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Three new acts change tax and employee benefit rules and might require employer action

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Congress and the Administration have been busy recently, enacting not only the TCJA on December 22, 2017, but also a Continuing Resolution on January 23, 2018, and the Bipartisan Budget Act of 2018 on February 9, 2018. Each includes a number of modifications to rules relating to employee benefits that will affect taxable and nontaxable employers and pass-throughs and their employees, partners and service-providers. Read below to learn more about what they mean for you.

1. Tax Cuts and Jobs Act

On December 22, 2017, President Trump signed H.R. 1, commonly referred to by its pre-enactment name, the Tax Cuts and Jobs Act (TCJA), into law as Pub. L. No. 115-97. Included in the TCJA are a number of modifications to various rules relating to employee benefits that will affect taxable and nontaxable employers and pass-throughs and their employees, partners and other service-providers.

This is the second Employee Benefits Group Update on the TCJA. The first was issued December 21, 2017.

A copy of the TCJA can be found here: https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf.

Provisions affecting all employers

Changes to withholding (Section 11001). Under prior law, the regular tax rates for individuals were 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. Employers were required to withhold income tax from an employee's regular wages at rates corresponding to these rates, after subtractions to reflect the number of the employee's withholding allowances, which were declared on the employee's Form W-4. An employee who expected to owe no income tax could use Form W-4 to claim complete exemption from withholding. Different rules applied to supplemental wages, which included bonuses, stock option income and many other forms of executive compensation received outside the usual payroll schedule. Employers were required to withhold income tax from supplemental wages over US$1 million at the top rate of 39.6% and were allowed to withhold income tax

from supplemental wages under US$1 million at the third-highest rate of 25%, in both cases without regard to the employee's Form W-4.

Effective for tax years 2018-2025, the TCJA replaces the regular tax rates for individuals with lower tax rates of 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The TCJA also makes significant changes to the rules regarding deductions and credits, which will affect employees' effective tax rates.

Employers that have not acted already will need to modify their withholding systems quickly to reflect these changes. So far, the IRS has issued two notices (Notice 1036 and Notice 2018-14) on employers' withholding obligations for 2018, and a revised version of Form W-4. Notice 1036 contains early release copies of the 2018 Percentage Method Tables and indicates that the rate of withholding on supplemental wages over and under US$1 million in 2018 will be 37% and 22%, respectively. It also has released a "Withholding Calculator" for employees to use to determine whether their withholding amounts are correct.

The guidance states that employers should implement the new withholding tables and the 22% rate of withholding on supplemental wages under US$1 million "as soon as possible" but not later than February 15, 2018. It does not provide any grace period for implementing the maximum 37% rate of withholding on supplemental wages over US$1 million. The guidance also announces procedures that are likely to reduce the number of new Forms W-4 received by employers in 2018. Notwithstanding this relief, the guidance gives employers very little time to implement significant changes to their payroll and supplemental wage withholding systems.

Changes to depreciation limits on luxury automobiles and computers (Section 13202). Effective for property placed in service after 2017, the TCJA substantially increases the depreciation limits for "luxury" automobiles under section 280F and amends that section to remove computer and peripheral equipment from the definition of "listed property" on which additional depreciation limits and business purpose substantiation requirements are placed.

The changes will make it less expensive and burdensome for employers to provide passenger automobiles, computers, and peripheral equipment to employees who need them, and employers might wish to expand their programs accordingly.

New limits on deductions for certain expenses (Section 13304)

Entertainment, amusement, and recreation. Under section 274 of prior law, taxpayers could not deduct their expenses for entertainment, amusement, or recreational activities, or for facilities used in connection with those activities, unless they could establish that they were directly related to or associated with the active conduct of their trade or business (subject to certain exceptions). The rule applied to employers, but there were several important employment-related exceptions from it, including for food and beverages (and related facilities) furnished on the business premises of the employer primarily for employees (such as at a holiday party), entertainment (including food and beverage) expenses that were treated as compensation by the employer, reimbursed business expenses that were treated as compensation, recreational expenses of nonhighly compensated employees, and business meetings of employees.

Effective beginning in 2018, the TCJA deletes the exception in section 274 for entertainment, amusement, or recreational activities, and related facilities, that have a business purpose. However, it appears to leave the employment-related exceptions intact, thus having little impact on entertainment etc. provided to employees.

Meals, food, and beverages. Under section 274 of prior law, taxpayers could deduct only 50% of their expenses for food and beverages. The rule applied to food and beverages provided to employees (such as meals with clients, meals provided on the employer's business premises, and meals while on business travel), but there were

several employment-related exceptions from it, including for entertainment (including food and beverage) expenses that were treated as compensation by the employer, reimbursed business expenses that were treated as compensation, recreational expenses of nonhighly compensated employees, and business meetings of employees, and an important exception for food or beverages that were de minimis fringes under section 132. Under a special rule, meals provided for the convenience of the employer on the business premises of the employer were able to take advantage of this exception.

Effective beginning in 2018, the TCJA deletes the special exception in section 274 for de minimis fringes, thus making most employer-provided meals, including those provided at employer-operated eating facilities and for the convenience of the employer – but not the cost of the facilities themselves – subject to 50% disallowance. In a separate provision that is not effective until 2026, the TCJA also disallows a full 100% of the deductions for employer-operated eating facilities, for food or beverages "associated with" those facilities, and for meals provided for the convenience of the employer on the business premises of the employer. The employment-related exceptions will continue to apply to the 50% disallowance rule, but will not apply to the 100% disallowance rule that becomes effective in 2026.

Qualified transportation fringe benefits. Qualified transportation fringes such as van pools, transit passes and parking on or near the business premises of the employer can be provided to employees tax-free, subject to certain limits. Under prior law, an employer also could deduct the cost of those fringe benefits, even though they were excluded from employees' income.

Effective beginning in 2018, the TCJA generally disallows any deduction for qualified transportation fringes, as well as for transportation or any payment or reimbursement for commuting to work that might not otherwise be excluded from income as a qualified transportation fringe, except as necessary to ensure the safety of an employee. Under existing law there is a partial exclusion from income, as a de minimis fringe, for occasional employer reimbursements for local transportation such as taxis where other modes of transportation are unsafe. Possibly similar standards will be applied. In its recent revisions to Publication 15-B, the IRS states that this rule applies to qualified transportation benefits regardless of whether they are provided directly or through a reimbursement arrangement or compensation reduction agreement.

Consequences. The changes described above will make it more expensive for employers to pay for business-related entertainment activities and facilities, and to provide food and beverages, qualified transportation fringes and other commuting benefits to their employees. Employers might wish to restrict their programs accordingly. Since some benefits still appear to be fully deductible to the extent they are treated as compensation or provided as cash, employers might wish to provide the benefits on a taxable basis. New York City, Washington, D.C., San Francisco, and many other jurisdictions in the Bay Area require certain employers to offer transportation benefits to their employees, and therefore those employers might be unable to avoid disallowance for these expenses.

The changes generally do not prevent the disallowed amounts from continuing to be excluded from the employees' own incomes where that was possible under prior law. However, guidance would be useful to confirm that the repeal of the business-substantiation exception will not affect either the general exclusion for working-condition fringes or the exclusions for business-related club dues and spousal travel.

Denial of deduction for certain sexual harassment expenses (Section 13307). Under prior law, an employer could deduct as a business expense under section 162 the cost of settling or paying a claim against it relating to sexual harassment or sexual abuse, including any related attorney's fees. The victim also could deduct his or her attorney's fees from any settlement or judgment he or she received. Effective for amounts paid or incurred after the date of enactment, the TCJA prohibits the employer from deducting the cost of settling or

paying such a claim, including any related attorney's fees, if the settlement was subject to a nondisclosure agreement. It also appears to prohibit the victim from deducting his or her own attorney's fees in such a situation, although this might not have been the intended result. It is not clear how close the relationship must be between the costs incurred and the claims of sexual harassment or sexual abuse. It also is not clear whether the limitation will affect the degree to which an employee or board member who is the beneficiary of such a payment by his or her employer or company, or employment practices insurance purchased by his or her employer or company, can exclude the payment or the cost of the insurance from income as a working-condition fringe.

Limits on employee achievement awards (Section 13310). An employer may deduct achievement awards to an employee for length of service or safety achievements to the extent the cost does not exceed US$400 (or US$1,600 in certain cases). The awards generally are excluded from the employee's income to the extent the cost (or the value, if greater) does not exceed the employer's deduction.

Effective beginning in 2018, the TCJA codifies the exclusion from the definition of employee achievement awards currently found in the proposed regulations for cash, gift coupons, gift certificates (except for those allowing the recipient to choose from a limited selection of items pre-selected or preapproved by the employer), vacations, meals, lodging, tickets to sporting or theater events, securities, and "other similar items." Employers may wish to revise their award programs to take this change into account.

Employer credit for paid family and medical leave (Section 13403). Effective for wages paid in 2018 and 2019, the TCJA allows an employer with a family and medical leave program that pays eligible employees at least 50% of their normal wages while they are on leave, and meets certain other requirements, to claim a tax credit equal to 12.5% of the wages paid to those employees for up to 12 weeks of leave. The credit is increased by 0.25% (not to exceed 25% in the aggregate) for each percentage point by which payments exceed 50% of the employees' normal wages. Eligible employees are those with at least one year of service who earn no more than 60% of the section 414(q) dollar limit (i.e., US$72,000 in 2018).

The credit will make it less expensive for employers to provide paid family and medical leave, and employers might wish to expand their leave programs accordingly. An employer that takes a credit for the wages cannot deduct those wages. Therefore, employers with higher effective tax rates generally will not find the credit useful.

Provisions affecting partnerships and other pass-through entities

20% deduction for qualified non-corporate business income (Section 11011). Under prior law, business income and dividends received by sole proprietors and other individuals, or allocated to partners and S corporation shareholders, were subject to tax at the regular income tax rates applicable to individuals unless they qualified as capital gain.

Effective for tax years 2018-2025, the TCJA adds a new section 199A to the Internal Revenue Code (the Code). Section 199A allows a taxpayer other than a corporation to deduct 20% of his or her "qualified business income," "qualified REIT dividends," "qualified cooperative dividends" and "qualified publicly traded partnership income." It appears that in the case of an S corporation the deduction is taken at the shareholder level.

"Qualified business income" generally means income from the conduct of a "qualified trade or business" within the United States, excluding certain categories of (1) investment-related income, such as short- and long-term capital gain, or (2) compensation income, including wage income and guaranteed payments for services described in section 707(c). For individuals in the 32% rate bracket or above, a "qualified trade or business" also generally does not include service-oriented businesses such as health, law or consulting (but not engineering or architecture) or investment or investment management businesses. Also for individuals in the 32% rate bracket or above, the 20% deduction from "qualified business income" is limited to 50% of the individual's share of the

W-2 wages paid by the trade or business (or 25% of the W-2 wages plus 2.5% of the original cost of certain tangible property, if greater).

Section 199A is likely to create an incentive for some individuals currently working as employees to convert to independent contractors, S corporation owners, or partners, to the extent possible. It might also create an incentive for individuals already working as independent contractors, S corporation owners, or partners to maximize the portion of their income that is treated as business rather than compensation income. It might also create an incentive for businesses that do not pay any Form W-2 wages to hire employees or recharacterize independent contractors as employees, to the extent possible.

However, section 199A is a complex provision which will require significant administrative effort in order to implement fully. This includes, in particular, guidance on the types of compensation income that are excluded from the provision for all individuals, the types of service-oriented businesses that are excluded from the provision for individuals in the 32% rate bracket or above, and how a partner's share of W-2 wages will be calculated, for example when W-2 employees are employed through a separate entity.

Employers operating as sole proprietors, partnerships, or S corporations, or considering the creation of such entities, should take section 199A into account in their tax planning.

Three-year holding period for certain profits interests received for services (Section 13309). Under prior law, a taxpayer who received a partnership interest for services was treated the same as any other partner for tax purposes, at least once the interest vested. Thus, the character of the taxpayer's distributive share of partnership income as ordinary income or as short- or long-term capital gains generally was determined at the partnership level, based on what activities the partnership engaged in and how long it held its assets, and passed through to the taxpayer. Generally, gains from the sale of a capital asset were long-term capital gains if the asset was held for at least one year. In addition, because the interest itself was a capital asset, any gains realized by the taxpayer when he or she disposed of the interest qualified as long-term capital gains if the interest was held for at least one year (subject to some exceptions under Subchapter K).

Effective in 2018, the TCJA adds a new section 1061 to the Code. Section 1061 requires a taxpayer who holds an "applicable partnership interest" to treat his distributive share of partnership income as short-term capital gains if the income otherwise would be treated as long-term capital gains but the underlying partnership assets were held for three years or less.

An "applicable partnership interest" generally is any interest in a partnership that is transferred "directly or indirectly" to the taxpayer in connection with the performance of substantial services by the taxpayer or by a related person in any "applicable trade or business." An "applicable trade or business" is one involved in investing in or developing certain "specified assets," which are investment-type assets such as securities, commodities, and real estate held for rental or investment. Income attributable to assets that are not held for portfolio investment on behalf of third-party investors is exempt "to the extent provided" in regulations. Thus, the provision focuses on interests in investment funds with short-term investments, such as hedge funds rather than PE funds, that are received by service-providers to those funds.

The Joint Explanatory Statement says that a "specified asset" includes an interest in a partnership that is not widely held or publicly traded, although that does not appear to be supported by the text of the provision.

An "applicable partnership interest" does not include an interest held by a corporation or a capital interest that allows the taxpayer to share in partnership capital in an amount commensurate with the amount of capital he contributed or the value of the interest taxed on receipt or vesting under section 83 (determined as of the time the partnership interest was acquired). Thus, the provision applies only to interests that were profits interests

when they were acquired.

However, within that area it applies broadly to include, for example, a profits interest that is transferred to a party other than the service-provider, such as an entity (other than a corporation) formed by the service-provider just to hold the interest, or an interest received for services performed by a related party, such as a management company through which an individual provides his services. (Questions have arisen already regarding whether an S corporation would be a "corporation" for this purpose, and if so what would prevent a service-provider from forming an S corporation to hold the interest. However, the IRS recently announced that regulations will be issued that prohibit this.)

An "applicable partnership interest" also does not include "an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity." This exception seems designed to exclude profits interests received by employees of portfolio companies.

If the taxpayer transfers an applicable partnership interest to a "related person," the TCJA also requires the taxpayer to treat a portion of the taxpayer's gains from the transfer as short-term capital gains. A "related person" is any family member or any "colleague" who performed services in the current calendar year or the preceding three calendar years in the same trade or business as the taxpayer. Although the provision is unclear on this point, it appears that the three-year holding period in this situation relates to the partnership interest itself, and the gains that are recharacterized are gains realized or recognized by the partner on the transfer of the interest.

Partnerships will have to revise their K-1 calculations and might wish to inform recipients of profits interests about the new rules. Guidance will be needed on whether the exemption for income attributable to assets not held for portfolio investment is self-executing or will require the issuance of regulations, and on whether a "colleague" includes a management company through which an individual provides his services. Guidance also will be useful to confirm that, in the case of a transfer to a related person, the three-year holding period relates to the partnership interest itself.

Provisions affecting tax-exempt employers

Excise tax on certain executive compensation paid by tax-exempts (Section 13602). Effective for taxable years beginning after December 31, 2017, the TCJA adds a new section 4960 to the Code, which will impose a 21% excise tax on (1) "remuneration" over US$1 million other than "excess parachute payment" and (2) "excess parachute payments" that are paid for a taxable year by an "eligible tax-exempt organization" with respect to its employment of a "covered employee." The excise tax is imposed on the tax-exempt organization, not the employee.

An "eligible tax-exempt organization" is an organization that is exempt from tax under section 501(c) (tax-exempt organizations) or (d) (religious or apostolic organizations) or section 401(a) (tax-qualified plans), a farmers' co-op described in section 521(b)(1), an entity with income that is exempt from tax under section 115(1), or a political organization described in section 527(e)(1). A "covered employee" is an employee or former employee who is one of the five highest compensated employees of the organization for the taxable year, or was such a "covered employee" of the organization or a predecessor for any taxable year beginning after December 31, 2016.

"Remuneration" for purposes of the excise tax on amounts over US$1 million means "wages" subject to income tax withholding, other than Roth contributions. Section 4960 specifically states that "remuneration" includes amounts required to be included in gross income under section 457(f) (even if they are not wages), and that

remuneration is "paid" when there is no substantial risk of forfeiture within the meaning of section 457(f). Therefore, nonqualified deferred compensation described in section 457(f) generally is taken into account when it vests, even if it was earned over several years.

Remuneration that is paid by a person or governmental entity that is "related" to a tax-exempt organization is included in determining the total amount of remuneration for purposes of the excise tax on amounts over US$1 million. (The same rule probably applies to any excess parachute payment.) A person or governmental entity generally is "related" to the tax-exempt if it "(i) controls, or is controlled by, the tax-exempt, (ii) is controlled by one or more persons which control the tax-exempt, (iii) is a supported organization (as defined in section 509(f)(3)) during the taxable year with respect to the tax-exempt, or (iv) is a supporting organization described in section 509(a)(3) during the taxable year with respect to the tax-exempt." If remuneration is paid by related persons or entities, liability for the excise tax will be allocated pro rata among them and the tax-exempt in proportion to the remuneration each pays.

On the other hand, the excise tax does not apply to remuneration over US$1 million (or any excess parachute payment) paid to a licensed medical professional for medical or veterinary services.

An "excess parachute payment" is similar to an excess parachute payment under section 280G, which applies primarily to for-profit businesses, except that it is contingent on a "separation from service" by the covered employee rather than – as under section 280G – a change of control or sale of a substantial portion of the assets of the employer. Specifically, a "parachute payment" under the new provision means a "payment in the nature of compensation" for the benefit of a covered employee that is "contingent on [the] employee's separation from employment with the employer" (i.e., severance pay and the like). As under section 280G, the excise tax applies only if total parachute payments equal or exceed three times the employee's "base amount," which generally means average annual taxable compensation for the preceding five years. As under section 280G, if the excise tax is determined to apply, it applies to the portion of the payments that exceeds one times the employee's base amount, which is called the "excess parachute payment."

Guidance will be needed to explain many aspects of section 4960, including (1) whether all remuneration is subject to the US$1 million cap when it vests, or only remuneration subject to section 457(f), and in that case how payments to church employees will be treated as they are not subject to section 457, (2) when a "separation from employment" occurs, (3) whether a payment is "contingent" on separation from employment if the mere timing of the payment, and not the employee's right to the payment, is contingent on separation from employment, and in that case how the value of any acceleration of the timing of payment is measured, (4) the scope of the term "predecessor," which is potentially quite broad, (5) whether the principles of section 1.414(c)-5 of the Treasury Regulations should be applied to determine when "control" exists with respect to a related entity, (6) whether states and their political subdivisions, and entities that are integral parts of them (including many public universities), are subject to the provision even if they rely as many do on implied statutory immunity rather than section 115 for their tax exemption, (7) whether the top five employees are identified on an individual employer or controlled-group basis, and whether, in identifying them, compensation excludes the remuneration for medical or veterinary services that is excluded when determining excess parachute payments and amounts over US$1 million, (8) how to determine what portion of the payments to a medical professional are for medical or veterinary services (e.g., in the common situation of a doctor who also serves as the administrator of a hospital), and (9) whether the limits will have any effect on what is considered reasonable compensation for purposes of the intermediate sanctions provisions in section 4958. The "taxable years" beginning after December 31, 2017, that are referred to in the effective date appear to mean the tax years used for Form 990 purposes, but confirmation of that would be helpful, as well.

Treasury is directed to issue "such regulations as may be necessary to prevent avoidance of the tax under this section, including regulations to prevent avoidance of such tax through the performance of services other than as an employee or by providing compensation through a pass-through or other entity to avoid such tax."

Tax-exempt employers will need to revise their deferred compensation and severance policies to the extent possible to take this tax into account. Compensation that averages less than US$1 million per year but spikes or vests in particular years might be able to be spread out, and compensation that is contingent on separation from employment might be able to be paid or vest while the employee is still an active employee.

Higher limits on length of service awards for public safety volunteers (Section 13612). Under prior law, a length of service award given to a volunteer who provides firefighting and prevention, emergency medical, and ambulance services was not considered deferred compensation under section 457 as long as the aggregate amount accruing for each year of service did not exceed US$3,000. The TCJA doubles the limit to US$6,000 and adds a cost-of-living adjustment, effective beginning in 2018. The TCJA also clarifies that for awards made pursuant to a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service.

Tax-exempt employers may wish to revise their length-of-service award programs to take advantage of this change.

UBIT on certain fringe benefits provided by tax exempt entities (Section 13703). As noted above, qualified transportation fringes such as van pools, transit passes and parking on or near the business premises of the employer can be provided tax-free, subject to certain limits, but effective beginning in 2018 the TCJA generally prohibits taxable employers from deducting the cost of those benefits, as well as the cost of certain other commuting benefits.

Effective beginning in 2018, the TCJA attempts to create a similar rule for tax-exempt organizations by increasing the amount of the organization's unrelated business taxable income (UBTI) by any amount "paid or incurred" for (1) qualified transportation fringes, (2) a parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or (3) any on-premises athletic facility (as defined in section 132(j)(4)(B)), but in each case only to the extent it is not deductible by reason of section 274 (limits on deductions for meals, entertainment and certain other expenses). The provision does not apply if the amount is "directly connected" with an unrelated trade or business regularly carried on by the organization, presumably because section 274 applies directly in that case.

Guidance will be needed on the scope of the provision. Some tax-exempt organizations read the rule on qualified transportation fringes to apply only to direct payments or reimbursements provided to employees, and not to benefits such as parking that are provided in kind. The rules on parking and athletic facilities might have limited effect, as well: while the House version of the TCJA would have amended section 274 specifically to disallow deductions for these expenses, the TCJA followed the Senate amendment, which did not. While deductions for some of these expenses might be disallowed under existing section 274, most appear not to be. If the new provision is interpreted to apply to such a facility, it might be possible and helpful to treat it as a separate unrelated trade or business.

Tax-exempt organizations might wish to discuss the impact of these rules with their tax advisors and those who prepare their Form 990. For many tax-exempt organizations, the new provision is likely to be the only reason that they are required to file Form 990-T (the UBIT tax return). New York City, Washington, D.C., San Francisco and many other jurisdictions in the Bay Area require certain employers to offer transportation benefits to their employees, and therefore those employers might be unable to avoid the tax on these benefits.

<u>**Provisions affecting employees and other service providers**</u>

Temporary reduction in medical expense deduction floor (Section 11027). Under prior law, individuals could deduct unreimbursed medical expenses only to the extent that they exceeded 10% of their adjusted gross incomes. Before 2017, the 10% threshold was reduced to 7.5% for individuals age 65 or older.

Effective for tax years 2017-2018, the TCJA reduces to threshold to 7.5% for all individuals, both for regular income tax and for AMT purposes.

Employers might wish to alert employees to this change and to take it into account in deciding whether to purchase insurance or contribute to an FSA.

2016 disaster area tax relief (Section 11028). The TCJA expands the tax relief for distributions from retirement plans and IRAs that were taken in 2016 and 2017 by certain individuals who lived in presidentially declared disaster areas during 2016 and sustained economic losses as a result of the disasters. The IRS provided similar relief in Announcement 2016-39 and elsewhere, but the relief was more limited.

For such "qualified 2016 disaster distributions," the TCJA provides (1) an exception to the 10% early distribution penalty under section 72(t), (2) an exemption from mandatory 20% withholding, (3) the ability to include the income ratably over three years, and (4) the ability to make repayments or rollovers (to the extent that a plan or IRA accepts rollovers) within three years. Qualified plans also appear to be protected from disqualification for distributions that were not otherwise permitted, and employers appear to be allowed to be allowed to adopt amendments retroactively permitting the distributions on or before the last day of the first plan year beginning in 2018 (or 2020 for governmental plans).

This special tax treatment is limited to distributions of US$100,000 or less; there is no guidance on distributions that exceeded US$100,000. The language of the effective date might also limit the scope of the provision. Nevertheless, employers might wish to inform individuals who took "qualified 2016 disaster distributions" about the possible availability of additional tax relief, and employers that made the distributions might wish to adopt amendments specifically permitting them before the deadlines set forth in the provision if they have not done so already.

Elimination of miscellaneous itemized deductions (Section 11045). Under prior law, an individual could deduct expenses for the production or collection of income and unreimbursed expenses attributable to the trade or business of being an employee, but only to the extent they exceeded 2% of the individual's adjusted gross income. Such "miscellaneous itemized deductions" included deductions by employees for home office expenses, job search expenses and legal fees related to the employee's job. They also included repayments to an employer or employer plan of income received under a "claim of right," unless the special rule in section 1341 applied. The Joint Explanatory Statement implies that section 1341 applies whenever the amount of the repayment exceeds US$3,000, although that is not consistent with the IRS's historically narrow interpretation of section 1341.

Effective for tax years 2018-2025, the TCJA completely disallows deductions for any miscellaneous itemized expenses.

Employers might wish to warn employees about these changes and take them into account in determining, for example, how to correct excess wage payments and enforce clawbacks. The suspension might create an incentive for individuals currently working as employees to convert to independent contractors, S corporation owners or partners, because of their greater ability to deduct business expenses. The rule does not appear to affect employer

reimbursements of business expenses otherwise subject to the 2% floor, which are exempt from tax under section 62(a)(2) (for accountable plans) or 132(d) (for working condition fringes) notwithstanding the floor, but guidance confirming that would be useful.

Elimination of exclusion for qualified bicycle commuting reimbursement (Section 11047). Effective for tax years 2018-2025, the TCJA repeals the exclusion for qualified bicycle commuting reimbursements.

Employers might wish to reconsider providing this benefit, or simply provide it as additional cash, given the lack of a tax preference.

Elimination of exclusion for qualified moving expenses (Section 11048). Effective for tax years 2018-2025, the TCJA repeals the exclusion for qualified moving expense reimbursements, except for members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station (or their spouses or dependents). It also repeals the individual deduction for moving expenses for the same period.

Employers might wish to reconsider providing this benefit, or simply provide it as additional cash, given the lack of a tax preference.

Elimination of shared responsibility penalty for individuals (Section 11081). In perhaps its most politically charged change, the TCJA reduces to zero the shared responsibility payment required under the Affordable Care Act (ACA) for taxpayers without minimum essential health coverage, effectively repealing the individual mandate under the ACA. The change is effective beginning in 2019.

Employers may wish to consider informing employees of this change. The change does not relieve “applicable large employers” from their own obligation under the ACA to make health insurance available to 95% of their “full-time employees.” However, technical questions have been raised about the IRS’s legal right to collect penalties related to that obligation.

Prohibition of Roth recharacterizations (Section 13611). An individual may contribute directly to a Roth IRA, or may contribute to it via a Roth IRA conversion. A Roth IRA conversion involves converting an existing traditional IRA SEP or SIMPLE to a Roth IRA (which is treated as a rollover to the Roth IRA), or rolling a distribution from an eligible retirement plan, such as a section 401(k) or 403(b) plan, over to a Roth IRA. Under prior law, if the individual made a direct contribution or a conversion contribution to a Roth IRA for one year, but later changed his or her mind, the contribution or conversion could be reversed, i.e., treated as a contribution to a traditional IRA for that year, as long as that was done by the due date (including extensions) for the individual’s tax return for the year (normally October 15 of the following year).

The TCJA prohibits the recharacterization of Roth IRA conversion contributions, effective beginning in 2018. The change will have no effect on the recharacterization of direct contributions. In addition, the IRS has issued Qs & As stating that the new rule will not apply to a Roth IRA conversion made in 2017 if the recharacterization is made by October 15, 2018.

This change removes a valuable tax-planning tool previously available to taxpayers and may result in fewer Roth IRA conversions.

Extended deadline for loan repayments (Section 13613). Loans from retirement plans generally become due and payable upon a plan’s termination or the participant’s termination of employment. If a loan is not repaid

in such circumstances, the plan is permitted to offset the loan against the participant's account balance.

Under prior law, the loan offset amount, which is treated as a distribution from the plan, had to be rolled over to an IRA or another qualified plan within 60 days of the offset in order to avoid treatment as a taxable distribution. Beginning in 2018, the TCJA extends the period to rollover the offset amount to the due date (including extensions) for the individual's tax return for the year of the offset, if the offset occurs because of the termination of the plan or the employee's failure to meet the repayment terms of the loan because of his severance from employment (e.g., the loan program requires installments to be able to be withheld from the employee's wages).

This change offers additional tax relief to individuals who have outstanding plan loans at the time of a plan termination or the individual's termination of employment.

2. Continuing resolution

On January 23, 2018, President Trump signed H.R. 195 (the Continuing Resolution) into law as Pub. L. No. 115-120. The Continuing Resolution authorized an extension of the appropriations necessary to run the government, but also contains several other substantive provisions, which are described below.

Cadillac tax delay (Section 4002). The Continuing Resolution amends section 9001 of the ACA to delay the effective date of the "Cadillac tax" imposed by section 4980I of the Code for an additional two years, to years beginning after December 31, 2021. The "Cadillac tax" is a nondeductible 40% excise tax imposed on health insurance issuers (and, in the case of self-insured plans, plan administrators) on the amount by which the cost of health coverage exceeds US$10,200 (in the case of individual coverage) or US$27,500 (in the case of family coverage). The Consolidated Appropriations Act, 2016, already delayed the effective date originally set in the ACA to years beginning after December 31, 2019.

Insurance provider fee suspension (Section 4003). The Continuing Resolution amends section 9010 of the ACA to suspend the health insurance provider fee imposed by that section in 2019. Section 9010 imposes a fee on each covered entity engaged in the business of providing health insurance for United States health risks. The Consolidated Appropriations Act, 2016, already suspended the fee in 2017.

3. Bipartisan Budget Act of 2018

On February 9, 2018, President Trump signed H.R. 1892 (the Budget Act) into law as Pub. L. No. 115-123. The Budget Act contains a number of significant provisions affecting employee benefit plans.

2017 California wildfire area tax relief (Section 20102). The Budget Act provides relief for individuals impacted by the 2017 California wildfires. It exempts a distribution of up to US$100,000 that is made between October 8, 2017, and January 1, 2019, to a participant who lives in a California wildfire disaster area from the 10% tax imposed by section 72(t) of the Code, and allows the distribution to be included in income ratably over a three-year period or, alternatively, recontributed to the plan and treated as an eligible rollover contribution. It also allows a withdrawal to purchase a home in a California wildfire disaster area to be recontributed to the plan and treated as an eligible rollover contribution, and increases the maximum amount of a plan loan for a participant who lives in such an area to US$100,000 and allows loan repayments to be delayed for a one-year period.

Creation of select committee on multiemployer plans (Sections 30421-24). The Budget Act creates a bi-partisan joint select committee to address solvency issues for multiemployer plans and the PBGC, requires it to provide legislative language by November 30, 2018, and provides special streamlined procedures for

approving that legislation. The committee is chaired by Sens. Sherrod Brown (D-Ohio) and Orrin Hatch (R-Utah), and met for the first time on March 14.

Relief for improper IRS levies (Section 41104). The Budget Act allows an amount paid from a retirement plan under an improper levy by the IRS in tax years beginning after December 31, 2017, to be recontributed to the plan and treated as an eligible rollover contribution. Plans are not required to be amended to allow such recontributions.

Relief for hardship distributions (Sections 41113-14). The Budget Act directs the IRS to eliminate, by February 9, 2019, the regulations (1) requiring a participant who receives a hardship withdrawal to be suspended from making elective contributions for six months under certain circumstances (2) requiring a participant who receives a hardship withdrawal to obtain any loans available under the plan first under certain circumstances, and (3) limiting the amounts available for hardship distributions to include elective deferrals (plus earnings) to profit sharing or stock bonus plans, qualified matching contributions (plus earnings) and qualified nonelective contributions (plus earnings). Plans are not required to be amended to adopt these changes.

Next steps

Employers should consider whether any modifications to their benefit arrangements or business practices are required or desired as a result of the TCJA's or the other laws' modifications to the rules governing employee benefits. Employers should also consider whether any amendments to plan documents or policies are desirable or needed to reflect the new rules, and whether any employee communications are advisable given these changes.

This Employee Benefits Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or the lawyers listed on this update.

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