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Tax Cuts and Jobs Act of 2017

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On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act of 2017[1] (TCJA), which significantly amends the Internal Revenue Code of 1986 (Code). While the main focus of the TCJA may be on lowering corporate and individual tax rates, the TCJA also includes meaningful changes in the area of employee benefits and executive compensation, including changes to the Patient Protection and Affordable Care Act (ACA), the tax treatment of how public companies and tax-exempt organizations pay their executives, and the tax treatment of various fringe benefits. Among the changes in the benefits and compensation arena, the TCJA effectively repeals the ACA individual mandate by reducing the individual mandate penalty to zero, effective as of January 1, 2019;[2] prohibits public companies from deducting certain performance-based compensation paid to their top executives; and provides that nonprofit organizations are subject to excise taxes for certain compensation packages paid to their highest paid employees.

Some expected changes impacting benefits and compensation never came to fruition. For example, while some earlier drafts of the TCJA included a repeal of Section 409A of the Code and the expansion of

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Health Savings Accounts (HSAs), the final law does not include any meaningful changes in these areas.

This column provides an overview of some of the changes enacted by the TCJA that impact the employer-employee relationship. Employers will want to work with their legal counsel to understand the nuances of the TCJA to determine whether any of their employee benefits plans or executive compensation arrangements should be amended in light of the TCJA and whether they should consider revising benefit packages offered to their employees.

ACA Individual Mandate

Under the ACA individual mandate, individuals who are not covered under a health insurance plan that qualifies as minimum essential coverage during a tax year are subject to a penalty for each month in which such individual does not maintain such coverage.[3] The penalty is the greater of (i) a percentage of the individual's household income in excess of the return filing threshold; or (ii) a flat dollar amount.[4] The penalty is capped at the cost of the national average premium for a bronze level health plan available through the Marketplace for the individual's family size.[5]

Under the TCJA, the ACA individual mandate penalty is reduced to zero.[6] Because this change will apply to months beginning after December 31, 2018, individuals still will need to be covered under a health insurance plan that qualifies as minimum essential coverage during the 2018 tax year or face a penalty.[7] By reducing the ACA individual mandate penalty to zero, the TCJA effectively repeals the ACA individual mandate as of January 1, 2019. Employers may need to recognize that individuals who only obtained coverage to avoid the ACA individual mandate penalty will no longer be incentivized to do so beginning in 2019.

The ACA employer mandate is not affected by the TCJA, so applicable large employers must still offer full-time equivalent employees the opportunity to enroll in minimum essential coverage that is affordable and provides minimum value under an eligible employer-sponsored health insurance plan.[8] An applicable large employer means an employer that employs at least 50 full-time equivalent employees.[9] An applicable large employer is subject to a "pay or play" penalty under the ACA if at least one full-time equivalent employee receives a premium tax credit to help pay for health insurance from the Marketplace and an employer either (i) does not offer minimum essential coverage to at least 95 percent of its full-time employees; or (ii) offers such coverage, but such coverage is not deemed affordable or providing minimum value.[10]

While the ACA employer mandate is not directly impacted by the TCJA, applicable large employers may experience a reduction in penalties under the ACA since individuals are less incentivized to obtain health insurance from the Marketplace without the ACA individual mandate penalty. If there are fewer individuals going to the Marketplace for their health insurance, fewer individuals are likely to receive a premium tax credit to help pay for health insurance. Because a premium tax credit is one of the required triggers for the "pay or play" penalties, fewer premium tax credits being handed out likely will reduce the number of applicable large employers subject to such penalties and/or reduce the size of such penalties.

Public Companies – Executive Compensation

Prior to the enactment of the TCJA, publicly held corporations (i.e., corporations issuing any class of common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934 (the Exchange Act))[11] were not allowed to deduct amounts exceeding $1 million paid to covered employees as remuneration for a given tax year.[12] A covered employee included any employee who, on the last day of the company's fiscal year, was either the chief executive officer (or equivalent) of the company or one of the next three highest paid officers of the company (other than the chief executive officer) whose compensation was required to be reported in the company's proxy statement.[13] This $1 million deduction limit did not apply to certain performance-based compensation.[14] This exception created an incentive for a company to structure its executive compensation packages as performance-based compensation.

The TCJA amends and expands the definition of covered employee and remuneration under Section 162(m) of the Code (Section 162(m)).[15] These expanded definitions limit a company's ability to structure its executive compensation packages to allow the company to take a deduction for such compensation packages. Under the TCJA, a covered employee will now also include an individual who is named the chief executive officer or the chief financial officer of the company or one of the three highest paid officers of the company (other than the chief executive officer or chief financial officer).[16] Additionally, once an individual is considered a covered employee for any tax year commencing after December 31, 2016, his or her compensation would remain subject to the $1 million deduction limit for each subsequent tax year.[17] This expanded definition of covered employee is commonly referred to as the "once covered, always covered" rule. Because an individual never loses his or her status as a covered employee, all compensation paid to that individual, including all payments made upon or following termination (including payments to the individual's beneficiaries following the individual's death) will be subject to the $1 million deduction limit. Therefore, severance pay, deferred compensation payments, supplemental executive retirement plans, and other similar types of post-termination of employment payments to a covered employee or his or her beneficiaries are subject to the $1 million deduction limit under the TCJA. Under the "once covered, always covered" rule, the number of covered employees may increase with each passing year if the company's top executives change. This may lead companies to consider strategies for keeping their covered employee list as small as possible.

In addition to the expansion of the definition of covered employees, the TCJA broadens the definition of remuneration to include performance-based compensation.[18] As noted above, certain performance-based compensation arrangements previously were excluded when calculating remuneration paid to covered employees for purposes of the Section 162(m) limitation. Without the exclusion for performance-based compensation under Section 162(m), all compensation paid to a covered employee in excess of $1 million will no longer be deductible for the company. Equity awards such as stock options, stock appreciation rights, performance stock units, and performance shares granted to covered employees are commonly used performance-based compensation vehicles, all of which will now be subject to the $1 million deduction limit.

This change may lead companies to move away from providing performance-based awards, which received favorable tax treatment prior to the enactment of the TCJA, to discretionary bonuses, which did not receive favorable treatment. A shift towards discretionary bonuses will allow a company to reward (or punish) executives in real-time based on their performances instead of relying on performance forecasts. However, some shareholder activist groups will continue to expect executive compensation packages to emphasize awards that are conditioned on the achievement of rigorous and transparent performance goals.[19] The purpose of these performance-based awards is to retain and incentivize executives to drive performance in accordance with the company's long-term goals and strategies which, in turn, creates value for shareholders.[20]

Additionally, the TCJA expands the scope of companies subject to the Section 162(m) deduction limitation. Specifically, Section 162(m) now covers any company that is an issuer of securities registered under Section 12 of the Exchange Act or is required to file reports under Section 15(d) of the Exchange Act (public debt filers).

Companies should work with their legal counsel to help them understand the impact of the changes to the Section 162(m) deduction for excess executive compensation, including assessing which individuals are now considered covered employees. Companies that previously utilized the performance-based compensation exclusion should consult with their legal counsel, including whether they should modify the structure of their current executive compensation packages.

Tax-Exempt Organizations – Executive Compensation

Public companies are not the only entities that will face new requirements related to their executive compensation packages. Specifically, a tax-exempt organization may be subject to an excise tax for its executive compensation packages that are in excess of $1 million.[21] Prior to the enactment of the TCJA, a tax-exempt organization had to make sure its executive compensation packages were reasonable.[22] In drafting the TCJA excise tax provisions, Congress borrowed extensively from the newly amended Section 162(m) rules and the existing rules under Section 280G of the Code (Section 280G) and applied them to tax-exempt organizations.

Under the TCJA, tax-exempt organizations will be subject to an excise tax on compensation exceeding $1 million paid to any covered employee.[23] A covered employee for a tax-exempt organization means an employee that is one of the five highest paid employees of the tax-exempt organization in any tax year commencing after December 31, 2016, regardless of the employee's title or position.[24] This definition is different from the definition of covered employee for public companies under the revised Section 162(m). However, similar to the Section 162(m) amendments, the "once covered, always covered" rule applies to covered employees of tax-exempt organizations.[25] Once an employee qualifies as a covered employee in one year, the employee will be deemed a covered employee for all future years even after termination of employment; meaning, a tax-exempt organization may be subject to an excise tax for compensation paid to a covered employee after his or her termination of employment and for payments made to the covered employee's beneficiaries.[26]

Tax-exempt organizations also will be subject to an excise tax for "excess parachute payments" under the TCJA.[27] An excess parachute payment is a payment that is contingent on a covered employee's separation from employment with the employer and exceeds three times such covered employee's base amount. A covered employee for this purpose uses the same definition above regarding a tax-exempt organization's excess executive compensation. Base amount is calculated under the rules of Section 280G (b)(3) of the Code.

While this excess parachute payment excise tax under the TCJA may seem similar to the Section 280G excise tax, the TCJA excise tax differs in a number of respects, including the following: (1) the TCJA excise tax is imposed on the tax-exempt organization, not the employee; (2) the TCJA excise tax is not contingent on a change in control of the tax-exempt organization; and (3) the recipient must receive the compensation upon his or her termination of employment with the tax-exempt organization.[28] In contrast, Section 280G imposes an excise tax on the recipient who received any excess parachute payments, not the employer that paid the amounts.[29] Also, the Section 280G excise tax applies to compensation that is contingent on a change of control of the corporation and does not require the recipient to experience a termination of his or her employment with the corporation in order to be entitled to the payments.[30]

Employer Credit for Paid FMLA Leave

Under the TCJA, employers will be able to claim a tax credit for providing employees with paid leave under the Family and Medical Leave

Act (FMLA).[31] As of now, this credit is only available for the 2018 and 2019 tax years.[32]

In order for an employer to be eligible to claim this credit, the employer must have a written policy providing that full-time employees are eligible for a minimum of two weeks' paid leave and part-time employees must be eligible for a commensurate amount of leave on a *pro rata* basis.[33] The written policy must also provide that an employee's compensation under the program must be at least 50 percent of the wages normally paid to such employee for services performed for the employer.[34] The program must be available to all full-time and part-time[35] employees who have worked for at least one year at the employer.[36] An employer can receive a credit only for employees who have been employed with the employer for at least one year and who were paid no more than $72,000 in 2017.[37]

If available, the credit is equal to a percentage of the wages paid to a qualifying employee during such employee's FMLA leave.[38] Employers can claim a credit for up to 12 weeks of paid FMLA leave per qualifying employee per year.[39] The percentage starts at 12.50 percent and increases by 0.25 percent (up to a maximum of 25 percent) for each percentage point by which wages paid during the FMLA leave exceed 50 percent of the wages normally paid to the qualifying employee.[40] Any benefits that are mandated under state or local law cannot be taken into account for purposes of determining the amount paid by an employer during the FMLA leave.[41]

Companies that are interested in exploring their eligibility for this tax credit should contact their legal counsel to ensure that they have an adequate written policy in place and to design a program that complies with state and local leave laws while providing a tax credit.

Employee Achievement Awards

The TCJA clarifies what types of employee achievement awards are eligible to be deducted by employers and excluded from taxable income by employees.[42] The TCJA provides that the employee achievement awards exclusion is only available when an employer gives an employee an achievement award in the form of tangible personal property, which cannot include cash, cash equivalents, gift cards, gift coupons, gift certificates, vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, or other similar items.[43] Such awards are excludable up to $400 per employee per year if the award was not given pursuant to a qualified plan and up to $1,600 under a qualified plan.[44]

Sexual Harassment Settlements

Companies previously were able to deduct amounts paid in connection with a legal settlement pursuant to a claim by an employee of sexual harassment or sexual abuse under Section 162 of the Code. Section 13307 of the TCJA adds a new subsection under Section 162 of the Code to disallow any deduction for any settlement, payment, or attorneys' fees related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement.[45] Employers should work with their legal counsel to understand the corporate deduction implications when structuring sexual harassment settlements and to structure settlements in light of these new rules.

Roth IRA Conversions

Previously, an individual who made a contribution to a traditional IRA was able to recharacterize the contribution as a Roth IRA contribution if the recharacterization was done prior to the individual's tax filing deadline (including extensions).[46] Under the TCJA, for tax years beginning after December 31, 2017, individuals will no longer be allowed to recharacterize a traditional IRA contribution as a Roth IRA contribution.[47]

401(k) Plan Hardship Withdrawals

The TCJA modifies the deduction for personal casualty losses under Section 165 of the Code to limit the deduction to losses attributable to a disaster declared by the President under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (a Federally Declared Disaster).[48] These changes will impact how a retirement plan approves hardship distributions if the plan relies on safe harbor hardship withdrawal reasons.[49] Under the TCJA, a plan participant may not receive a hardship distribution to pay expenses to repair damage caused by a casualty loss unless the loss was the result of a Federally Declared Disaster.[50] These changes apply to losses incurred in tax years beginning after December 31, 2017, and before January 1, 2026.[51]

529 Account Funding For Elementary and Secondary Education

The TCJA amends Section 529(c) of the Code to include expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school as a qualified higher education expense.[52] Such expenses will be able to be distributed from 529 accounts without being subject to federal income tax on any earnings.[53] The amended and expanded definition of qualified higher education expense may increase employees' interest in having employers include access to 529 accounts and vendors.

Some states will need to amend their tax laws to account for the expanded definition of qualified higher education expense. Therefore, in such states, distributions from 529 accounts still may be subject to state and local income tax.

Unreimbursed Business Expenses

The TCJA amends Section 67 of the code by disallowing an employee's personal deduction for unreimbursed business expenses for the expenses that exceed two percent of the employee's adjusted gross income.[54]

Fringe Benefits

The TCJA amends fringe benefits offered by employers that previously received favorable tax treatment, including moving expenses, entertainment expenses, eating facilities, qualified transportation, and qualified bicycle commuting reimbursements. Many of the business deductions for these types of fringe benefits are no longer available.

Moving Expenses

Prior to the enactment of the TCJA, certain moving expenses that were either reimbursed or directly paid by an employer were excludible from an employee recipient's taxable income.[55] Eligible moving expenses included reasonable expenses related to (i) moving household goods and personal effects from the former residence to the new residence, and (ii) traveling (including lodging) from the former residence to the new residence, provided that the new principal place of work would add 50 miles to the employee's commute from the employee's former residence.[56] Under the TCJA, moving expenses that were either reimbursed or directly paid by an employer will no longer be excluded from an employee recipient's taxable income, except in the case of a member of the Armed Forces on active duty who moves pursuant to a military order and incident to a permanent change of station.[57]

Entertainment Expenses

Expenses relating to entertainment, amusement, or recreation activities were previously deductible up to 50 percent of the expense, if there was a substantial and *bona fide* business discussion that took place during, directly preceding, or following the outing.[58] Under the TCJA, such expenses will no longer be deductible as of January 1, 2018, regardless of legitimate business discussions taking place during, directly preceding, or following the outing.[59]

Eating Facilities

Meals offered at a facility for employees were previously deductible to the employer and excludible from the employee's taxable income if such facility is located on or near the business premises of the employer and revenue derived from such facility normally equals or exceeds the direct operating costs of such facility.[60] Under the TCJA, an employer's business deduction will be limited to 50 percent for expenses incurred from after January 1, 2018 through December 31, 2025.[61] Effective January 1, 2026, employers will no longer be able to take any deduction in connection with such eating facilities.[62] Employees, however, still will be able to exclude the value of the meals offered at such facilities under the TCJA.

Qualified Transportation

Employers that have been previously deducting qualified transportation fringe benefits that they provide to their employees will no longer be able to deduct such amounts under the TCJA.[63] Qualified transportation fringe benefits include transportation in a commuter highway vehicle[64] in connection with travel between an employee's residence and place of employment, transit passes, parking for commuter highway vehicles or carpool, and qualified bicycle commuting reimbursements.[65] An employer will only be able to continue deducting qualified transportation fringe benefits provided to its employees that are necessary to ensure the safety of such employees.[66]

These changes to the qualified transportation fringe benefits deduction will apply to tax-exempt organizations as well.[67] A tax-exempt organization will be subject to a tax on unrelated business income for any qualified transportation benefits provided to its employees.[68]

Although employers will no longer be eligible to receive a tax deduction for providing qualified transportation fringe benefits to employees, employees will continue to be able to set aside pre-tax dollars from their paychecks (up to $260/month in 2018) to cover their qualified transportation expenses.[69] These amounts that employees elect to set aside from their paychecks also will not be deductible to employers.[70]

The loss of the qualified transportation fringe benefits deduction may cause some employers to stop providing qualified transportation fringe benefits to their employees, however, such benefits are popular among employees, which may make it difficult for employers to stop offering them. Additionally, some jurisdictions have enacted laws that require employers to offer transportation benefits to their employees.[71]

Employers in these jurisdictions will still have to offer transportation benefits to their employees regardless of no longer being able to take a related tax deduction.

Qualified Bicycle Commuting Reimbursements

For tax years prior to 2018, qualified bicycle commuting reimbursements of up to $20 per qualifying bicycle commuting month were excludible from an employee's gross income.[72] A qualifying bicycle commuting month is any month during which an employee regularly uses a bicycle for a substantial portion of travel to a place of employment and during which the employee does not receive transportation benefits in the form of a commuter highway vehicle, a transit pass, or qualified parking from an employer.[73] Qualified bicycle commuting reimbursements are any amounts received from an employer during a 15-month period beginning with the first day of the calendar year as payment for reasonable expenses during a calendar year.[74] Reasonable expenses include a purchase of a bicycle and bicycle improvements, repair, and storage, if the bicycle is regularly used for travel between the employee's residence and place of employment.[75]

Under the TCJA, effective as of January 1, 2018, employees will no longer be able to exclude qualified bicycle commuting reimbursements from their taxable income.[76] Accordingly, employers will have to start including any qualified bicycle commuting reimbursements in employees' income and such reimbursements will be subject to payroll taxes and income tax withholding. Without the individual tax deduction, employees may be less interested in this benefit. Therefore, employers may face less pushback from their employees if employers stop offering qualified bicycle commuting reimbursements than if the employer stopped its transit and parking benefits.

NOTES

1. Pub. L. No. 115-97.
2. TCJA § 11081.
3. 26 U.S.C. § 5000A(c) (1986) (amended 2017).
4. *Id*. at § 5000A(c)(1) and (2).
5. *Id*. at § 5000A(c)(1)(B).
6. TCJA § 11081(a).
7. *Id*. at § 11081(b).
8. 26 U.S.C. § 4980H(a) and (b).
9. *Id*. at § 4980H(c)(2)(B)(i).

10. *Id*.

11. *Id*. at § 162(m)(2) (1986) (amended 2017).

12. *Id*. at § 162(m)(1).

13. *Id*. at § 162(m)(3).

14. *Id*. at § 162(m)(4)(C).

15. TCJA § 13601(a) and (b).

16. *Id*. at § 13601(b).

17. *Id*.

18. *Id*. at § 13601(a).

19. U.S. Tax Reform: Changes to 162(m) and Implications for Investors, *https://corpgov.law.harvard.edu/2018/01/25/u-s-tax-reform-changes-to-162m-and-implications-for-investors/* (last visited Feb. 12, 2018).

20. *Id*.

21. TCJA § 13602(a).

22. 26 U.S.C. § 4958

23. TCJA § 13602(a).

24. *Id*.

25. *Id*.

26. *Id*.

27. *Id*.

28. *Id*.

29. 26 U.S.C. § 280G(a); 4999(a).

30. *Id*. at § 280G(b)(2)(A)(i).

31. TCJA § 13409(a)(1). Other types of leave, such as paid vacation, personal leave, or other types of medical or sick leave do not qualify for the credit.

32. *Id*.

33. *Id*.

34. *Id*.

35. Any employee who is customarily employed for fewer than 30 hours per week. 26 U.S.C. § 4980E(d)(4)(B).

36. TCJA § 13409(a)(1).

37. *Id*.

38. *Id*.

39. *Id*.

40. *Id*.

41. *Id*.

42. TCJA § 133310(a).

43. *Id*.

44. 26 U.S.C. § 274(j)(2).

45. TCJA § 13307.

46. 26 U.S.C. § 408A (1986) (amended 2017).

47. TCJA § 13611.

48. *Id*. at § 11044.

49. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B).

50. *Id*. at § 1.401(k)-1(d)(3)(iii)(B)(6).

51. TCJA § 11044.

52. *Id*. at § 11032(a)(1).

53. 26 U.S.C. § 529(c)(1).

54. TCJA § 11045

55. 26 U.S.C. § 132(g); 217.

56. § 217(b) and (c)(1).

57. TCJA § 11048 and 11049.

58. 26 U.S.C. § 274(a)(1) and (n) (1986) (amended 2017).

59. TCJA § 11048(a).

60. 26 U.S.C. § 274(n)(2)(B); 132(e); and 119 (1986) (amended 2017).

61. TCJA § 13304.

62. *Id*.

63. *Id*. at § 13304(c).

64. A commuter highway vehicle is a vehicle (a) with the seating capacity of which is at least six adults (not including the driver), and (b) 80 percent of the vehicle's mileage use (i) is to transport employees in connection with travel between their residences and their place of employment, and (ii) at least half of the adult seating capacity of such vehicle (not including the driver) is used on such trips. 26 U.S.C. § 132(f)(5)(B).

65. *Id*. at 132(f)(1).

66. *Id*.

67. TCJA § 13703(a).

68. *Id*.

69. 26 U.S.C. § 132(a)(5).

70. TCJA § 13304(c).

71. *See, e.g.,* Title 20 Chapter 9 of the Administrative Code of the City of New York.

72. 26 U.S.C. § 132(a)(5) and 132(f)(1)(D).

73. *Id*. at § 132(f)(5)(F)(iii).

74. *Id*. at § 132(f)(5)(F)(i).

75. *Id*.

76. TCJA § 11047.