BusinessManagement DAILY

The 2017 Tax Reform Law: What HR, Payroll & Employers Need to Know

HR SPECIALIST

In December 2017, Congress passed what has been colloquially called the Tax Cuts and Jobs Act (H.R. 1), the first overhaul of the U.S. tax code in more than 30 years. (Officially, the new law will be known as "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." We'll just call it the TCJA.)

The changes the TCJA makes are far reaching—every taxpayer will be affected by it.

Specifically, employers confront an altered landscape when it comes to certain fringe benefits and pay policies. And, you will have to adjust your payroll system very quickly to accommodate these changes, as no transition relief has been provided.

Payroll provisions

The IRS usually releases the next year's withholding tables, W-4 form, withholding allowance amounts and various payroll publications—*Circular E, the Employer's Supplemental Tax Guide and the Employer's Tax Guide to Fringe Benefits*—in late November or early December.

In a statement released Dec. 13, 2017, the IRS said it was continuing to closely monitor the TCJA and that it was taking some initial steps to prepare guidance on withholding for 2018. Notice 1036, which is the early release of the year's withholding allowance amounts and percentage method income tax withholding tables, should be issued in January 2018, according to the statement.

Upshot: It's now certain that you will start out 2018 using the 2017 income tax withholding formulas.

In addition, the IRS said that it will give employers sufficient time to test their payroll software for the 2018 tax year.

➲ **YOU WERE HEARD:** On Dec. 8, the American Payroll Association sent a letter to Sen. Orrin Hatch (R. – Utah), chair of the Senate Finance Committee, excoriating Congress over the fact that the payroll changes were coming so late in the year that payroll departments won't have time to adjust. A provision in the TCJA gives the IRS discretion to continue the current wage withholding rules through 2018. But it's not clear whether the IRS will do so.

In addition to the income tax withholding wrinkles created by this late-in-the-year enactment of tax reform, the TCJA directly targets two payroll-related provisions: the flat rate withholding percentages and employees' income tax withholding via their W-4s.

Flat withholding rates. Flat rates apply to income tax withholding on supplemental wages and backup withholding on independent contractors. Beginning Jan. 1, 2018, the flat withholding rates are:

- For supplemental wages up to $1 million, the optional flat rate is the third highest personal income tax rate, or 22%
- For supplemental wages in excess of $1 million, the mandatory flat rate is the highest personal income tax rate, or 37%
- The mandatory backup withholding rate, which applies when independent contractors don't give you their taxpayer identification numbers before you pay them, or you're withholding under the IRS' B notice program, is the fourth highest rate, or 24%.

These flat rates will sunset at the end of 2025. Unless subsequent legislation extends them, beginning in 2026, they will revert to the 2017 rates: 25% on supplemental wages up to $1 million, 39.6% on supplemental wages exceeding $1 million and 28% on backup withholding.

Employees' W-4s. Employees have long been told that, as a rough rule of thumb, they can take one withholding allowance on their W-4s for each tax dependent and itemized deduction they take on their 1040s. That's no longer the case. Through 2025, the TCJA almost doubles the standard deduction amounts and increases the child tax credit. It suspends the personal exemption amount, the 2% floor on itemized deductions, the overall limitation on itemized deductions and many deductions that taxpayers take on Schedule A.

These structural changes to the individual income tax provisions will likely mean that employees can't just coast along on their old W-4s. *Worse:* W-4s and the formulas for calculating the proper number of withholding allowances may not be available until early spring.

➲ **BE A PAYROLL CHAMPION:** Once the new W-4 is released, employees will either be required to refile their W-4s with you or, like now, may refile. You should provide new forms to everyone and encourage them to reassess their tax situation in light of these changes, since those who fail to readjust their W-4 may be overwithheld or underwithheld at the end of 2018. You should also be prepared to process an onslaught of new forms in a timely manner.

Employee business expenses no longer deductible

The tax code has always allowed employees to be in the business of being employees. That means employees could deduct certain business expenses on Schedule A of Form 1040. These deductions are subject to the 2% floor on itemized deductions. Employees must also attach Form 2106 to their 1040s. These deductions include:

- Expenses that aren't reimbursable by employers
- Dues to professional societies
- Occupational licenses
- Passports for business trips
- Subscriptions to professional journals and trade magazines
- Tools and supplies
- Work clothes and uniforms, if required and not suitable for everyday use
- Work-related education.

Since the TCJA temporarily almost doubles the standard deduction, most employees won't be deducting anything on Schedule A. It also sunsets through 2025 many of the Schedule A deductions, including the provision of the tax code that allows employees to deduct their business-related expenses.

Without the ability to deduct their business expenses, employees may be out-of-pocket for some rather large expenses. That's not good for employee morale. If you haven't done so already, you might want to consider adopting a business-expense reimbursement plan. Any business-expense reimbursement plan must satisfy the IRS' accountable plan rules:

- Employees must have paid or incurred deductible expenses while working for you (i.e., there must be a business connection)

- Employees must adequately account to you for those expenses within a reasonable period of time. Employees must also submit receipts, canceled checks or other bills
- Employees must return excess allowances or reimbursements within a reasonable period of time.

Business connection. To have a business connection, employees must incur business expenses that either are directly related to your business or associated with your business. In other words, the expense was "in connection with," and did not simply arise from, or have its origins in, the employee's trade or business.

Key: The business connection requirement is the threshold requirement. Plans that require employees to substantiate their expenses, and to return excess expenses, but that lack a business connection, will fail the accountable plan rules.

Reasonable time and adequate accounting. A reasonable period of time is determined on a case-by-case basis. The IRS has a safe harbor under which it's considered reasonable for employees to:

- Receive an advance within 30 days of the time they incur an expense
- Adequately account for the expense within 60 days after it was paid or incurred
- Return any excess reimbursement to you within 120 days after the expense was paid or incurred.

In the alternative, if you give employees a periodic statement (at least quarterly) that asks them to either return or adequately account for outstanding amounts and they comply within 120 days, the amounts are considered adequately accounted for or returned within a reasonable period of time.

Employees adequately account by giving you documentary evidence (i.e., receipts, canceled checks and bills) of *all* their business expenses (e.g., mileage, travel and other incidental expenses), along with a detailed, itemized statement of expenses, account book, diary or similar record of where they incurred each expense, at or near the time they incurred it.

Returning excess amounts. You must require employees to return any excess reimbursement or other expense allowance to you. Excess reimbursements are amounts for which employees don't adequately account within a reasonable period of time. Under the IRS safe harbor, it's reasonable for employees to return any excess amounts within 120 days after the expense was paid or incurred.

Fringe Benefits

The TCJA makes some substantial changes to the benefits that can be offered on a tax-free basis and the benefits that can (and can't) be deducted on a corporate return.

These changes may force you to quickly rethink the fringe benefits you offer to employees, since they're effective on Jan. 1, 2018.

➲ **PAYROLL PRACTICE TIP:** Any change to the definition of taxable wages at the federal level will impact states that tie their definition of taxable wages through IRC conformity laws. States can do this in several ways—they can automatically tie their tax provisions to the IRC, they can tie their tax provisions to the IRC as of a specific date or they can tie only specific provisions to the IRC as of a specific date.

The following states have automatic IRC conformity laws, which means you should be prepared to make changes to state income tax withholding on Jan. 1, 2018, as well: Alabama, Colorado, Connecticut, Delaware, District of Columbia, Illinois, Kansas, Maryland, Massachusetts, Missouri, Montana, Nebraska, New York, Oklahoma, Rhode Island and Utah.

Qualified transportation fringe benefits. Qualified transportation fringe benefits consist of four separate items:

1. Transportation to and from work in a car or van pool (known as a commuter highway vehicle). *Key:* The vehicle must accommodate at least six adults (not including the driver), at least 80% of the mileage must result from commuting to and from work and at least 50% of those passengers must be employees. The TCJA denies a business deduction for this benefit.
2. Transit passes, tokens, farecards, vouchers and other items that enable employees to commute via public transportation. Employees may pay for this benefit on a pretax basis. The TCJA denies a business deduction, but preserves employees' pretax contributions for these fringes.
3. Parking that's at or near the workplace or a location from which employees commute via mass transportation. Employees may not pay for this benefit on a pretax basis. The TCJA denies a business deduction for this benefit.
4. Up to $20 a month may be offered to employees who bicycle to work. This benefit can't be funded on a pretax basis. Employees must regularly use their bicycles for a substantial portion of their commute. Employees who receive this benefit can't receive other qualified transportation fringe benefit. The TCJA suspends this benefit through 2025.

➲ **SAFETY FIRST:** You may pick up employees' commuting expenses if it's for employees' safety. The IRS will need to flesh out how jeopardized employees must feel to satisfy the safety threshold. The tax regulations already contain two similar provisions. You may pick up the tab for employees' commute home if they're working late in the office and it's not safe to ride on public transportation after hours and you may provide employees with special cars (e.g., armored cars) and chauffeurs under certain circumstances.

You can continue to provide these benefits if you want to forgo your corporate tax deduction. The TCJA doesn't eliminate these benefits from Section 132, so, presumably they could still be offered to employees on a tax-free basis. However, the IRS may need to provide guidance on this. As a last resort, you could continue to provide these benefits, but you'll have to tax them. *Downside:* Taxing a benefit that was once tax-free might upset employees.

Moving expenses. It's common for employers to pick up all or some of a new hire's or relocating employee's moving expenses. The TCJA suspends this fringe through 2025. *Upshot:* You're going to need to rethink this policy.

➲ **PAYROLL PRACTICE TIP:** If you've already made a deal with an employee to reimburse these expenses, but couldn't pay it before the end of 2017, you have two choices: You can either tax the reimbursement or, considering that this probably won't meet the employee's expectations, you can gross up the reimbursement.

Employee achievement awards. Non-cash awards for length-of-service or safety achievement may be provided to employees tax-free if you have a qualified plan. Qualified plans must be written and can't discriminate in favor of upper management. There are some additional limitations on qualified plans:

- The maximum that can be excluded from employees' income is $1,600; the average cost of all awards per year can't exceed $400
- Presentations to employees must be part of a meaningful ceremony
- Length-of-service awards can only be given in five-year increments, beginning with the fifth year
- Safety achievement awards are limited to 10% of eligible employees a year and can't be given to management.

If you don't have a qualified plan, you can exclude up to $400 from employees' income.

The TCJA clarifies that achievement awards must be tangible personal property, like a watch. Awards can't be cash, gift cards, vacations, theater or sports tickets, etc.

➲ **REWARDS FOR VOLUNTEERS:** State and local governments and tax-exempt organizations often provide length-of-service awards to long-serving volunteers. The TCJA doubles the value of a length-of-service award to $6,000 and adjusts that amount for inflation.

Meals. You usually can't pick up employees' meal costs tax-free, because those expenses are personal expenses. Further, your corporate deductions for employees' business-related meals are limited to 50%. Meals provided in company cafeterias, or on the premises for your convenience, may be provided to employees tax-free and may be deducted 100% on your corporate return.

The TCJA extends the 50% deduction disallowance to meals provided in company cafeterias and for meals provided on the premises for your convenience. And, beginning Jan. 1, 2026, corporate deductions will no longer be able allowed for meals provided in company cafeterias or for your convenience.

Corporate deduction disallowances. The TCJA drops the corporate tax rate considerably. As a tradeoff for that substantially lower corporate tax rate, you can no longer deduct 50% of employees' business-related entertainment expenses.

Corporate deductions are no longer allowed for activities that are generally considered to be entertainment, amusement or recreation; membership dues for any club organized for business, pleasure, recreation or other social purposes; or a facility used in connection with any of those items. *Flip side:* Corporate salary deductions would be available if you included these items in employees' income.

➲ **WHAT ABOUT THE ACCOUNTABLE PLAN RULES?** Just because your corporate deduction for employees' business-related entertainment expenses is disallowed doesn't mean that employees will stop incurring those expenses on your behalf. Clients are still going to need to be schmoozed. A similar situation arose when the IRS disallowed corporate deductions for employees' business use of a country club's facilities. Your reimbursement to employees remained tax-free. It's anticipated that the IRS will still permit employees to be reimbursed 100% tax-free for their business entertainment expenses, but the IRS may need to clarify this in guidance.

Paid family leave

A new general business tax credit applies if you provide full-time employees with at least two weeks of paid family and medical leave, as defined under the federal Family and Medical Leave Act. Part-time employees must be provided with a commensurate amount of leave on a prorated basis. The maximum amount of leave that qualifies for the credit is 12 weeks. Employees must receive at least 50% of their regular salary while on they're on leave.

Paid leave, such as vacation leave, personal leave or other medical or sick leave, doesn't count toward paid family and medical leave.

The credit equals 12.5% of wages paid, and increases by 0.25% (up to 25%) for each percentage point by which the rate of pay exceeds 50%. The credit applies to wages paid in 2018 and 2019.

➲ **NO DOUBLE DIPPING:** This credit is part of the general business credit. And as with other credits, there's no double dipping with your corporate salary deductions. You'll have to run the numbers yourself to see whether a continued salary deduction or the credit is more valuable.

Employers covered: Employers that are covered under the FMLA qualify for the credit. In addition, employers that aren't covered by the FMLA can qualify for the credit if they provide paid family and medical leave under a policy that ensures that they won't interfere with, restrain or deny leave to qualified employees and they won't fire or discriminate against employees who take paid family leave.

Employees covered: To qualify for paid family and medical leave, employees must work for their employers for at least one year and, for the preceding year, be paid no more than 60% of the compensation threshold for highly compensated employees—$120,000 for 2018. Therefore, for 2018, employees can't be paid more than $72,000.

Limitations: Leave paid by a state or local government, and employers located in states or municipalities that mandate paid leave are ineligible for this credit. Currently 10 states require paid sick leave: Arizona, California, Connecticut, District of Columbia, Massachusetts, New York, Oregon, Rhode Island, Vermont and Washington. Hawaii and New Jersey have paid leave programs that are run under the auspices of their disability laws.

These municipalities require paid sick leave:

- **California:** Berkeley, Emeryville, Los Angeles, Oakland, San Diego, San Francisco and Santa Monica
- **Illinois:** Cook County and Chicago
- **Maryland:** Montgomery County
- **Minnesota:** Minneapolis and St. Paul
- **New Jersey:** Bloomfield, East Orange, Elizabeth, Irvington,Jersey City, Montclair, Morristown, Newark, New Brunswick, Passaic, Paterson, Plainfield and Trenton
- **Pennsylvania:** Philadelphia
- **Oregon:** Portland
- **Washington:** Seattle, Spokane and Tacoma.

Equity grants

Employees may be paid in cash compensation or in noncash compensation, such as stock. It's common for vesting restrictions to be placed on compensation-related stock. A typical vesting restriction requires employees to work for five years before their stock vests.

Under tax code Section 83, employees aren't taxed currently on the value of stock that's subject to a substantial risk of forfeiture. Instead, taxes and withholding apply when the risk of forfeiture lapses and the stock vests. *Exception:* Employees who make Section 83(b) elections are taxed currently. *Downside:* Employees are still on the hook for the taxes if they don't satisfy the restriction.

It's increasingly common, especially in the tech world, for employees of start-up companies to be paid in stock or stock options. Section 83 has been amended to allow employees to elect to defer income taxes on the value of compensation-related stock.

Employers covered: Corporate employers are eligible if the following conditions are met:

- Their stock (or the stock of a predecessor employer) isn't readily traded on an exchange

- A written plan provides that at least 80% of all employees are granted stock options or restricted stock units with the same rights and privileges to receive qualified stock. Employees won't fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to them differs, provided that the number of shares available to each employee is more than a *de minimis* amount. *Catch:* You can't satisfy this requirement by granting some employees stock options and others RSUs; instead, all employees must either be granted stock options or RSUs for that year.

Employees covered: All employees are covered, except the following:

- Employees who were 1% owners during the current calendar year or at any time during the 10 preceding calendar years (1% owner status is determined under the rules that apply to top-heavy retirement plans)
- Employees who are, or who have been at any prior time, the CEO or CFO or who have acted in those capacities
- Employees whose family members are 1% owners or were CEO or CFO at a prior time
- Employees who have been one of the four highest compensated corporate officers for the current taxable year or for any of the 10 preceding taxable years. These officers are determined on the basis of shareholder disclosure rules for compensation under the Securities Exchange Act of 1934.

Qualified stock. Qualified stock is any corporate stock if an employee receives the stock in connection with the exercise of a stock option or in settlement of a restricted stock unit. Qualified stock, however, doesn't include stock appreciation rights, restricted stock or stock that employees sell back to the corporation.

Deferral elections. Employees' elections to defer income and income taxes must be made within 30 days of the earlier of the date their stock substantially vests or is transferrable. Elections are made under a process similar to Section 83(b) elections. Employees who make elections must take amounts into income, and are taxed, at the earliest of:

- The first date their stock becomes transferable, including, solely for this purpose, transferable to the employer
- The date an employee first becomes an excepted employee
- The first date any of the employer's stock becomes readily tradable on an exchange
- The date that's five years after the first date their right to the stock becomes substantially vested
- The date on which employees revoke their elections.

➲ **ONE OR THE OTHER, BUT NOT BOTH:** Employees may make deferral elections with respect to options granted to them as incentive stock options or under an employee stock purchase plan. *Downside:* Deferral elections will wipe out any favorable tax treatment ISOs or ESPPs receive.

Employees must receive notice of this favored tax treatment within 30 days of their stock vesting. The notice must certify to employees that their stock is qualified stock, that they're eligible to elect to defer the income attributable to the stock and that if they make an election, the income required to be included at the end of the deferral period will be based on the value of the stock at the time their right to the stock first becomes substantially vested.

Withholding and reporting. An election to defer taxes applies only for income tax withholding purposes. FICA and FUTA apply when the stock is substantially vested or is transferable.

Income tax withholding applies to the earliest date employees must take the amounts into income (*see above*). You withhold at the highest income tax rate for the year.

On employees' W-2s, you must report the amount of income covered under a deferral election for the year of deferral and for the year the income is required to be included in employees' incomes. In addition, for any calendar year, you must report on the aggregate amount of income covered by a deferral election, determined as of the close of the calendar year.

➲ **CLARIFICATION NEEDED:** This provision is more complicated than it appears. The IRS will need to answer such questions as: what is more than a *de minimis* amount; what exactly does the "same rights and privileges" mean (i.e., does this apply to issues other than vesting); what happens if an employee terminates (i.e., does the employer have the right to buy back the stock and if it does, is the deferral election period ended).

Sexual harassment awards

Allegations of sexual harassment have been rife since fall 2017. The TCJA disallows any corporate deduction for any settlement, payout or attorney fees related to sexual harassment or sexual abuse if these payments are subject to a nondisclosure agreement.

Section 179

Section 179 of the tax code isn't strictly a payroll provision, but it does allow certain small businesses to deduct expenses, rather than depreciate them. That's important to any department manager who wants to buy new computers and software, but has to compete with other departments that also want shiny new things on their desks.

These amounts are inflation adjusted every year. For 2018, the aggregate cost of Section 179 property that you can deduct can't exceed $520,000. This $520,000 limitation is reduced (but not below zero) by the amount that all Section 179 property exceeds $2,070,000.

The TCJA increases these to $1 million and $2.5 million respectively.

ACA's individual mandate

Beginning in 2019, the TCJA dials down to $0 the tax penalty levied on individuals who don't obtain health insurance, either on the exchange or through an employment-based group health plan, as the Affordable Care Act requires.

This all-but-in-name only repeal of the individual mandate doesn't affect applicable large employers' obligation to offer full-time employees affordable group coverage that provides minimum value. However, it may change the dynamic of annual information reporting on Forms 1095-C/1094-C, since one of the purposes of reporting in the first place was to identify full-time employees who turned down your offer and then didn't buy individual insurance on the exchange.

➲ **NO IMPACT ON 2017 REPORTING:** For applicable large employers that have insured major medical plans, this doesn't affect your responsibility to provide full-time employees with copies of Form 1095-C by the end of January and to file those forms, along with the transmittal, Form 1094-C, with the IRS by Feb. 28, if you're filing on paper, or by April 2, if you're filing electronically.

ALEs that are self-insured must provide every employee who enrolls in coverage with forms and file those forms by the aforementioned due dates.

Small self-insured employers (i.e., employers with fewer than 50 full-time employees) must provide every employee who enrolls in coverage with Form 1095-B and file those forms, along with the transmittal, Form 1094-B with the IRS by Feb. 28; small self-insured employers may file electronically, if they choose.

Higher-level tax considerations

The TCJA makes major changes to corporate taxes, including dropping the income tax rate from 35% to 21%, limiting the net interest deduction to 30% of adjusted taxable income and modifying the net operating loss deduction.

While those are not considerations that normally concern Payroll, the law also impacts several compensation-related provisions that may affect you.

Converting to a C corp. C corporations are regular tax-paying entities and are so named because they fall under Subtitle A, Chapter 1, Subchapter C of the tax code. As a result of the TCJA, some S corporations may choose to revoke their S corp elections in favor of converting to C corps. Shareholder-employees of closely-held C corps are still in overall charge of their pay, and they must receive reasonable salaries.

Problem for Payroll: bonus policies that zero out a corporation's book income. Although bonus payments are fully subject to withholding, that's not the end of the story. *How the IRS reacts:* It recharacterizes those bonus payments as nondeductible dividends, and worse, it will impose penalties on the corporation.

Deduction for incentive pay repealed. Publicly-held corporations can deduct up to $1 million in salary for the following four individuals:

- Any employee who is the principal executive officer, or an individual who's acting in that capacity
- Any employee who is among the three most highly compensated corporate officers for the taxable year, other than the principal executive officer.

Incentive pay, such as commissions, stock options, stock appreciation rights and similar performance-based payments, aren't subject to the $1 million deduction cap, so these amounts are 100% deductible on a corporate return.

The TCJA, however, repeals the deduction for performance-based compensation, so all executive pay now falls within the $1 million cap. Under a transition rule, the provision doesn't apply to performance-based compensation that's paid under a binding, written contract that was in effect on Nov. 2, 2017, provided the contract wasn't materially modified after Nov. 2 and any substantial risk of forfeiture lapses by Dec. 31, 2017.

➲ **HEADS UP FOR PAYROLL:** Executive pay packages may now lean more heavily on restricted stock. As is the case with equity grants, which were discussed earlier, payroll taxation of restricted stock is controlled by tax code Section 83.

Deductions for pass-through entities. Currently, owners and shareholders of pass-through entities—sole proprietorships, S corps, partnerships and LLCs—pay taxes at the individual tax rates. Profits distributions aren't subject to FICA taxes, which often motivates owners/shareholders to misclassify FICA-taxable salary as FICA-free distributions.

The IRS has established a rule under which pass-through entities must pay their shareholder/employees reasonable FICA-taxable salaries. Moreover, the IRS can recharacterize FICA-free distributions as FICA-taxable wages, and, in addition to the recharacterization, can impose penalties and interest on the entity for not doing so.

Under the TCJA, through 2025, subject to certain limitations, owners of pass-through entities can deduct 20% of qualified business income. Qualified business income doesn't include reasonable compensation paid to the owners for services rendered with respect to the trade or business or guaranteed payments paid to partners.

Exclusions: Pass-through entities don't include a trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services or brokerage services. The TCJA also carries over from current law an exclusion for or any trade or business where the business's principal asset is the reputation or skill of its employees or owners.

➲ **THE SAME OLD PROBLEM:** Although the TCJA specifically retains the reasonable compensation requirement, owners in high tax brackets may try to classify more income as qualified business income to take advantage of the 20% rate. You need to be vigilant if this occurs and remind owners that the IRS will mostly likely disagree with those actions.

Where did all those employees go? The disparity in tax rates may also motivate some employees to become pass-through entities and then contract with their employers to provide the same services they were providing as employees. Depending on how the IRS interprets the limitation on businesses whose principal asset is employees' or owners' reputation or skill, nothing right now would seem to stop employees from becoming pass-through entities.

While this isn't a payroll matter *per se*, you should be aware of the following:

- These individuals would need to be removed from your cafeteria plan, since only employees can participate in cafeteria plans (i.e., they would become responsible for their own health insurance)

- These individuals would also need to be removed from your 401(k) plan for the same reason
- All other employee benefits would need to cease, as well
- The company could decide to pick up these individuals' business-related expenses, although it would be under no obligation to do so
- Unless these individuals are S corps or LLCs, you must provide Forms 1099-MISC to them by Jan. 31, 2019.

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