Tax Reform Provisions Affecting Employer-Provided Compensation and Benefits

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The Tax Cuts and Jobs Act (the "Act") recently signed into law affects many employer-provided benefits and employee compensation, beginning as soon as next week. This alert highlights the affected benefits and provides a short summary of how the Act will change the tax treatment of those benefits and employee compensation. Unless specified below, the changes described are effective January 1, 2018. If you need additional guidance regarding any of these changes before the New Year, please contact us. We will also continue to provide more detailed updates regarding these changes as we continue to analyze their impact or receive any related IRS guidance.

Repeal of Performance-Based Compensation Exception to $1,000,000 Deduction Limit

The Act amends section 162(m) of the Internal Revenue Code (the "Code") to eliminate the exceptions for performance- (and commission-) based compensation from the Code section 162(m) deduction limitation on compensation paid by public companies in excess of $1,000,000 to their "covered employees." The definition of covered employee has also been significantly changed. Prior to 2018, the company's chief financial officer (CFO) was not treated as a covered employee unless the CFO was also one of the five highest paid executives at the company. Under the 2018 revision, the covered employees consist of the chief executive officer, the CFO, and the other top three highest compensated officers of the company. In addition, if an officer becomes a covered employee during a single year with the company, that individual will forever be treated as a covered employee with respect to any compensation paid by the company to that employee (or even to the covered employee's beneficiaries).

Fortunately, payments made pursuant to "written agreements" that were in effect on November 2, 2017, and not materially modified after the cut-off date, are grandfathered from the new deduction limitations. Also, most compensation paid to a "covered employee" is already being paid pursuant to a written agreement due to requirements under tax and securities laws. Because the Act was just signed into law, there is no current IRS guidance for determining which written agreements will qualify for grandfathered status or what will be deemed to be a material

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modification. For that reason, public companies should avoid amending the written compensation arrangements for covered employees until the IRS provides guidance regarding what will constitute a material amendment.

Excessive Compensation of Non-Profit Covered Employees Subject to a 21% Tax Penalty

The Act also amends Code section 162(m) to provide that a 21% tax penalty applies to W-2 compensation in excess of $1,000,000, and any excess parachute payments, paid to a covered employee of an "applicable tax-exempt organization" or any related organizations (including any support organizations). Covered employees are the top five highest-paid employees of the tax-exempt organization. However, the penalty does not apply to remuneration paid "to a licensed medical professional (including a veterinarian) to the extent that such payment is for the performance of medical or veterinary services by such professional" or an employee that is not a highly compensated employee (as defined in Code section 414(q)). Excess parachute payments are generally defined as any payment triggered upon termination of employment that exceeds three times the covered employee's "base amount" for the prior three years. The rules under Code section 280G apply for determining an employee's base amount. If this tax penalty may apply to your organization, please contact us to discuss ways to limit the amount of compensation treated as excess compensation subject to the tax penalty.

Elimination of Business Deduction for Entertainment Expenses

The Act has eliminated the business deduction under Code section 274(a) for activities that are generally considered to be entertainment, amusement, or recreation expenses, and for facilities used to carry on these activities, in connection with conducting the employer's trade or business. Prior to January 1, 2018, the deduction for the cost of these expenses was already limited to 50% of the cost of the activity or facility. Employers may still deduct food or beverages provided to employees as part of carrying on the employer's trade or business, such as travel expenses. Also, the specific deduction for charity-related sports events in Code section 274(l) was deleted.

Clarification Regarding Employee Achievement Awards

Employee achievement and safety awards provided pursuant to the requirements of Code section 274(j) are excluded from employees' taxable income and are deductible by the employer as employee compensation. One of the requirements for deductible awards is that the award must constitute a transfer of tangible personal property, instead of cash or cash equivalents. The Act amends Code section 274(j)(3)(A) to specifically define what is not treated as tangible personal property. The items that will not be treated as an employee achievement award include cash, cash equivalents, gift cards, gift coupons, and 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), vacations, meals, lodging, tickets for theater or sporting events, stocks, bonds, other securities, and other similar items.

Limits and Phase-Out on Deduction for Employer-Operated Eating Facilities

Under current law, an employer can deduct the cost of food and beverages provided to employees at an employer-operated eating facility if the food and beverages are provided for the convenience of the employer. The qualifying employer-provided meals continue to be excluded from the employees' taxable income. However, the Act amends Code Section 274(n) to reduce

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the employer deduction to 50% beginning in 2018 and to completely eliminate the deduction beginning in 2026.

Elimination of Employer Deduction for Certain Transportation Fringe Benefits

While qualified transportation fringe benefits under Code section 132(a)(5) are still excludable from income for employees, the Act has eliminated the deduction for expenses associated with providing "qualified transportation fringe" (i.e., transportation in a commuter highway vehicle, any transit pass, qualified parking, and any qualified bicycle commuting reimbursement) to employees. The Act has also eliminated the deduction for any expenses incurred by 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 if it is provided to ensure the safety of the employee.

Suspension of Income Exclusion for Qualified Bicycle Commuting Reimbursement Fringe Benefit

The definition of a "qualified transportation fringe" under Code section 132(f)(5) currently includes "any qualified bicycle commuting reimbursement." The Act amends Code section 132(f) to suspend the income exclusion for qualified bicycle commuting reimbursements for the 2018 through 2025 tax years.

Suspension of Income Exclusion and Employer Deduction for Qualified Moving Expense Reimbursement

Moving expenses paid or reimbursed by an employer in connection with any costs incurred by an employee beginning employment in a new principal place of work have been excluded from the employee's income as "qualified moving expense reimbursements" under Code section 132(a)(6). This income exclusion is being suspended under the Act from 2018 until 2025.

However, the exclusion will still apply in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order and incident to a permanent change of station. In addition, the employer's deduction under Code section 217 for qualified moving expense reimbursements is also suspended for the same period.

Increase in the Amount of Length of Service Award Plans

The Acts doubles the maximum amount payable under a length of service award plan from $3,000 to $6,000, which will not be treated as a deferral of income under Code section 457(e)(11)(B). The current rule allows tax-exempt organizations to award length of service awards to bona fide volunteers up to a maximum aggregate amount of $3,000 in any given year of service. In addition, the new $6,000 limit will be increased annually by a cost-of-living adjustment in minimum increments of $500.

Extension of Rollover Period for Plan Loan Offsets

Plan loans in a 401(k) plan may be offset against a participant's account balance for a number of reasons, most commonly when a participant has not fully repaid a plan loan at termination of employment or when a plan terminates. Upon offset, the participant would generally be taxed on the amount of the outstanding loan balance. However, under Code section 402(c)(3), a participant can delay this taxation by rolling over the loan offset amount (which requires coming up

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with outside funds) to an Individual Retirement Account or another employer's plan within 60 days. For loan offsets caused by termination of employment or plan termination, the Act extends this rollover period to the employee's tax return due date (including extensions) for the taxable year when the loan offset occurred. For example, a calendar year taxpayer who has a loan offset of $10,000 in 2018 due to termination of employment would have until April 15, 2019 (or, October 15, 2019, if he or she obtained an extension) to come up with $10,000 and roll it over to an Individual Retirement Account or another employer's plan in order to delay taxation of the $10,000 loan offset.

Employer Credit for Paid Family and Medical Leave

Certain employers may now receive a tax credit for offering paid family and medical leave. The credit will be a part of the general business credit under Code section 38, and can be used to lower an employer's taxable income (subject to limitations) and any applicable alternative minimum tax. The credit is a temporary addition to the tax code and will not apply to wages provided after December 31, 2019.

An "eligible employer" is any employer that has a written policy in place that provides for the following:

- At least two weeks of paid family and medical leave per year for all qualifying employees who are not considered part-time (less than 30 hours per week).
- For qualified part-time employees, an amount of paid family and medical leave that is proportionally equal to the amount for full-time employees described above.
- A rate of payment for paid family and medical leave which is at least 50% of the normal pay rate for the applicable employee.

A "qualified employee" is an employee who has been employed by the employer for one or more years and whose salary in the preceding year did not exceed 60% of that of a highly compensated employee, as described in Code section 414(q)(1)(B)(i).

Paid leave for the following purposes is considered qualifying paid family and medical leave:

- The birth of a child and to care for the child.
- Placement of a child with the employee for adoption or foster care.
- To care for a spouse, child, or parent with a serious health condition.
- The employee has a serious health condition that makes him/her unable to perform.
- Any qualifying exigency, as defined by the Secretary of Labor, related to a spouse, child, or parent of the employee being on covered active duty.

If the paid leave is processed as vacation time, personal leave, or sick leave, then it will not be considered paid family and medical leave, and amounts paid under state or local law are not taken into consideration.

The amount of the credit will be calculated based on a percentage of the wages paid to employees for paid family and medical leave. The calculation begins at 12.5% of the wages paid to employees for paid family and medical leave, and increases in increments of .25% (not to exceed 25% total)

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for every percentage point by which the rate of pay for paid family and medical leave exceeds 50% of normal wages for the employee.

Example: Employer pays employee $1,000 in paid family and medical leave. If $1,000 is 50% of the normal rate of pay for the employee, then the employer may take a tax credit of $125 for this employee ($1,000 x 12.5% = $125). However, if $1,000 is 100% of the normal rate of pay for the employee, then the employer may take a tax credit of $250 ($1,000 x 25% = $250).

The credit for a given employee may not exceed the normal hourly wage of the employee (if the employee is not paid hourly, his/her salary will be prorated to an hourly wage) multiplied by the amount of hours taken for paid family and medical leave. Additionally, the amount of paid family and medical leave used to determine the tax credit for a given employee may not exceed twelve (12) weeks.

We will provide additional updates regarding this new employer credit as we continue to analyze it and its potential impacts — or when the IRS issues any clarifying guidance.

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