SEYFARTH SHAW

Tax Reform

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Tax Reform Impact on Employers and Employees

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This is the fifth issue in a planned series of alerts designed to provide an in-depth analysis on topics related to tax reform.

On December 15, 2017, Congressional Leaders announced that the conferees appointed by both the House and the Senate reached an agreement to reconcile differences between the House's version of the Tax Cuts and Jobs Act (the "House Bill") with the Senate's version of the Tax Cuts and Jobs Act and unveiled the text of a final bill (the "Tax Bill"). On December 19, 2017, the Senate voted to approve the Tax Bill and, on December 20, 2017, the House voted to approve the Tax Bill. The Tax Bill was sent to the White House for President Trump's signature. We expect that the Tax Bill will be signed into law without further changes.

The Tax Bill has many provisions that impact employers with respect to their employees. We have summarized some of the more important provisions below.

Denial of deduction for settlements subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse: Under current law (Internal Revenue Code ("Code") Section 162(a)), a taxpayer is generally allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Under the Tax Bill, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

Repeal of employee deduction and income exclusion for moving expenses: Under current law (Code Section 132(a)(6) and (g)), an employee can exclude qualified moving expense reimbursements from gross income. Under current law (Code Section 217), an employee can deduct qualified moving expenses for which the employee is not reimbursed. The Tax Bill suspends the exclusion for qualified moving expense reimbursements for taxable years 2018 through 2025. The Tax Bill also suspends the deduction for qualified moving expenses for taxable years 2018 through 2025. However, during the suspension period, the provision retains the exclusion for qualified moving expense reimbursements, the deduction for qualified 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.

Repeal of deduction for business entertainment: Under current law (Code Section 274(a)(1) and 274(n)(1)(A)), no deduction is allowed with respect to an activity generally considered to be entertainment, amusement, or recreation, unless the taxpayer establishes that the activity was directly related to (or, in certain cases, associated with) the active conduct of the

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taxpayer's trade or business. If the taxpayer can establish the relationship, then the taxpayer can deduct 50% of the amount otherwise deductible. Similarly, under current law, (1) no deduction is allowed with respect to a facility used in connection with entertainment, amusement, or recreation (Code Section 274(n)(1)(B)), and (2), no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation, or other social purpose (Code Section 274(a)(3)). The Tax Bill repeals the present-law exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50% limit to such deductions) and retains the current law rules that deny a deduction with respect to (1) a facility or portion thereof used in connection with entertainment, amusement, or recreation, or (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes.

Repeal of deduction for transportation expenses: Under current law (Code Section 132(f)(1) and (5)), an employee can exclude qualified transportation fringes (including qualified parking (parking on or near the employer's business premises or on or near a location from which the employee commutes to work by public transit), transit passes, vanpool benefits, and qualified bicycle commuting reimbursements) from income. The Tax Bill disallows a deduction for expenses associated with providing any qualified transportation fringe to employees, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for an employee's commuting between his or her residence and place of employment.

Modification and later repeal of the employee income exclusion for food and beverage provided at an employer eating facility: Under current law (Code Section 119(a)), an employee or an employee's spouse or dependents can exclude the value of meals furnished to them by or on behalf of the employer if the meals are furnished for the convenience of the employer and are provided on the employer's business premises. For amounts incurred and paid after December 31, 2017 and until December 31, 2025, the Tax Bill expands the 50% limitation to employer expenses associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer. Such amounts incurred and paid after December 31, 2025 are not deductible. An employer may still generally deduct 50% of the food and beverage expenses associated with operating its trade or business, such as amounts paid for an employee's meals while traveling for business.

Limitation on the deduction for employee achievement awards: Under current law (Code Section 274(j)), an employer may deduct a certain amount of the costs associated with providing an employee achievement award that is tangible personal property. The Tax Bill adds a definition of "tangible personal property." The provision 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-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items.

Repeal of certain miscellaneous itemized deductions subject to the 2% floor: Under current law, employees may claim itemized deductions for certain miscellaneous expenses. Certain of these expenses are not deductible unless, in aggregate, they exceed 2% of the employee's adjusted gross income. The Tax Bill suspends all miscellaneous itemized deductions that are subject to the 2% floor under present law. This includes the following deductions that an employee had been permitted to deduct under current law: (1) casualty and theft losses from property used in performing services as an employee, (2) business bad debt of an employee, (3) business liability insurance premiums, (4) damages paid to a former employer for breach of an employment contract, (5) depreciation on a computer a employee's employer requires him or her to use in his or her work, (6) dues to a chamber of commerce if membership helps the employee perform his or her job, (7) dues to professional societies, (8) educator expenses, (9) home office or part of a employee's home used regularly and exclusively in his or her work, (10) job search expenses in the employee's present occupation, (11) legal fees related to the employee's job, (12) licenses and regulatory fees, (13) malpractice insurance premiums, (14) medical examinations required by an employer, (15) occupational taxes, (16) passport fees for a business trip, (17) research expenses of a college professor, (18) subscriptions to professional journals and trade magazines related to the employee's work, (19) tools and supplies used in the employee's work, (20) costs for travel, transportation, meals, entertainment, gifts, and local lodging related to the employee's work, (21) union dues and expenses, (22) work clothes and uniforms if required and not suitable for everyday use; and (23)

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work-related education. Thus, under the provision, employees may not claim the above-listed items as itemized deductions for taxable years 2018 through 2025.

Modification of limitation on excessive employee remuneration: Under current law, an employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. Code Section 162(m) limits the deductibility of compensation expenses in the case of publicly traded corporate employers. The otherwise allowable deduction for compensation with respect to a covered employee of a publicly held corporation is limited to no more than $1 million per year.

The Tax Bill makes several modifications to the Code Section 162(m) limitation on the deductibility of compensation expenses (in excess of $1 million) for "covered employee" of publicly traded corporate employers.

First, the provision makes several revisions to the definition of covered employee: (1) the definition under the Tax Bill includes both the principal executive officer and the principal financial officer, (2) the definition applies to individuals who hold one of those positions at any time during the taxable year, (3) the definition also includes the three (rather than four) most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer) who are required to be reported on the company's statement required pursuant to executive compensation disclosure rules promulgated under the Exchange Act (the proxy statement) for the taxable 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).

Second, the provision states that if an individual is a covered employee on December 31, 2016, the individual will continue to be a covered employee for all subsequent years and his or her compensation will continue to be subject to the Code Section 162(m) limitation even after (1) he or she is no longer employed by the company or (2) he or she dies.

Third, the provision extends the definition of "publicly held corporation" to include all domestic publicly traded corporations and all foreign companies publicly traded through American depository receipts. The proposed definition may include certain additional corporations that are not publicly traded, such as large private C or S corporations.

Fourth, the provision eliminates the exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit. As a result, such compensation is taken into account in determining whether the amount of a covered employee's compensation for a taxable year exceeds $1 million and is therefore not deductible under Code Section 162.

Finally, the provision adds a transition rule for compensation that is provided pursuant to a written binding contract which was in effect on November 2, 2017. Under the transition rule, compensation provided pursuant to a contract that qualifies for the rule will not be subject to the changes made by the Tax Bill. The transition rule does not apply once (1) there is a material modification to the terms of the contract, (2) the contract is renewed, or (3) the contract becomes terminable or cancelable unconditionally at will by either party to the contract without the consent of the other or by both parties.

Observations

Overall, the Tax Bill may have a detrimental impact on employees because it does away with several tax-free fringe benefits that employers currently provide to their employees. However, it is worth noting that several other tax-free fringe benefits that would have been eliminated under the House Bill were not eliminated under the Tax Bill. Most notably, the (1) deduction for qualified tuition and related expenses, (2) exclusion for qualified tuition reductions, (3) exclusion for educational assistance programs, (4) exclusion for employer-provided housing, and (5) exclusion for adoption assistance programs all survived the Tax Bill. Perhaps the most interesting change made in the Tax Bill is the repeal of the deduction for sexual harassment or sexual abuse settlements subject to nondisclosure agreements. This repeal appears to be a punitive response to the use of nondisclosure agreements, perhaps triggered by the recent increase in sexual harassment and sexual abuse claims and lawsuits against high-profile individuals. This new provision may impact the way that the parties to a sexual harassment or sexual abuse suit negotiate during the settlement process, but is unlikely to significantly deter the use of nondisclosure agreements.

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Seyfarth Shaw will continue to monitor Congressional and regulatory efforts and will provide further alerts as new developments occur. If you would like further information, contact Paul Drizner at pdrizner@seyfarth.com and Michael Lobie at mlobie@seyfarth.com.

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