However, the limitation does not apply if at least 25 percent of the total dollar amount of the stock purchased is stock with respect to which an inclusion deferral election is in effect ("deferral stock") and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis (Code Sec. 83(i)(4)(B), as added by Act Sec. 13603(a)).

Eligible qualified employees exclude highest paid executives. Qualified employees eligible to make the income deferral election will *not* include any individual: (1) who was a 1 percent owner of the corporation at any time during the calendar year, or was a one-percent owner at any time during the 10 preceding calendar years; (2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity, (3) who is a family member of an individual described in (1) or (2); or (4) who has been one of the four highest compensated officers of the corporation for the tax year or any of the 10 preceding taxable years (Code Sec. 83(i)(3), as added by Act Sec. 13603(a)).

Qualified stock. Qualified stock to which the election applies includes any stock of a corporation if: (1) an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and (2) the option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation (Code Sec. 83(i)(2)(A), as added by Act Sec. 13603(a)).

> **Comment:** *Stock can be qualified only if it relates to stock received in connection with options or RSUs. Accordingly, qualified stock does not include stock received in connection with other forms of equity compensation, including stock appreciation rights or restricted stock.*

Right of employee to sell stock limits election option. Qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation (Code Sec. 83(i)(2)(B), as added by Act Sec. 13603(a)).

Eligible employer. A corporation is an eligible corporation with respect to a calendar year if: (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or restricted stock units, with the same rights and privileges to receive qualified stock (80-percent rule) (Code Sec. 83(i)(2)(C), as added by Act Sec. 13603(a)).

Same rights and privileges. For purposes of the 80-percent rule, an employer will not fail to treat employees as having the same rights and privileges to receive qualified stock merely because the number of shares available to all employees is not equal in amount. However, the number of shares available to each employee must be more than a de minimis amount (Code Sec. 83(i)(2)(C)(ii)(II), as added by Act Sec. 13603(a)).

> **Comment:** *The deferred income election will impact the time when the employer may deduct the amount of income attributable to the qualified stock. Thus, the employer's deduction will be deferred until the employer's tax year in which or with which ends the tax year of the employee for which the amount is included in the employee's income.*

Notice requirements. A corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee's right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election). The notice must certify to the employee that the stock is qualified stock and disclose the income tax consequences of the election (Code Sec. 83(i)(6), as added by Act Sec. 13603(a)).

Penalty for failure to provide notice. An employer is subject to a penalty of $100 for *each* failure to provide the required notice, unless the failure is due to reasonable cause. However, the total penalty imposed on an employer for all failures during the calendar year may not exceed $50,000 (Code Sec. 6652(p), as added by Act Sec. 13603(e)).

> **Comment:** *The penalty will apply to failures occurring after December 31, 2017 (Act Sec. 13603(f)).*

Withholding requirements. The inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA taxes is not affected. For the tax year for which income subject to an inclusion deferral election is required to be included in income by the employee, the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers (Code Secs. 3401(i) and 3402(t), as added by Act Sec. 13603(b)).

W-2 reporting. The employer must report on Form W-2 the amount of income covered by an inclusion deferral election for the year of deferral *and* for the year the income is required to be included in income by the employee (Code Sec. 6051(a)(16), as added by Act Sec. 13603(d)). In addition, the employer must report on Form W-2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year (Code Sec. 6051(a)(17), as added by Act Sec. 13603(d)).

Transition rule. The new deferral election rules generally apply with respect to stock attributable to options exercised or RSUs settled after December 31, 2017 (Act Sec. 13603(f)(1)). However, during a transition period, pending the release of guidance implementing the 80-percent rule and the employer notice requirements, a corporation will be treated as complying with the respective requirements by making a good faith interpretation of the requirements (Act Sec. 13603(g)).

MODIFICATION OF LIMITATION ON EXCESSIVE EMPLOYEE REMUNERATION

Employers may generally deduct reasonable compensation paid to employees as ordinary and necessary business expenses. However, a publicly held corporation may, under Code Sec. 162(m), generally not deduct compensation paid to a covered employee to the extent that the compensation exceeds $1 million per tax year. The limitation applies for purposes of both the regular income tax and the alternative minimum tax.

Publicly held corporation. A publicly held corporation includes any corporation issuing a class of common equity securities required to be registered under Sec. 12 of the Securities Exchange Act of 1934. A corporation is not publicly held if the registration of its securities is voluntary.

Affiliated groups included. A publicly held corporation includes an affiliated group of corporations. However, a publicly held subsidiary is not included in the affiliated group of its parent.

The effect of the affiliated group rule is that compensation received by a covered employee from more than one member of an affiliated group is aggregated. Amounts that may not be deducted are prorated among the payor corporations in proportion to the compensation paid by the corporation to the employee.

Covered employees. A "covered employee" is an individual who, on the *last day of the tax year*, is either the company's chief executive officer (or acting in that capacity); or an employee whose total compensation for the year is required to be reported to shareholders under the Securities Exchange Act of 1934 because the employee is among the four highest compensated officers for that tax year (other than the chief executive officer).

Compensation. For purposes of determining whether the $1 million limit has been reached, compensation includes the aggregate amount of cash and noncash benefits that were paid to an employee and are deductible by the employer as remuneration for services, regardless of whether the services were performed during the tax year. Compensation does not include: (1) remuneration that is exempt from treatment as wages for FICA purposes, including payments from sickness and accident disability plans, pension benefits, and payments from a 403(b) annuity plan or a SEP; (2) payments to tax-favored retirement plans, including salary reduction contributions; (3) benefits provided to or for an employee for which it is reasonable to believe, at the time the benefit is provided, the employee would be able to exclude from gross income; (4) compensation paid on a commission basis that is provided solely on account of income generated directly by the performance of the employee and not on account of the performance of a business unit or some other broader performance standard; (5) performance-based compensation; and (6) compensation payable under a written binding contract that was in effect on February 17, 1993.

Performance-based compensation exempt from deduction limit. Compensation in excess of $1 million may be deducted if it is payable because the employee has satisfied a written, objective performance goal established by the company's compensation committee (consisting solely of two or more outside directors) before the employee performed the relevant services and while the outcome of the goal was "substantially uncertain."

Stock options and SARs. Compensation attributable to stock options or stock appreciation rights (SARs) is treated as paid on the basis of pre-established performance goals if: (1) the grant or award is made by the compensation committee; (2) the plan restricts the number of shares for which options or SARs may be granted to any individual employee during a specified period; and (3) the compensation that the employee may receive under the option or SAR is based solely on an increase in the value of the stock (i.e., company performance) after the date of the grant or award.

Compensation tied to "discount" options, restricted stock, or other arrangements under which the compensation the employee receives is not based on an increase in the value of the stock after the grant or award, does not qualify as performance-based compensation. Compensation of this nature is paid regardless of whether a performance goal is met.

However, compensation attributable to a stock option, SAR, or other stock-based arrangement may reflect changes in corporation capitalization (i.e., stock splits or dividends), mergers, consolidations, spinoffs, or any reorganization or partial or complete liquidation.

Comment: *It is estimated that the compensation of a covered employee typically consists of 50-75 percent incentive compensation, which is intended to be deductible under Code Sec. 162(m).*

New law. The Act, generally effective for tax years beginning after December 31, 2017, will significantly alter the rules under Code Sec. 162(m) by: eliminating the exclusion from the $1 million compensation deduction limit for performance based compensation and commissions; expanding the type of companies subject to the compensation deduction limit; including chief financial officers (CFOs) among a corporation's covered employees; and extending the period during which an individual would be considered a covered employee. The Act will significantly impact the taxation and deductibility of executive compensation for public and large private companies, beginning in 2018. However, the Act does provide a transition rule that will allow limited relief for remuneration provided under contracts in effect on November 2, 2017 (Act Sec 13601).

Elimination of exception for performance based compensation and commissions. The Act eliminates the exceptions under Code Sec. 162(m)(4) for commissions and performance-based compensation from the definition of compensation subject to the deduction limit (Code Sec. 162(m)(4), as amended by Act Sec. 13601(a)). Accordingly, performance based compensation and commissions will be taken into account in determining the amount of compensation with respect to a covered employee for a tax year that exceeds $1 million and is thus, not deductible.

Performance based compensation will be taken into account in determining the amount of compensation with respect to a covered employee that exceeds $1 million and is, thus, not deductible.

Professional Insight: The elimination of the performance based compensation exclusion will relieve employers of the burden of complying with the technical requirements prerequisite to the exclusion. Michael Melbinger, partner at Winston & Strawn LLP and author of the "Executive Compensation Update," notes the following "silver linings" attendant the repeal of the performance based exemption.

1. Eliminating the deductibility of performance based compensation reduces the need for a company to base a substantial portion of its annual compensation on performance factors. However, best practices and the demands of investors make it likely that companies will continue to make executives' compensation heavily performance based.
2. Eliminating the requirement that the performance goals must be established by a compensation committee comprised solely of two or more outside directors will give companies the flexibility to include on their compensation committees, board members who would not have qualified as "outside directors" under the requirements of Code Sec. 162(m). Again, most companies likely will continue to

follow best practices in corporate governance and certainly will follow the independence requirements of the stock exchanges (required by Dodd- Frank Act Section 952) in selecting compensation committee members.

3. Eliminating the requirement that the material terms of any performance goals must be disclosed to and subsequently approved by the company's shareholders before the compensation is paid will give the compensation committee flexibility to select any performance metrics it wants. In addition, companies may no longer need to put their stock incentive plans and performance metrics up for reapproval by shareholders every five years.

Compensation paid after retirement or termination of employment continues to be subject to the $1 million deduction limit.

4. Eliminating the condition that the compensation be paid solely because the covered employee has attained one or more preestablished, objective performance goals, will give companies and compensation committees flexibility to include subjective performance measures in determining annual and long-term compensation. Compensation committees also will have greater flexibility to adjust the performance goals set at the beginning of the year to reflect unforeseen developments.
5. Eliminating the requirement that the compensation committee must certify in writing, before payment of the compensation, that the performance goals and any other material terms were satisfied, will slightly lessen the administrative burdens of boards and committee members and give them more flexibility as to the timing of payments.

Expanded definition of covered employees. The Act expands the definition of covered employee to include both the company's principal executive officer and the principal financial officer (Code Sec. 162(m)(3), as amended by Act Sec. 13601(b)).

Professional Insight: Melbinger notes that the expansion of covered employees to include a company's chief financial officer is not a surprising change, as it addresses a longstanding inconsistency in the tax law and proxy disclosure rules as to who is a covered employee.

Covered employee at any time during the tax year. Under the revised rules, an individual would be a covered employee if the individual held one of the specified positions *at any time* during the tax year (Code Sec. 162(m)(3), as amended by Act Sec. 13601(b)). Under Code Sec, 162(m)(3), prior to amendment, a covered employee needed to hold the position as of the *close of the tax year*.

3 most highly compensated officers. The Act redefines covered employees as the 3 (rather than the 4) most highly compensated officers for the tax year (other than the principal executive officer or principal financial officer) who are required to be reported on the company's proxy statement (i.e., the statement required pursuant to executive compensation disclosure rules promulgated under the Exchange Act) for the tax year (or who would be required to be reported on such a statement for a company not required to make such a report to shareholders) (Code Sec. 162(m)(3)(B), as amended by Act Sec. 13601(b)).

Length of status as covered employee. The Act significantly lengthens the period of time an individual will be subject to the compensation deduction limitation as a covered employee (Code Sec. 162(m)(3)(C), as added by Act Sec. 13601(b)). In the event an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual will remain a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died.

Professional Insight: Melbinger notes that the payment of deferred compensation or the exercise of stock options after a named executive officer retires or otherwise terminates employment would not alter the impact of the law. The compensation continues to be subject to the $1 million deduction limit. This is a significant change as, prior to amendment, Code Sec. 162(m) only applied to individuals who were named executive officers at the end of the tax year in which the tax deduction was claimed.

Remuneration paid to beneficiaries. Remuneration will remain compensation subject to the deduction limit for a tax year even if the remuneration is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the employee's death (Code Sec. 162(m)(4)(F), as added by Act Sec. 13601(d)). The treatment would also apply to remuneration provided to a former spouse pursuant to a domestic relations order.

Deduction limit applicable to more companies. The Act expands the publicly held corporations subject to the $1 million compensation limit to include all domestic publicly traded companies and all foreign companies that are publicly traded through American depository receipts (ADRs) (Code Sec. 162(m)(2), as amended by Act Sec. 13601(c)). The expanded definition could encompass certain additional corporations that are not publicly traded, such as large private C or S corporations. Effectively, the Act subjects any company required to file SEC reports to the $1 million compensation limit.

Transition rule. The Act provides relief for current plans, incentive awards and agreements. Specifically, the amended provisions will not apply to remuneration provided pursuant to a written binding contract that was in effect on November 2, 2017, and which was not modified in any material respect on or after such date (Act Sec. 13601(e)).

> **Comment:** *The grandfather exception will not apply to contracts entered into on or before November 2, 2017, that are subsequently renewed after that date. The renewed contract would be treated as a new contract entered into on the day the renewal takes effect.*

Terminable contracts. Contracts that are terminable or that can be canceled unconditionally at will by either party without the consent of the other, or by both parties to the contract, are also treated as new contracts entered into on the date any such termination or cancellation would be effective.

Professional Insight: Melbinger advises that companies, in the first month of 2018, will need to determine the extent to which their executive compensation plans and agreements qualify for the grandfathering protection.

Specifically, Melbinger suggests that companies should consider accelerating into 2017, payments that would be made to their CFOs or to a 2016 named executive officer who has terminated employment in 2017, to the extent that such payments would not satisfy the grandfathering exception and are permissible under other tax rules.

Melbinger also counsels companies and compensation committees to consider how they can reduce the impact of the lost deduction for performance based compensation for future cash and equity awards. One action available to many companies is to award qualifying incentive stock options (ISOs) under Code Section 422. Generally, ISOs do not result in a tax deduction for the company, but they do provide favorable tax consequences for the employee recipients. Some companies are considering mandatory compensation deferral (or encouraging executives to defer compensation). This action would not retrieve the company's tax deduction, but it will postpone the expenditure of cash, which many companies find helpful. Either of these actions would be subject to a series of legal requirements.

INCREASE IN EXCISE TAX RATE FOR STOCK COMPENSATION OF INSIDERS IN EXPATRIATED CORPORATIONS

The stock compensation of company officers, directors and other insiders ("disqualified individuals") in specified expatriated corporations is subject to a 15-percent excise tax. The excise tax will generally apply only if any of the expatriated corporation's shareholders recognize gain on any stock in the corporation as a result of a corporate inversion transaction that caused the expatriation.

The excise tax is assessed on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity (e.g., a partnership or trust) in which the individual, or a member of the individual's family, has an ownership interest.

Specified stock compensation subject to the excise tax includes any payment (or right to payment) granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group).

Specified stock compensation includes: compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, restricted stock units, phantom stock, and phantom stock options; nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member); a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder; and a payment directly tied to the value of the stock.

New Law. The Act, effective for corporations first becoming expatriated after the December 22, 2017 date of enactment, increases the excise tax imposed on the value of stock compensation realized in a corporate inversion by the corporation's insiders from 15 percent to 20 percent (Code Sec. 4985(a)(1), as amended by Act Sec. 13604).

EMPLOYEE BENEFITS

By: Tulay Turan, J.D.

The Act: expands the contribution options under 529 plans (including allowing for rollover contributions from ABLE Accounts); suspends the income tax exclusion for bicycle commuting reimbursements; repeals the limited employer deduction for certain fringe benefits (e.g., entertainment expenses); eliminates the deduction for qualified transportation benefits; suspends the income exclusion for moving expense reimbursements; restricts the deductibility of employee achievement awards; modifies the deduction limit for luxury automobiles by increasing the applicable depreciation limits; removes computers from listed property under Code Sec. 280F; eliminates the individual mandate penalty authorized under the Affordable Care Act; and provides a temporary employer credit for paid family and medical leave.

529 ACCOUNT FUNDING AND ROLLOVERS FROM ABLE ACCOUNTS

Under current law, an individual may open an account in a qualified tuition program to help pay for the qualified higher education expenses of a designated beneficiary either through a prepaid tuition or college savings program (Code Sec. 529). A 529 plan can be established and maintained by a state, state agency, or by an eligible educational institution (i.e., virtually any accredited public, nonprofit, or private college or university).

Contributions to a 529 plan on behalf of a designated beneficiary must be made in cash and are limited to the necessary amount of qualified higher education expenses for the beneficiary as determined under the program. Qualified higher education expenses include tuition, fees, books, supplies, and equipment required by an educational institution for enrollment or attendance. They also include amounts paid for computers and peripheral equipment, software, and internet access and related services if the items are to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution. Qualified expenses also include the reasonable cost of room and board if the beneficiary is enrolled at least half-time.

Distributions from the account for qualified education expenses are not subject to federal capital gains tax. In addition, many states allow a tax deduction or credit for contributions to the accounts.

New Law. For distributions made after December 31, 2017, the definition of higher education expenses includes expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school (Code Sec. 529(c)(7)(A), as added by Act. Sec. 11032(a)(1)).

Limitation on cash distributions. For distributions made after December 31, 2017, the amount of cash distributions from all qualified tuition programs with respect to a beneficiary during any taxable year cannot, in the aggregate, include more than $10,000 in expenses for tuition incurred during the tax 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 (Code Sec. 529(e)(3)(A), as amended by Act Sec. 11032(a)(2)).

> **Comment:** *The newly available funds available to taxpayers sending their children to private schools could lead to an increase in tuition at those schools. It could also force taxpayers to account for 529 assets in applying for financial aid from those schools, leading to less financial assistance for the 529 account holder, but possibly freeing up aid for the less affluent. Finally, the new tax break, and the potential attendant loss of revenue, may lead states to limit the deduction for contributions or condition the deduction on an income threshold.*

Rollovers. Amounts from a 529 plan can be rolled over to an ABLE account (a tax-favored savings program intended to benefit disabled individuals) without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 plan, or a member of such designated beneficiary's family. Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a tax year (Code Sec. 529(c)(3)(C)(i)(III), as added by Act Sec. 11025(a)).

> **Comment:** *The rollover provision applies to distributions after the December 22, 2017 date of enactment of the Act, but it is not effective for distributions after December 31, 2025 (Code Sec. 529(c)(3)(C)(i)(III), as added by Act Sec. 11025(a)).*

SUSPENSION OF EXCLUSION FOR QUALIFIED BICYCLE COMMUTING REIMBURSEMENT

Employees may exclude qualified bicycle commuting reimbursements from their taxable income. A qualified bicycle commuting reimbursement is any employer reimbursement during a 15-month period beginning with the first day of the calendar year for reasonable expenses incurred by the employee during the calendar year. The reasonable expenses must be for the purchase of a bicycle or bicycle improvements, bicycle repair and storage if the bicycle is regularly used for travel between the employee's residence and place of employment. The exclusion is subject to a per employee annual limitation of $20 multiplied by the number of qualified bicycle commuting months during the calendar year.

> *Higher education expenses will include expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.*

New Law. The exclusion for qualified bicycle commuting reimbursements will not apply to any taxable year beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 132(f)(8), as added by Act Sec. 11047).

LIMITATION ON DEDUCTION BY EMPLOYERS FOR FRINGE BENEFITS

Employers are not allowed to deduct an activity generally considered to be entertainment, amusement, or recreation unless the employer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the employer's trade or business. An employer also cannot deduct a facility used in connection with such activity. In addition, no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation or other social purpose.

If the employer establishes that entertainment expenses are directly related to (or associated with) the active conduct of its trade or business, the deduction generally is limited to 50 percent of the amount otherwise deductible. Similarly, a deduction for any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible.

Certain employer-provided fringe benefits are excluded from an employee's gross income and wages for employment tax purposes, including, but not limited to, *de minimis* fringes, qualified transportation fringes, on-premises athletic facilities, and meals provided for the "convenience of the employer."

Employers will not be able to claim transportation benefits as a business expense and they will pay FICA tax on the value of the benefit.

New Law. The Act provides that, effective for payments after December 31, 2017, no deduction is allowed with respect to: (1) an activity generally considered to be entertainment, amusement or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items (Code Sec. 274(a)(1)(A) and 274(a)(2)(C), as amended by Act Sec. 13304(a); Act Sec. 13304(e)(1)).

50-percent deduction retained for meal expenses. Employers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (*e.g.*, meals consumed by employees on work travel) (Code Sec. 274(n), as amended by Act Sec. 13304(a)(2)(D)). Thus, although the 50 percent limit on deductions for entertainment and membership dues was repealed, the rule as it relates to meal expenses was retained.

Note: *The deductibility of employer-provided meals is discussed further below.*

TREATMENT OF TRANSPORTATION BENEFITS

Qualified transportation fringe benefits provided by an employer to an employee may be excluded from the employee's gross income and wages. A qualified transportation fringe benefit includes employer-provided transit passes, qualified parking, van pooling, and qualified bicycle commuting reimbursement.

New Law. For amounts paid or incurred after December 31, 2017, employers cannot deduct the expense of any qualified transportation fringe benefit provided to an employee (Code Sec. 274(a)(4), as added by Act Sec. 13304(c)(1)(B)).

Also, employers cannot deduct any expense incurred for providing any transportation, or any payment or reimbursement, to an employee in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee (Code Sec. 274(l), as added by Act Sec. 13304(c)(2)).

Professional Insight: "Employers will make the decision whether or not to continue to provide this benefit to their workforce. What will likely factor into that decision is the composition of their workforce and the need for the benefit. Employers will not be able to claim transportation benefits as a business expense, and they'll pay FICA tax on the value of the benefit," states Kathleen Coulombe, SHRM Senior Advisor, Government Relations.

SUSPENSION OF EXCLUSION FOR MOVING EXPENSES REIMBURSEMENT

Current law provides that an employee may exclude any qualified moving expenses reimbursement from gross income and wages as a fringe benefit. A qualified moving expense reimbursement includes any amount received, directly or indirectly, by the employee from the employer as payment or reimbursement of expenses that would be deductible as moving expenses if directly paid or incurred by the employee.

New Law. The exclusion for qualified moving expense reimbursements is suspended (except in the case of a member of the Armed Forces of the U.S. on active duty, who moves pursuant to a military order), effective for tax years beginning after December 31, 2017, and before

January 1, 2026 (Code Sec. 132(g), as amended by Act Sec. 11048).

The suspension of the deduction for moving expenses is discussed below.

EMPLOYEE ACHIEVEMENT AWARDS

Employers may deduct the cost of certain employee achievement awards, subject to limitations under Code Sec. 274(j). An employee achievement award is an item of tangible personal property that is transferred by an employer to an employee for length-of-service achievement or safety achievement, awarded as part of a meaningful presentation, and awarded under conditions and circumstances that indicate the payment is not disguised compensation. Employee achievement awards that are deductible by an employer are excludible from an employee's gross income.

New Law. The Act adds a definition of "tangible personal property" that will effectively restrict items that may be considered a deductible employee achievement award. It provides that tangible personal property does not include cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items (Code Sec. 274(j)(3)(A), as amended by Act Sec. 13310).

> **Comment:** *The Tax Cuts and Jobs Act Conference Report states, "No inference is intended that this is a change from present law and guidance." Current and proposed regulations provide that the term "tangible personal property" does not include cash or a certificate (other than a nonnegotiable certificate conferring only the right to receive tangible personal property). The regulations also state that other items that will not be considered to be items of tangible personal property include vacations, meals, lodging, tickets to theater and sporting events, and stocks, bonds, and other securities. Thus, it appears that the new law codifies the list in the regulations, apparently allowing for the continued tax-free treatment of common achievement award programs, such as employee service award catalogs.*

MODIFICATIONS TO DEDUCTIONS ON LIMITATIONS ON LUXURY AUTOMOBILES

Current law places limitations on the amounts deductible in a given year for luxury cars. These limitations take the form of statutory ceilings on the amount of investment tax credit and the amount of depreciation that can be claimed for any car. The applicable maximum deduction limits imposed on luxury cars is a function of such factors as the date that the car was placed in service and the number of years that the car has been in service. For passenger automobiles placed in service in 2017, and for which the additional first-year depreciation deduction under Code Sec. 168(k) is not claimed, the maximum amount of allowable depreciation is $3,160 for the year in which the vehicle is placed in service, $5,100 for the second year, $3,050 for the third year, and $1,875 for the fourth and later years in the recovery period. The limits are subject to adjustments for inflation.

New Law. The Act increases the depreciation limitations under Code Sec. 280F that apply to listed property (Code Sec. 280F(a)(1)(A), as amended by Act Sec. 13202(a)). For passenger automobiles placed in service after December 31, 2017, and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the maximum amount of allowable depreciation is

- $10,000 for the year in which the vehicle is placed in service,
- $16,000 for the second year,
- $9,600 for the third year, and
- $5,760 for the fourth and later years in the recovery period.

The limitations are indexed for inflation for passenger automobiles placed in service after 2018.

REMOVAL OF COMPUTER EQUIPMENT FROM LISTED PROPERTY

Code Sec. 280F imposes special rules for depreciation of "listed property." Such property generally is defined as (1) any passenger automobile; (2)

any other property used as a means of transportation; (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment and (5) any other property of a type specified in Treasury regulations. Computers owned by an employer that employees use at home are treated as listed property. The fair market value of an employee's personal use is a taxable fringe benefit. The employee's business use qualifies as a working condition fringe benefit if the employee meets the substantiation requirements for listed property.

Without the mandate in place, millions of people in the ACA exchanges will face rising health insurance costs

New Law. The Act removes computer or peripheral equipment from the definition of listed property. Such property is, therefore, not subject to the heightened substantiation requirements that apply to listed property (Code Sec. 280F(d)(4)(A)(iv), as amended by Act Sec. 13202(b)). The provision is effective for property placed in service after December 31, 2017, in tax years ending after such date.

ELIMINATION OF INDIVIDUAL MANDATE PENALTY

The Patient Protection and Affordable Care Act imposes a penalty (also called a shared responsibility payment) on applicable individuals for each month they fail to have minimum essential coverage for themselves and their dependents ("individual mandate"). Minimum essential coverage includes that under 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. Unless an individual qualifies for an exemption, the penalty is $695 for 2017 and 2018.

New Law. With respect to health coverage status for months beginning after *December 31, 2018,* the Tax Cuts and Jobs Act reduces the amount of the individual responsibility payment to zero (Code Sec. 5000A(c), as amended by Act Sec. 11081).

Professional Insight: "The repeal of the ACA individual mandate will likely have a direct and indirect impact on employer-sponsored plans," according to Chatrane Birbal, SHRM Senior Advisor, Government Relations. "Without the mandate in place, millions of people in the ACA exchanges will face rising health insurance costs because healthier individuals will leave the marketplaces. This may result in cost shifting to employers and other private-sector payers as well as the federal government. Employers and employees could also experience increased premiums for 2019 and future years as insurers raise rates to recoup losses. In addition, individuals who can no longer afford coverage on the exchanges may seek to join employer-sponsored plans, which might drive up premiums."

"In addition, there will be implications for the ACA reporting requirements, Birbal states. "By way of background, under ACA sections 6055 & 6056, reporting requirements, businesses and insurance carriers are required to collect on a monthly basis and report annually to the IRS and employees/enrollees numerous data points that will be used to verify the employer and individual mandates, and administer tax credits/subsidies in the state and federally-facilitated exchanges."

Birbal also notes that "because the Senate's 'reconciliation' rules only allowed Republicans to zero out the penalty amount to $0, technically, the individual mandate penalty tax is still in the law. Which means that Code section 6055 is also still applicable. However, because the individual penalty tax is effectively repealed – because the penalty is $0, the Treasury department will likely have to issue guidance telling insurance carriers and government entities what to do about distributing 1095-B Forms. Employers should be aware that, the 1095-C Form – which is in the law to help the IRS enforce the 'employer mandate' and determine eligibility for a premium subsidy REMAINS in the law. The ONLY impact on the 1095-C Forms is that Section III will become obsolete because the individual mandate will not be in effect."

Comment: *Despite assertions to the contrary by the White House, the repeal of the individual mandate penalty in 2019 does not effectively repeal the Affordable Care Act. Without understating the effect of the repeal of the penalty on the individual insurance market, including a projected increase in premiums and a decrease in the number of insured citizens, it is important to acknowledge that the ACA and its popular provisions, including pre-existing condition coverage and the Medicaid expansion, remain in effect and unaltered.*

EMPLOYER CREDIT FOR PAID FAMILY AND MEDICAL LEAVE

The Family and Medical Leave Act (FMLA) generally requires private sector employers of 50 or more employees to provide up to 12 work weeks of unpaid, job-protected leave to eligible employees for certain family and medical reasons, such as for childbirth or serious illness. Current law does not provide a credit to employers for compensation paid to employees while on leave.

New Law. The Act allows eligible employers to claim a general business credit equal to 12.5 percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave if the rate of payment under the program is 50 percent of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent (Code Sec. 45S, as added by Act Sec. 13403).

Comment: *This credit is temporary. It is generally effective for wages paid in taxable years beginning after December 31, 2017. It would not apply to wages paid in taxable years beginning after December 31, 2019. Thus, the credit is only available in 2018 and 2019.*

Maximum amount of leave subject to credit. The amount of family and medical leave that may be taken into account with respect to any employee for any taxable year cannot exceed 12 weeks.

Eligible employer. An "eligible employer" is one that, pursuant to a written policy, allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and that allows all less-than-full-time qualifying employees a commensurate amount of leave on a pro rata basis. For purposes of this requirement, leave paid for by a state or local government is not taken into account.

Qualifying employee. A "qualifying employee" means any employee as defined in FLSA Sec. 3(e) who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees.

Leave defined. "Family and medical leave" is defined as leave described under FMLA Sec. 102(a)(1)(a)-(e) or 102(a)(3). If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave, this paid leave would not be considered to be family and medical leave.

PAYROLL ADMINISTRATION

By: John W. Strzelecki, J.D.

The Act: modifies the personal income tax rates; increases the standard deduction; suspends the currently applicable personal exemptions; suspends the moving expense deduction; and modifies the deduction for employer-provided meals.

PERSONAL INCOME TAX RATES

In determining regular tax liability under current law, 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 (see the 2018 rates below). Special rules (generally referred to as the ''kiddie tax'') apply to the net unearned income of certain children, capital gains, dividends, etc., all unrelated to payroll.

New Law. The Act changes the personal income tax rates and adjusts the tax rate schedules for 2018. Individuals use the tax rate schedules to determine individual tax liability for personal income tax purposes. Behind the scenes, the rates are used together with the standard deduction and personal exemption (allowance) amounts to create withholding tables that employers then use to calculate the income tax amount to withhold from employees' paychecks. Generally, the IRS issues withholding tables on an annual basis and will issue new withholding tables for wages paid on and after January 1, 2018. The withholding table rate schedules do not necessarily match the personal income tax rate schedules.

> ***COMMENT:*** *The IRS has issued a statement on the status of withholding for 2018, indicating that it anticipates issuing the initial withholding guidance (IRS Notice 1036) in January to reflect the new legislation, which would allow taxpayers to see changes as early as February 2018 (IRS e-News for Tax Professionals Issue 2017-50, December 15, 2017). In the meantime, employers and payroll service providers should continue to use the existing 2017 withholding tables and systems.*

> ***COMMENT:*** *Generally, it takes the payroll industry about 30 days to implement new withholding tables.*

Income tax rate brackets. The income tax rates and brackets for 2018 are set forth below. Adjustments for inflation will begin after December 31, 2018. However, the inflation adjustments will be based on a new consumer price index (CPI) measure called the Chained Consumer Price Index for All Urban Consumers (C–CPI–U). The personal income tax rate inflation adjustments will apply to taxable years beginning after December 31, 2018. (Code Sec. 1(a)(j)(3), as added by Act Sec. 11001).

Single Individuals.

- Not over $9,525—10% of the 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

Heads of Households.

- Not over $13,600—10% of the taxable income
- Over $13,600 but not over $51,800—$1,360 plus 12% of the excess over $13,600
- Over $51,800 but not over $82,500—$5,944 plus 22% of the excess over $51,800
- Over $82,500 but not over $157,500—$12,698 plus 24% of the excess over $82,500
- Over $157,500 but not over $200,000—$30,698 plus 32% of the excess over $157,500
- Over $200,000 but not over $500,000—$44,298 plus 35% of the excess over $200,000
- Over $500,000—$149,298 plus 37% of the excess over $500,000

Married Individuals Filing Joint Returns and Surviving Spouses.

- Not over $19,050—10% of the 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

Married Individuals Filing Separate Returns.

- Not over $9,525—10% of the 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 $300,000—$45,689.50 plus 35% of the excess over $200,000
- Over $300,000—$80,689.50 plus 37% of the excess over $300,000

Estates and Trusts.

- Not over $2,550—10% of the taxable income
- Over $2,550 but not over $9,150—$255 plus 24% of the excess over $2,550
- Over $9,150 but not over $12,500—$1,839 plus 35% of the excess over $9,150
- Over $12,500—$3,011.50 plus 37% of the excess over $12,500

The tax rates and tax rate schedules apply to tax years beginning after December 31, 2017, and before January 1 , 2026 (Code Sec. 1(j), as added by Act Sec. 11001).

> **Comment:** *There is a mandatory withholding requirement on supplemental wages in excess of $1 million from any one employer. The mandatory withholding rate for supplemental wages in excess of $1 million is (currently, 39.6%). The rate will decrease to 37%, effective January 1, 2018, because the rate is tied to the "highest rate of tax applicable under section 1" by IRS Reg. Sec. 31.3402(g)-1(a)(2).*

Other inflation adjustments. The Act permanently ties numerous other amounts, which are strewn throughout the Internal Revenue Code (Code), to the new C-CPI-U such as: (1) the basic standard deduction; (2) the additional standard deduction for aged and blind; (3) the personal exemption amount; (4) the thresholds for the overall limitation on itemized deductions and the personal exemption phase-out; (5) the phase-in and phase-out thresholds of the earned income credit; (6) IRA contribution limits and deductible amounts; and (8) the saver's credit. Many are not payroll-related and are not discussed in this briefing.

The other inflation adjustments apply to tax years beginning after December 31, 2017, and are permanent (Code Sec. 1(f), as amended by Act Sec. 11002).

STANDARD DEDUCTIONS

Currently, an individual who does not elect to itemize deductions may reduce his or her adjusted gross income (AGI) by the amount of the applicable standard deduction in arriving at his or her taxable income. For 2017, the amount of the basic standard deduction is $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. An additional standard deduction is allowed with respect to any individual who is elderly or blind. The standard deduction is indexed annually for inflation. In the case of a dependent for whom a deduction for a personal exemption is allowed to another taxpayer, the standard deduction may not exceed the greater of (i) $1,050 (in 2017) or (ii) the sum of $350 (in 2017) plus the individual's earned income.

New Law. The standard deduction will increase to $24,000 for joint filers (and surviving spouses). The standard deduction will increase to $18,000 for head-of-household filers and $12,000 for all other taxpayers. The standard deductions will be indexed for inflation using the C–CPI–U for tax years beginning after December 31, 2018. The inflation adjustments will apply to tax years beginning after December 31, 2018. (Code Sec. 63(7)(B), as added by Act Sec. 11021, which refers to Code Sec. 1(f)(3), as amended by Act Sec. 11002).

The additional standard deduction for the elderly and the blind will not be changed. Again, these figures are mainly related to personal income taxation, but are used in the creation of withholding tables. The standard deduction changes apply to tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 63(c)(7), as added by Act Sec. 11021).

PERSONAL EXEMPTIONS

Currently, to determine taxable income, an individual reduces adjusted gross income (AGI) by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2018, the amount for each personal exemption was scheduled to be $4,150. The personal exemptions are phased out based on various income levels.

Withholding. Under present law, the amount of tax required to be withheld by employers from a taxpayer's wages is based in part on the number of withholding exemptions a taxpayer claims on his Form W– 4. An employee is entitled to the following exemptions: (1) an exemption for himself, unless he is allowed to be claimed as a dependent of another person; (2) an exemption to which the employee's spouse would be entitled, if that spouse does not file a Form W– 4 for that taxable year claiming the exemption in (1); (3) an exemption for each individual who is a dependent (but only if the employee's spouse has not also claimed such a withholding exemption on a Form W–4); (4) additional withholding allowances (taking into account estimated itemized deductions, estimated tax credits, and additional deductions as provided by the Secretary of the Treasury; and (5) a standard deduction allowance.

The amount of the allowance for the future is unknown at this time and the IRS has not issued any specific guidance on the issue.

New Law. The deduction for personal exemptions is suspended for personal income tax and withholding purposes. The personal exemption (allowance) amount changes apply to tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 151(d)(5), as added by Act Sec. 11041(a)).

In addition, the Act and the Conference Report provide that the IRS may administer the withholding rules under Code Sec. 3402 for tax years beginning before January 1, 2019, without regard to the suspension of the personal exemptions. In other words, at the IRS's discretion, wage withholding rules might remain the same as under present law for 2018. The 2018 annual personal exemption amount is currently scheduled to increase to $4,150 and the IRS has stated that it will issue withholding tables to be implemented by February. The withholding provision will apply to tax years beginning before 2019 and its implementation is authorized pursuant to Code Sec. 3402 (Code Sec. 3402, referred to by Act Sec. 11041(f)(2)).

> **Comment:** *The changes in the tax rates, standard deductions, and personal exemptions (allowances) will affect Form W-4, Employee's Withholding Allowance Certificate, which is used by employees to claim the number of personal exemptions that they are entitled to for purposes of withholding. A new form can be submitted to an employer anytime. The IRS revises Form W-4 annually.*
>
> *The Act may cause employees to submit a new certificate to avoid overwithholding or underwithholding situations.*

Form W-4. The Act maintains the current W-4 allowance system by conforming the applicable Code sections that cover withholding. Specifically, an employee will be entitled to claim withholding allowances (similar to the current system) based on: (1) himself, unless the individual can be claimed as a dependent by someone else, (2) a spouse, if eligible and if the spouse does not currently have a W-4 claiming the same allowance, (3) child tax credits, (4) itemized deductions, and (5) standard deductions. Withholding allowances may also be based on whether the employee has more than one employer.

New employees are still required to give a signed Form W-4 to the employer. If there is a current change in status a new form may be submitted at any time, and likewise if there will be a change in status for the next year.

> **Comment:** *The amount of the allowance for the future is unknown at this time and the IRS has not issued any specific guidance on the issue.*

The Act changes the word "exemption" to "allowance" everywhere it appears in Code Secs. 3402 and 3405.

The personal exemption (allowance) conforming amendments apply to taxable years beginning after December 31, 2017 (Code Secs. 3401, 3402, and 3405, as amended by Act Sec. 11041(f)(1) and (2)).

SINAI COMBAT PAY

Currently, members of the Armed Forces serving in a combat zone are afforded a number of tax benefits including an exclusion from gross income of certain military pay received for any month during which the member served in a combat zone or was hospitalized as a result of serving in a combat zone. The combat pay amounts are also exempt from withholding under Code Secs. 112 and 3401(a)(1).

New Law. The law expands the combat zone pay benefit to services performed in the Sinai Peninsula of Egypt by treating hazardous duty areas the same as combat zones (Code Secs. 112 and 3401, referred to by Act Sec. 11026 (a) and (b)).

The benefit lasts only during the withholding applicable period, which is the first tax year ending after the date of the law's enactment, but not later than tax years beginning before January 1, 2026 (Act Sec. 11026(c)(2)). Generally, the withholding provision applies for remuneration paid after the date of enactment (Act Sec. 11026 (d)(2)).

MOVING EXPENSE DEDUCTION

Currently, individuals are permitted an above-the-line deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work. Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location. Special rules apply in the case of a member of the U.S. Armed Forces.

New Law. The income tax deduction allowed for moving expenses is suspended, but not for members of the Armed Forces. Specifically, the law retains the deduction for moving expenses and the rules providing for exclusions of amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) for members of the Armed Forces (or their spouse or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station.

The moving expense suspension applies to tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 217(k), as added by Act Sec. 11049(a) and (b)).

MEAL EXPENSES NEAR BUSINESS PREMISES

Currently, certain employer-provided fringe benefits are excluded from an employee's gross income and wages for employment tax purposes, including, but not limited to, de minimis fringe benfits. A de minimis fringe benefit generally means any property or service the value of which (taking into account the frequency with which similar fringes are provided by the employer) is so small as to make accounting for it unreasonable or administratively impracticable. De minimis fringe benefits also include food and beverages provided to employees through an eating facility operated by the employer that is located on or near the employer's business premises and that meets certain requirements. Employers are allowed to deduct the cost of many fringe benefits, but there is a 50 percent cap on most of them, but not all.

New Law. The 50 percent deduction cap is expanded by the Act to cover expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes. It does not affect an employee for employment tax purposes. The 50 percent meal expense deduction limitation applies to tax years beginning after December 31, 2017, and before January 1, 2026 (Code Sec. 274(n), as amended by Act Sec. 13304(b)).

MEALS FOR THE CONVENIENCE OF THE EMPLOYER

Currently, the value of meals furnished to an employee or the employee's spouse or dependents by or on behalf of an employer for the convenience of the employer is excludible from the employee's gross income. Employers are allowed to deduct the cost of providing such meals.

New Law. The Act repeals the employer deduction. However, the Act does not affect an employee for employment tax purposes.

The meal deduction repeal applies to amounts incurred or paid after tax years beginning after December 31, 2025 (Code Sec. 274(o), as added by Act Sec. 13304(d)).

CONCLUSION

The broad sweep of the Tax Cuts and Jobs Act suggests its disruptive force. However, the true impact of the Act, whether on the continued maintenance of qualified plans by small employers, the nature of executive compensation arrangements, the popularity of employer-provided fringe benefit programs, the viability of the individual health insurance market, or withholding and other aspects of payroll administration, will not be fully known until implementation of the provisions begins in earnest. As always, the process will be aided or hindered by regulatory guidance, possible anti-abuse measures, and probable technical corrections legislation.