An employer's guide to the Tax Cuts and Jobs Act

June 1, 2018

Building a better working world

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An employer's guide to the Tax Cuts and Jobs Act of 2017

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act of 2017 (TCJA). The TCJA represents the Republican Party's plan for tax reform and is the most significant tax overhaul in more than 30 years. (***P.L. 115-97***.)

Although the impact of the law on employers is far less than was proposed by the House, the compliance effort will nonetheless be substantial, particularly as it relates to the state and local implications.

As with any substantial legislation, there are areas of uncertainty that will require resolution through IRS regulations and other guidance. We can also expect future technical corrections to address inadvertent errors or unintended consequences. Realistically, the process for analyzing the law and coordinating regulations across various IRS departments could stretch well into 2018. In the meantime, businesses will need to identify provisions where clarity is needed, acting prudently in the absence of IRS guidance.

Here we provide an analysis of the TCJA's employer provisions with a focus on actions that employers need to take now and areas where IRS guidance will be needed. A summary chart of employer considerations begins on page 29.

This guide will be updated periodically to reflect IRS guidance as it becomes available.

Affordable Care Act: repeal of the individual mandate

Current law

IRC §5000A imposes an excise tax on individuals (referred to as the "individual responsibility payment" or "individual mandate") who do not maintain health insurance for themselves and their family members, unless a specific exception applies. Premium tax credits under IRC §36B are available to individuals below certain income thresholds who do not have access to employer-provided or government coverage and who purchase their coverage through a state or federal exchange (also referred to as "marketplace" coverage).

Changes under the TCJA

Effective January 1, 2019, the amount of the individual responsibility payment is reduced to zero. This provision does not undo any other provision of the Affordable Care Act (ACA) or its cousin, the Health Care and Education Reconciliation Act. Therefore, the 3.8% net investment income tax and the 0.9% Additional Medicare Tax, remain intact. Also unaffected are the current reporting requirements that apply to employers and insurers. (*TCJA §11081*.)

- **ACA reporting for tax year 2017.** The IRS issued Notice 2018-06 again providing an automatic extension of the due dates to comply with the ACA reporting requirements for tax year 2017. The due date to furnish individuals the 2017 Form 1095-B, *Health Coverage*, and the 2017 Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage*, was extended for 30 days from January 31, 2018, to March 2, 2018. Like the automatic extension granted for the 2016 information returns, the IRS did not entertain any requests for further extensions of this new, blanket deadline.

  Like for tax year 2016, the due date to file with the IRS the 2017 Form 1094-B, *Transmittal of Health Coverage Information Returns*, and the 2017 Form 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns*, was not extended. Those dates remained February 28, 2018, for those filing less than 250 forms on paper and April 2, 2018 (the Monday following the statutory March 31 deadline), for those filing electronically. However, filers could request an automatic 30-day extension to those filing deadlines.

  In addition, the IRS has stated that penalties would not be imposed on health insurers and employers that make a good faith effort to comply with the reporting requirements, provided statements were furnished to individuals and filings were made with the IRS on a timely basis.

The IRS again acknowledged that some taxpayers may not have their forms when they are ready to file their individual tax returns. The IRS stated taxpayers could rely on "other information" for determining eligibility for premium tax credits under IRC §36B and confirming that they had minimum essential coverage for purposes of the individual mandate of IRC §5000A (which was effectively repealed, but not until 2019). Taxpayers do not need to wait to receive these forms before filing.

Federal income tax withholding, supplemental wages and backup tax

Current law

Under IRC §3402, employers are required to withhold federal income tax from the wages they pay their employees using the tables and methods provided by the IRS and Form W-4 provided by employees. Reg. §31.3402 contains the IRS regulations governing the income tax withholding requirements. For each tax year, the IRS updates Publication 15 containing the income tax withholding tables and percentage method based on the inflation adjustments to the individual tax brackets in IRC §1 and the applicable allowances and exemptions in IRC §151. The IRS also publishes Form W-4 for each tax year reflecting the applicable inflation adjustments.

- **Supplemental withholding.** Provided that income tax was withheld from the regular wages of the employee in the current or preceding tax year and supplemental wages are separately identified and do not exceed $1 million, employers may optionally use a flat rate of income tax withholding on supplemental wages.

  Under IRC §1(i)(2), the optional flat tax rate for 2017 is tied to the third tax bracket, which for 2017 was 25%. (*IRS Reg. §31.3402(g)-1(a)(7)(iii)(F)*.)

  If the employee's year-to-date supplemental wages exceed $1 million, employers are required to withhold at the highest rate bracket under IRC §1, which for 2017 was 39.6%. (*IRS Reg. §31.3402(g)-1(a)(2)*.)

- **Backup withholding.** Businesses are also required under IRC §3406 to withhold backup tax from nonwage payments under certain conditions (e.g., when payees fail to provide their taxpayer identification number). The backup withholding rate is tied to the fourth tax bracket, which for 2017 was 28%. (*IRC §3406(a)(1)(D)*.)

- **US nonresident aliens.** Special income tax withholding and Form W-4 instructions apply to US nonresident aliens. (See *IRS Notice 1392*.) Instructions for income tax withholding on wages paid to US nonresident employees are contained in Publication 15.

Changes under the TCJA

Effective January 1, 2018, and through December 31, 2025, the current seven individual income tax rates of 10%, 15%, 25%, 28%, 33%, 35% and 39.6% are changed to 10%, 12%, 22%, 24%, 32%, 35% and 37%. (*TCJA §11001*.)

See Fig. 1 for a comparison of the individual income tax rates between 2017 and 2018.

Fig. 1:
Change in individual income tax rates: 2017 compared to 2018

	2017 individual income tax rates	2018 individual income tax rates
1	10%	10%
2	15%	12%
3	25%	22%
4	28%	24%
5	33%	32%
6	35%	35%
7	39.6%	37%

Also effective January 1, 2018, and through December 31, 2025, the personal exemption deduction is suspended; however, the law provides that the IRS may administer the income tax withholding rules under IRC §3402 without regard to this provision for tax years beginning before January 1, 2019. Whether the wage withholding rules pursuant to the personal exemption remain unchanged for 2018 is at the discretion of Treasury and the IRS. (*TCJA §11041*.)

On January 11, 2018, the IRS issued Notice 1036 containing the much-anticipated 2018 percentage method tables for income tax withholding incorporating some of the changes contained in the Tax Cuts and Jobs Act of 2017 (TCJA). Employers were asked to implement the new withholding methods as soon as possible, but no later than February 15, 2018. Employers were instructed to use the 2017 withholding tables and methods until these tables are implemented. (The tables used for 2018 start on page 4.)

- **Supplemental withholding.** If the employee's year-to-date supplemental wages exceed $1 million, employers are required to withhold at the highest rate bracket, which effective January 1, 2018, through December 31, 2025, is 37%. (See Fig. 1.)

  Employers may optionally use a flat income tax withholding rate of 22% (down from 25%) on supplemental wages of up to $1 million provided income tax was withheld from regular wages in the current or previous year and supplemental wages are separately identified. Technically, the TCJA called for a rate of 28%; however, the IRS has determined it will refer to the third tax bracket for this rate, as it has done in prior years. (See Fig. 1.)

- **Backup withholding.** The backup withholding rate is tied to the fourth tax bracket, which effective January 1, 2018, through December 31, 2025, is 24%. (See Fig. 1.)

- **US nonresident aliens.** The IRS has updated the amounts that are added back to the wages of nonresident aliens for purposes of computing federal income tax withholding. (See page 5.) The IRS will need to update IRS Notice 1392 to reflect the changes under the TCJA (e.g., suspension of personal allowances for years 2018 through 2025).

- **Form W-4.** The IRS explains that it has designed the income tax withholding tables to work with the employee's current Form W-4. Therefore, although the deduction for personal allowances and itemized deductions subject to the 2% floor are suspended for tax years 2018 through 2025, the 2018 income tax withholding tables continue to provide for personal allowances with values higher than they were in 2017. The IRS states in IR-2018-36 that there is no mandatory requirement at this time that all employees furnish a new Form W-4.

  In late February 2018, the IRS published the 2018 Form W-4 that employees were required to begin using effective on and after March 30, 2018. Employees who used the 2017 Form W-4 through March 29, 2018 for making changes in their 2018 income tax withholding are not required to resubmit those changes using the 2018 Form W-4.

  For tax year 2018, the IRS warns that some employees with more complex tax situations could face the possibility of being under-withheld. For example, employees who itemize their deductions, couples with multiple jobs or individuals with more than one job a year are encouraged to review their tax situations and determine if an adjustment to their Form W-4 is necessary. The IRS encourages workers, particularly those with more than one income in their household, to check their 2018 withholding. In tandem with the publication of the 2018 Form W-4, the IRS made a new withholding calculator available on its website.

Continued

Federal income tax withholding tables: 2017 and 2018

Personal allowances

The following is a reprint of the personal allowance values to be used in connection with the annual percentage method of withholding.

2017	
Payroll period	One withholding allowance
Daily or miscellaneous	$ 15.60
Weekly	$ 77.90
Biweekly	$ 155.80
Semimonthly	$ 168.80
Monthly	$ 337.50
Quarterly	$ 1,012.50
Semiannually	$ 2,025.00
Annually	$ 4,050.00

2018	
Payroll period	One withholding allowance
Daily or miscellaneous	$ 16.00
Weekly	$ 79.80
Biweekly	$ 159.60
Semimonthly	$ 172.90
Monthly	$ 345.80
Quarterly	$ 1,037.50
Semiannually	$ 2,075.00
Annually	$ 4,150.00

Annual percentage method

Table 7 — Annual payroll period — 2017
(For wages paid January 1, 2018, through February 14, 2018)

(a) Single person (including head of household)

If the amount of wages (after subtracting withholding allowances) is:		The amount of income tax to withhold is:	
Not over $2,300		$-0-	
Over	But not over		Of excess over
$ 2,300	$ 11,625	$ 000.00 + 10.0%	$ 2,300
$ 11,625	$ 40,250	$ 932.50 + 15.0%	$ 11,625
$ 40,250	$ 94,200	$ 5,226.25 + 25.0%	$ 40,250
$ 94,200	$ 193,950	$ 18,713.75 + 28.0%	$ 94,200
$ 193,950	$ 419,000	$ 46,643.75 + 33.0%	$ 193,950
$ 419,000	$ 420,700	$120,910.25 + 35.0%	$ 419,000
$ 420,700	And over	$121,505.25 + 39.6%	$ 420,700

(b) Married person

If the amount of wages (after subtracting withholding allowances) is:		The amount of income tax to withhold is:	
Not over $8,650		$-0-	
Over	But not over		Of excess over
$ 8,650	$ 27,300	$ 000.00 + 10.0%	$ 8,650
$ 27,300	$ 84,550	$ 1,865.00 + 15.0%	$ 27,300
$ 84,550	$ 161,750	$ 10,452.50 + 25.0%	$ 84,550
$ 161,750	$ 242,000	$ 29,752.50 + 28.0%	$ 161,750
$ 242,000	$ 425,350	$ 52,222.50 + 33.0%	$ 242,000
$ 425,350	$ 479,350	$112,728.00 + 35.0%	$ 425,350
$ 479,350		$131,628.00 + 39.6%	$ 479,350

Table 7— Annual payroll period – 2018
(For wages paid February 15, 2018, through December 31, 2018)

(a) Single person (including head of household)

If the amount of wages (after subtracting withholding allowances) is:		The amount of income tax to withhold is:	
Not over $3,700		$-0-	
Over	But not over		Of excess over
$ 3,700	$ 13,225	$ 000.00 + 10.0%	$3,700
$ 13,225	$ 42,400	$ 952.50 + 12.0%	$13,225
$ 42,400	$ 86,200	$ 4,453.50 + 22.0%	$42,400
$ 86,200	$ 161,200	$ 14,089.50 + 24.0%	$86,200
$ 161,200	$ 203,700	$ 32,089.50 + 32.0%	$161,200
$ 203,700	$ 503,700	$ 45,689.50 + 35.0%	$203,700
$ 503,700	And over	$150,689.50 + 37.0%	$503,700

(b) Married person

If the amount of wages (after subtracting withholding allowances) is:		The amount of income tax to withhold is:	
Not over $11,550		$-0-	
Over	But not over		Of excess over
$ 11,550	$ 30,600	$ 000.00 + 10.0%	$ 11,550
$ 30,600	$ 88,950	$ 1,905.00 + 12.0%	$ 30,600
$ 88,950	$ 176,550	$ 8,907.00 + 22.0%	$ 88,950
$176,550	$326,550	$ 28,179.00 + 24.0%	$176,550
$326,550	$411,550	$ 64,179.00 + 32.0%	$326,550
$411,550	$611,550	$ 91,379.00 + 35.0%	$411,550
$611,550		$161,379.00 + 37.0%	$611,550

Nonresident alien employees

Add these amounts to employee's wages for calculating income tax withholding. (Nonresident alien students and business apprentices from India aren't subject to this procedure.)

2017	
Payroll period	Add additional
Daily or miscellaneous	$ 8.80
Weekly	$ 44.20
Biweekly	$ 88.50
Semimonthly	$ 95.80
Monthly	$ 191.70
Quarterly	$ 575.00
Semiannually	$ 1,150.00
Annually	$ 2,300.00

2018	
Payroll period	Add additional
Daily or miscellaneous	$ 30.20
Weekly	$ 151.00
Biweekly	$ 301.90
Semimonthly	$ 327.10
Monthly	$ 654.20
Quarterly	$ 1,962.50
Semiannually	$ 3,925.00
Annually	$ 7,850.00

Action steps: income tax withholding

- **Income tax withholding on regular wages, including those paid to US nonresident aliens.** Employers were required to implement the 2018 income tax tables as contained in Notice 1036 no later than February 15, 2018.
- **Supplemental wages.** No later than February 15, 2018, employers are required to use the optional rate of 22% for supplemental wages of up to $1 million and the mandatory rate of 37% for supplemental wages of more than $1 million.
- **Backup withholding.** For nonwage payments paid on and after January 1, 2018, and through December 31, 2025, a backup withholding rate of 24% applies.
- **Forms W-4.** Employees are not required to submit a revised Form W-4 at this time solely due to the TCJA; however, the IRS encourages employees to review their 2018 income tax withholding. For tax year 2019, the IRS plans to issue a Form W-4 that more closely reflects the changes under the TCJA. Employers can expect added administrative burden this year and next as the IRS gradually phases in the changes to the Form W-4 and the income tax withholding calculations.
- **Employee communications.** Many employees are likely anticipating a reduction in their federal income tax withholding in 2018 and may also have questions about when and how to change their Forms W-4. For these reasons, employers should consider employee communications that explain their need to check their withholding in light of the changes under the TCJA. See the IRS frequency asked questions here. For an explanation of the individual income tax changes under the TCJA, consider sharing Ernst & Young LLP's tax alert with employee.

Federal tax levies (suspension of personal exemption)

Current law

When the IRS takes action to levy an employee's wages, the employer is sent Form 668-W(ICS) or Form 668-W(C)DO, *Notice of Levy on Wages, Salary, and Other Income* (or other levy form). Contained in the Form 668 levy form is a statement of exemptions and filing status to be completed by the employee. Using this statement of filing status and personal exemptions provided by the employee, the employer computes the portion of wages exempt from levy using Publication 1494, *Tables for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income (Forms 668-W(ACS), 668-W(c)(DO) and 668-W(ICS))*.

Under IRC §6334(d)(2), the amount exempt from levy is computed as the annual value of the standard deduction plus personal allowances divided by the number of payroll periods the employee is paid. Because the value of the standard deduction and personal allowance is indexed each year for inflation, the IRS updates Publication 1494 each tax year. However, the annual inflation adjustment is not taken into account in computing the amount exempt from levy unless the employee submits another statement of filing status and personal exemptions for the new tax year. (*IRS website*; *Internal Revenue Manual, 5.11.5*.)

Example: The employer received a federal tax levy in June 2015. In the same month, the employee completed and submitted to the employer a statement of filing status and personal exemptions showing married and one personal exemption. The employee did not provide an updated statement of filing status and personal exemptions for 2016 or 2017.

The employer computes the amount exempt from levy for tax years 2015, 2016 and 2017 using the 2015 Publication 1494.

Changes under the TCJA

Because of the suspension of the personal exemption deduction effective January 1, 2018, through December 31, 2025, a conforming amendment is made to IRC §6334(d)(2) to reflect that the amount exempt from levy is computed as only the annual value of the standard deduction divided by the number of payroll periods the employee is paid.

As previously noted, the law gives the IRS until 2019 to implement the change in the personal exemption deduction. (*TCJA §11041*.)

Action steps: federal tax levies

- **2018 Publication 1494.** The IRS issued the 2018 Publication 1494 without taking into account the TCJA suspension of the personal allowances.
- **Federal tax levies received before January 1, 2018.** Because personal exemptions are not factored into the amount exempt from levy effective January 1, 2018, the IRS will need to clarify the extent that employees with active federal tax levies are required to submit a revised statement of filing status to their employers. For this purpose, the IRS would need to revise the employee statement contained in the Form 668-W to reflect only the standard deduction. IRS guidance is also needed as to the deadline for employee submission of the Form 668-W statement of filing status and the employer deadline for implementing changes in the amount exempt from levy.

  The IRS is currently evaluating what further changes will be made to Publication 1494 and the employer instructions for soliciting filing status information from employees subject to a federal tax levy. Any changes will be published in a future IRS announcement.

Bicycle commuting benefits (repeal of payroll tax exclusion)

Current law

Under IRC §132(f) and IRC §132(f)(1)(D), an exclusion from wages for federal income tax (FIT), federal income tax withholding (FITW), Social Security/Medicare (FICA) and federal unemployment insurance (FUTA) purposes applies to qualified bicycle commuting expenses of up to $20 per month during which the employee regularly uses the bicycle for a substantial portion of travel between home and work. The exclusion does not apply in the same month the employee receives other transportation fringe benefits from the employer (e.g., van pool, transit pass, parking on the employer's premises).

Changes under the TCJA

Bicycle commuting benefits under IRC 132(f) received by employees on and after January 1, 2018, and through December 31, 2025, are included in wages subject to FIT, FITW, FICA and FUTA. (TCJA §11047.)

Action steps: bicycle commuting benefits

- **Benefits provided in 2017.** Employers will need to be certain that they pay all bicycle commuting benefits owed for tax year 2017 before January 1, 2018. Keep in mind that absent IRS guidance otherwise, benefits paid on and after January 1, 2018, are included in wages subject to FIT, FITW, FICA and FUTA even if related to benefits earned in 2017.
- Benefits provided on and after January 1, 2018. Employers will need to change their tax configuration settings for earnings to reflect the inclusion of bicycle commuting benefits in wages subject to FIT, FITW, FICA and FUTA effective January 1, 2018. A corresponding change is also required for state and local income tax and withholding purposes for those states that conform to the Internal Revenue Code (IRC) as of January 1, 2018.

Eating facilities and de minimis meals (business deduction rules)

Current law

Unlike meals incurred as a travel expense where the deduction limit is 50%, IRC §274(n)(2) allows businesses a 100% deduction for de minimis meal expenses incurred under IRC §132(e).

IRC §132(e)(2) provides that the operation by an employer of any eating facility is de minimis if both of the following apply:

- The facility is located on or near the business premises of the employer
- Revenue derived from the facility normally equals or exceeds the direct operating cost of the facility

For purposes of determining if the revenue derived from the facility normally equals or exceeds its direct operating costs, an employee entitled under IRC §119 to exclude the value of a meal provided at such facility is treated as having paid an amount for such meal equal to the direct operating costs of the facility attributable to such meal.

IRC §119 provides that meals provided to employees and their spouses and dependents are excluded from gross income if provided for the convenience of the employer on or near the employer's business premises. IRC §119 also provides that all meals furnished to employees on the business premises of an employer are treated as furnished for the convenience of the employer if more than half of the meals are furnished for the convenience of the employer.

IRC §132(e)(1) provides that a de minimis benefit also includes any property or service provided to employees if the value (after taking into account the frequency with which similar fringes are provided by the employer to employees) is so small as to make accounting for it unreasonable or administratively impracticable.

In IRS Reg. §1.132-6(d)(2), the IRS includes as an exempt de minimis fringe benefit:

- Meals or meal money provided to the employee on an occasional basis.
- Meals or meal money provided to an employee because overtime work necessitates an extension of the employee's normal work schedule. This condition does not fail to be satisfied merely because the circumstances giving rise to the need for overtime work are reasonably foreseeable.
- In the case of a meal or meal money, the meal or meal money is provided to enable the employee to work overtime. Thus, for example, meals provided on the employer's premises that are consumed during the period that the employee works overtime or meal money provided for meals consumed during such period satisfy this condition.

Continued

Changes under the TCJA

Effective January 1, 2018, IRC §274(n) is modified to reflect that the business deduction for de minimis meals under IRC §132(e)(1) and meals provided for the convenience of the employer at or near the employer's business premises under IRC §132(e)(2) is limited to 50%.

Effective January 1, 2026, IRC §274(n) is further modified to reflect that no business deduction is allowed for any expense incurred for meals under IRC §119(a), any expense for the operation of an eating facility in IRC §132(e)(2) and any expense for food or beverages associated with the eating facility including under IRC §132(e)(1). (*TCJA §13304*.)

The IRS explains in Publication 15-B that food or beverage expenses related to employee recreation, such as holiday parties or annual picnics, aren't subject to this 50% deduction limit (meaning, a 100% deduction is allowed) when provided primarily for the benefit of employees other than employees who are officers, shareholders or other owners who own a 10% or greater interest in the employer's business, or other highly compensated employees. (*Publication 15-B, page 17*.).

Note that there is no change in the federal payroll tax treatment of eating facilities and de minimis meals.

Action steps: eating facilities and de minimis meals

- **Eating facilities.** In light of the reduction in the business deduction to 50% for expenses incurred through December 31, 2025, and the total loss of the business deduction effective January 1, 2026, employers will need to consider if there will be any change in policy concerning free meals provided to employees for the employer's convenience and in the operation of their on-premises eating facilities in general.

  IRS guidance will be necessary to understand how the business deduction is computed when revenues from the on-premises eating facility meet or exceed its actual operating costs.

- **Supper money and overtime meals.** IRS guidance will be necessary to fully understand the implications of the TCJA on other de minimis meals such as overtime meals and supper money.

Employee achievement awards (clarification)

Current law

IRC §74(c) and IRC §274(j) provide an exclusion from wages for FIT, FITW, FICA and FUTA for employer-provided length-of-service and safety achievement awards. The exclusion is limited to $400 per employee per year if there is no qualified plan, and up to $1,600 under a qualified plan with the average not exceeding $400 per employee. Other limitations apply. For instance, a length-of-service award is excluded from taxable wages only once every five years.

IRC §274(j)(3)(A) stipulates that the award must be an item of personal tangible property (for example, a watch, ring or other item of merchandise). The IRS explains that the exclusion does not apply to items of intangible personal property including awards of cash, cash equivalents (e.g., gift cards), gift certificates, or other intangible property such as vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, and other securities. (*Publication 15-B*, *p. 7*.)

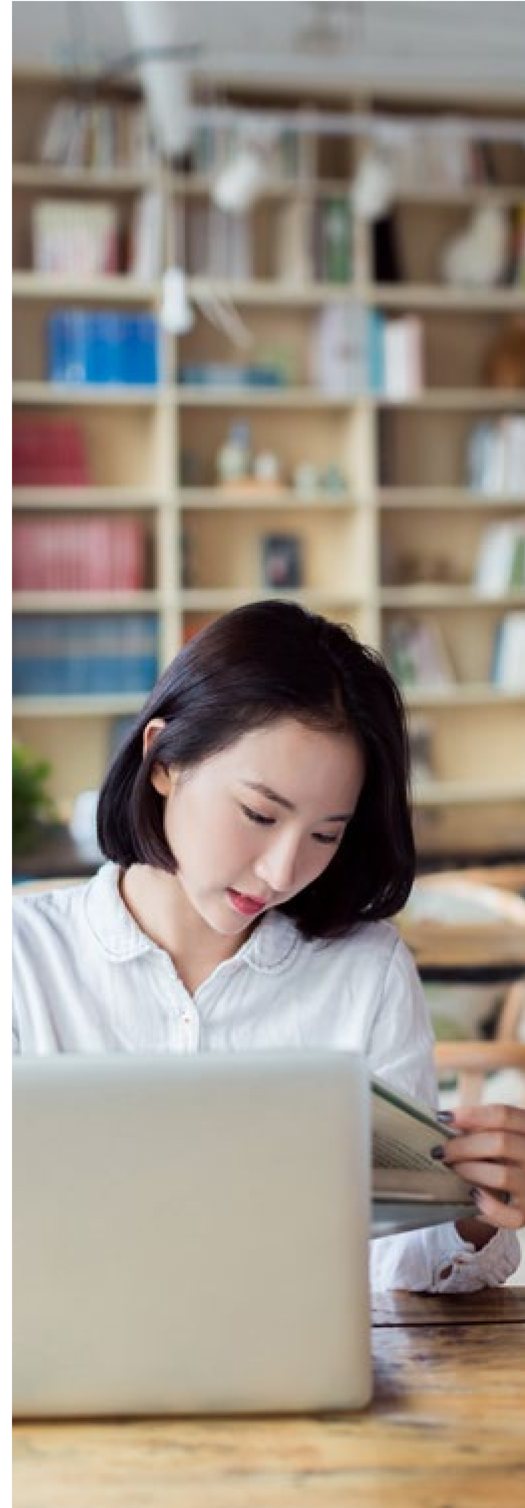
Changes under the TCJA

Effective January 1, 2018, IRC §274(j)(3) is amended to clarify that qualified employee achievement awards do 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-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items.

It is important to note that within the Conference Agreement it states that no inference is intended that this is a change from present law and guidance. In fact, in Publication 15-B (p. 7) (rev. 2017) the IRS already makes these stipulations. (*TCJA §13310*.)

Action steps: employee achievement awards

- **Review length-of-service and safety achievement policies.** If you are currently providing items of intangible personal property (e.g., gift cards, vacations, gift certificates), determine if you will continue to allow them going forward.
- **Prior-year adjustments.** If you have, for years prior to 2018, been giving employees items other than tangible personal property and you have not included them in federal taxable wages, consider if you will protect yourself from future IRS audit assessments by disclosing the taxable wages and paying the tax owed using Form 941-X and issuing/filing Form W-2c. Consider also state and local voluntary disclosures.
- **Communications.** Consider communicating your policy of allowing only items of tangible personal property for length-of-service and safety awards to all managers and supervisors to prevent inadvertent taxable awards.



Equity compensation-stock and RSU (election to defer income tax)

Current law

Under IRC §83, the value of property transferred in connection with the performance of services in excess of the amount paid for the property is included in the employee's gross income when the property is no longer subject to a substantial risk of forfeiture. This rule applies to the transfer of stock of a publicly held corporation or a privately held corporation.

For stock option awards, the employee includes in gross income the value of the vested transferred shares determined on the option exercise date over the amount paid as the exercise price.

For restricted stock units (RSUs), the employee includes in gross income the value of the shares that are transferred upon settlement of RSUs following vesting.

Employees of private companies that receive stock option and RSU awards often have taxable income when the stock option is exercised or the RSU is settled. Some, but not all, private employers permit employees to sell back to the company a number of shares sufficient to pay the withholding taxes owed. If the employer does not offer this liquidity option, the employee may have taxable income but no cash to pay the withholding taxes.

Changes under the TCJA

Effective January 1, 2018, the TCJA adds to IRC §83 a new subsection (i), creating a federal income tax deferral election for eligible employees who receive private company stock options and RSU awards (qualified stock). If the eligible employee elects to defer the federal income tax of the stock option exercise or receipt of the shares in settlement of an RSU, the employer is not entitled to a business deduction until the tax year that the employee pays the federal income tax.

An eligible employee has 30 days from the date that vested qualified stock is transferred to make an election not to recognize income at that time. If this election is made, the amount that is included in federal taxable income when the vested stock was transferred is locked in.

The recognition of this federal taxable income is deferred to the earliest of five years following the date that the vested shares were transferred and a liquidity date (i.e., when the stock becomes transferable or becomes publicly traded). The amount is also included in the employee's federal taxable income as of the date that the employee becomes an excluded employee, as described later, or the date that the employee revokes the election.

This election is not available if the employee has previously made an IRC §83(b) election with respect to the stock or if the corporation in the prior year bought back certain stock subject to an IRC §83(i) election (certain broad-based buybacks are excepted).

Qualified stock is granted only by a corporation that has never been publicly held (including predecessor corporations and determined on a controlled-group basis). To grant qualified stock eligible for this inclusion deferral election, 80% or more of the US employees must be granted qualified stock with the same rights and privileges in an amount that is more than de minimis.

Only stock options and RSUs awarded in connection with services are eligible for the federal income tax deferral election.

Qualified stock includes incentive stock options (ISO) or an option under an employee stock purchase plan (ESPP), but an election would disqualify the ISO or the ESPP option. Qualified stock may not include a put right or be eligible to be cashed out at vesting.

The CEO, CFO, one of the four highest-paid officers of the corporation, as well as 1% owners are not be eligible to make the federal income tax deferral election on any stock option or RSU. All other full-time employees are qualified to make the election, provided the employee agrees to comply with the income tax withholding rules (to be provided in forthcoming regulations) on the qualified stock.

At vesting, the employer must certify to a qualified employee that the stock is qualified stock, and notify the employee: (a) of the IRC §83(i) election right, (b) that the amount that will ultimately be included in federal taxable income is the value at vesting even if that value decreases, and (c) that the included amount will be subject to federal income tax withholding (to be further specified in regulations) at the time of inclusion. Upon inclusion, federal income tax withholding is computed at the maximum individual rate under IRC §1 (i.e., 37% effective January 1, 2018, through December 31, 2025). Failure to provide the employee notice subjects the employer to a penalty liability of $100 per failure, up to $50,000 per year.

The federal taxable income inclusion is treated as a noncash fringe benefit under IRC §3501(b), which allows for flexibility in the timing of federal income tax withholding.

While an election is in place, the employee's Form W-2, box 12 must reflect: (1) the amount excluded from federal income tax in the current year by reason of the IRC §83(i) election; (2) the amount included in federal taxable income in the current year by reason of the IRC §83(i) election; and (3) the aggregate amount currently deferred by the employee pursuant to all active IRC §83(i) elections.

This provision is expressly self-implementing without regulatory action and may be applied by employers using a reasonable good faith interpretation of the statute. (*TCJA §13603*.)

In Publication 15-B the IRS explains that the election under IRC §83(i) applies only for federal income tax purposes and has no effect on the application of Social Security, Medicare, and federal unemployment insurance taxes. For federal income tax purposes, the employer must withhold federal income tax at 37% in the tax year that the amount deferred is included in the employee's income. If an IRC §83(i) election is made for an option exercise, that option will not be considered an incentive stock option or an option granted pursuant to an employee stock purchase plan. These rules apply to stock attributable to options exercised, or RSUs settled, after December 31, 2017.

- **Form W-2 reporting requirements.** For each employee, report in Form W-2, box 12, code GG the amount included in income in the calendar year from qualified equity grants under IRC§83(i). Also report in Form W-2, code HH the total amount of income deferred under IRC §83(i) determined as of the close of the calendar year. (*Publication 15-B, page 12*.)

This provision is expressly self-implementing without regulatory action and may be applied by employers using a reasonable good faith interpretation of the statute. (*TCJA §13603*.)

Action steps: equity compensation

- **Educate employees.** When making this determination, take the following into account:

  Private business employers that award stock options or RSUs to a broad-based group that are interested in compensating employees with stock may find new IRC §83(i) beneficial for the eligible employees and the business. Eligible employees would be able to defer federal income tax on the value of their vested shares. The employer would not receive a deduction until the employee is subject to federal income tax on the value of the shares; however, the employer's cash flow may improve because the employer would not be obligated or permitted to buy back the shares to provide the employee with liquidity.

  Private businesses that establish a stock option or RSU program designed to be eligible for the IRC §83(i) election will need to educate their employees on the benefit of the federal income tax deferral election. If the share value increases, employees will receive capital gain treatment on any increase in the value after the exercise of the option or issuance of the RSU; if the share value declines after the exercise or RSU issuance, however, the employee would still owe tax based upon the original value on transfer.

- **Payroll system tax configuration.** Earnings codes will need to be established that reflect the new income tax deferral and the reporting requirements for Form W-2, box 12.

Entertainment expenses (business deduction rules)

Current law

IRC §274 disallows an otherwise available deduction for expenses relating to entertainment, amusement, or recreation activities and facilities unless the item is directly related to or associated with business. This generally means that the deduction is not disallowed if there was a substantial and bona fide business discussion right before or after the entertainment, amusement or recreation event. For these purposes, most leisure activities are treated as included under the umbrella of entertainment, amusement or recreation. The disallowance is subject to a number of exceptions, including food and beverages for employees furnished on the business premises; expenses treated as compensation; reimbursed expenses; nondiscriminatory recreation for employees; business meetings for employees, stockholders, agents or directors; business league meetings; items available to the public; and entertainment sold to customers.

If an entertainment expense is exempt from disallowance by virtue of one of the exceptions or because the expense was directly related to or associated with business, IRC §274(n) nevertheless generally permits deduction of only 50% of the expense. This 50% disallowance also applies to otherwise deductible expenses for meals. An entertainment or meal expense is exempt from the 50% disallowance under one of a number of exceptions, including if the expense is treated as compensation, or as previously explained, if the cost of the meal is excludable from the employee's income under IRC §132(e).

Changes under the TCJA

Effective January 1, 2018, IRC §274 is modified to disallow the business deduction for entertainment expenses, or for a facility or portion thereof used for these activities, even if directly related to, or associated with the conduct of business.

The 50% deduction limit that previously applied to meals and entertainment expenses now applies only to meal expenses. This change generally makes sense within the framework of the statutory change because the IRC §274 business deduction disallowance now comprehensively disallows entertainment expenses without regard to whether the expense relates to a trade or business.

Hence, all forms of business entertainment, including golf outings, fishing, sailing, sporting events, theater and resort events, are likely to be entirely nondeductible going forward even if substantial and bona fide business discussions were associated with the activity.

There may, however, be a subset of entertainment expenses that are exempt from the deduction disallowance of IRC §274 by virtue of one of the exceptions — such as business meetings of employees, stockholders, agents, or directors and meetings of business leagues. (*TCJA §13304*.)

Action steps: entertainment expenses

- **General ledger accounts.** It will be necessary to establish general ledger accounts that are sufficient in identifying entertainment expenses where the business deduction is disallowed, those that are subject to the 50% deduction limit, and those where a 100% deduction is allowed. For example, separate general ledger accounts are needed for (1) a theater event provided to an employee where a 100% business deduction is allowed (meeting the requirements of IRC §132), (2) a theater event for a customer where no business deduction is allowed and (3) meal expenses incurred for a business meeting or as a travel expense where a 50% deduction limit applies under IRC §162.
- **Entertainment policy.** Businesses will need to consider how the deduction disallowance for entertainment events and related facilities will alter their business expense policy as it pertains to business entertainment.
- **Inclusion of entertainment expense reimbursements in taxable wages.** If entertainment expense reimbursements will be included in the employee's taxable wages (and a 100% deduction allowed for compensation expenses), consider if federal income tax and FICA taxes will be paid on behalf of employees (gross up). Also consider adding an earnings code to the payroll system for capturing reimbursed entertainment expenses because while subject to FIT, FITW, FICA and FUTA, they may be exempt from state and local income tax (e.g., those states that don't conform to the IRC as of January 1, 2018).

Executive compensation (deduction limit)

Current law

IRC §162(m) applies a deduction limit of $1 million per tax year to the compensation paid to a public company's "covered employees," consisting of the CEO and the next three highest-compensated officers (but specifically excluding the CFO). The $1 million-per-tax-year deduction limitation applies to compensation that is otherwise deductible in a given year that is paid to an individual who is a covered employee at the close of the tax year. Thus, compensation paid after an individual is no longer a covered employee (such as severance and other deferred compensation payments) is not subject to the $1 million deduction limit.

In addition, a significant exception is provided for performance-based compensation, which includes cash compensation contingent upon the attainment of objective performance goals and meeting other requirements, as well as most stock options and stock appreciation rights. Amounts that constitute performance-based compensation are not subject to the $1 million deduction limit. Only publicly traded companies that are required to register their common stock under Section 12 of the Securities Exchange Act are subject to Section 162(m). Because of the specific definition used in the statute, IRC §162(m) does not apply to other companies that register debt, that voluntarily register their common stock or that are foreign private issuers traded on US exchanges via American Depository Receipts (ADRs).

Changes under the TCJA

Effective January 1, 2018, the TCJA amends IRC §162(m) to expand the $1 million compensation deduction limitation for covered employees. A transition rule applies to compensation paid pursuant to a written binding contract that was in effect on November 2, 2017. A further explanation of the binding contract rule appears later.

The TCJA eliminates the exception for performance-based compensation and expands the definition of "covered employees." "Covered employees" includes the CFO, plus any individual who has previously been a covered employee, even after the individual no longer holds the position. Thus, once an individual is identified as a covered employee, the deduction limitation applies to the compensation paid to that individual, even after the individual no longer holds that position or has separated from service. In addition, any executive who is identified as a covered employee for a tax year after December 31, 2016, remains a covered employee for all future years.

The TCJA also expands the definition of public company to include other securities registrants. It includes foreign private issuers, as well as private companies that have registered debt offerings and must report under Section 15(d) of the Securities Exchange Act.

The transition rule exempts any compensation paid "pursuant to a written binding contract [that] was in effect on November 2, 2017, and [that] was not modified in any material respect on or after such date." This transition rule is identical in all material respects to the transition rule included in the statute when IRC §162(m) was first enacted in 1993. That rule provided that "the term 'applicable employee remuneration' shall not include any remuneration payable under a written binding contract [that] was in effect on February 17, 1993, and [that] was not modified thereafter in any material respect before such remuneration is paid."

The Conference Agreement includes a discussion of the interpretation of this transition rule that closely tracks the provisions of the IRC §162(m) regulations' interpretation of the 1993 transition rule. The regulations interpret the 1993 transition rule narrowly to provide that it does not apply unless the corporation is obligated under state law to pay the compensation as the employee performs the services. The Conference Agreement, similar to the regulations, states that a contract renewed after November 2, 2017, is treated as a new contract. In addition, a contract that is terminable or cancelable unconditionally at will by either party without consent of the other is treated as a new contract entered on the date of the termination or cancellation.

The Conference Agreement confirms that compensation paid pursuant to a plan qualifies for the exception under the transition rule, but only if the right to participate in the plan is part of a written binding contract with the covered employee in effect on November 2, 2017. The fact that a plan existed on November 2 is not by itself sufficient to qualify the plan for the exception for written binding contracts. If the covered employee has a written employment contract in effect on November 2 providing that the executive is eligible to receive incentive compensation at a future date in accordance with plan terms, however, that employment contract may be sufficient to "grandfather" the payments made to the executive under the plan, provided that the employer does not have the right to amend the plan materially or terminate the plan (except on a prospective basis).

The Conference Agreement does not address what constitutes a material modification of a contract or when a modification would constitute a new contract. The Treasury Department and IRS are likely to look to the existing IRC §162(m) regulations, which include detailed rules on what constitutes a material modification. Under the regulations, a material modification occurs when the contract is amended to increase the amount of the compensation payable to the employee. A material modification also may occur if payment of the compensation amount is accelerated or the parties agree to a supplemental arrangement to pay an additional amount of compensation.

- **Implications for exempt organizations.** See our tax alert on exempt organizations.
- **Implications for private companies.** The Treasury and IRS likely will rely on the existing IRC §162(m) regulations to provide future guidance on what constitutes a written binding contract and also what constitutes a material modification of the contract that would create a new contract that would not be "grandfathered" under the transition rule.

Upon enactment, public companies will need to determine immediately what compensation awards would have been exempt from the $1 million deduction limit but will no longer be deductible under the new law. This process will require interpretation of the November 2, 2017, grandfather rule and its application to the company's existing arrangements. While the terms of each plan or contract will need to be analyzed specifically, companies may find that the grandfather rule is more limited than originally anticipated given the clarifications provided in the Conference Agreement.

The question of whether a binding contract exists ultimately would seem to be a question of underlying contract and employment law and whether an individual executive would prevail if he or she sought to enforce the payment of compensation determined as of November 2, 2017. The Conference Agreement indicates that the right to terminate or materially amend a contract indicates that it is not grandfathered. Therefore, an arrangement, including a performance-based compensation plan that includes so-called negative discretion, may not be grandfathered under the transition rule because, under such provisions, the company could choose to materially change or not pay the promised amounts.

This interpretation to the "written binding contract" transition rule would severely limit the application of the rule unless an employer could conclude as a legal matter that the negative discretion was unenforceable and the employee is legally entitled to the stated compensation amount.

Additional questions may arise regarding plans or agreements that may be terminated prospectively and what portion of the deferred compensation accrued under the plan or agreement after the effective date is grandfathered. The Conference Agreement states that if a contract is terminable or cancelable by either party (not including a termination solely on account of the employee's termination of employment), then the contract is treated as a new contract on the date that the cancellation or termination could have occurred. For example, assume an executive is participating in a deferred compensation plan that is designed to pay out after the executive leaves employment. Under existing law, the plan is not be subject to the $1 million deduction limit because post-employment payments are exempt. It is not uncommon for such plans to provide that the company may terminate the plan prospectively at any time. In other words, the company may have reserved the right to cease or terminate accrual under the plan prospectively, as long as amounts accrued through that date are not reduced. If such a provision were included in the plan document, then a logical reading of the grandfather rule would indicate that only the account balance as of November 2, 2017, is actually grandfathered since, in theory, the employer could terminate or cancel the plan prospectively on any date after November 2, 2017. Again, an employer may need to determine whether underlying employment law would preclude such a termination to satisfy the transition rule grandfather provision for benefits earned after November 2, 2017.

The Conference Agreement includes virtually the same language that was included in the committee reports when IRC §162(m) was originally enacted in 1993. In 1993, however, there was a policy reason to limit the transition rule and apply the written binding contract exception very narrowly because Congress wanted to incentivize employers to immediately adopt performance-based plans rather than try to continue with prior arrangements. Such a policy rationale simply is not present under the TCJA because the performance-based compensation exemption is being eliminated altogether.

More favorably, termination provisions are not as common under certain types of equity grants such as stock option or appreciation right grants. In those cases, grants made on or before November 2, 2017, likely will continue to be grandfathered, but review of the documents is necessary to confirm that analysis. The Conference Agreement also indicates that a requirement to perform future services is not a bar to grandfather treatment; thus, if a compensation grant is contingent only because the employee must continue to perform services in the future (i.e., it is unvested), that contingency itself does not bar grandfather treatment, assuming that the grant was made on the requisite date.

Given the practical effect of the Conference Agreement language, further Treasury and IRS guidance is possible on what constitutes a written binding contract. It will be important for companies to monitor those developments.

Going forward, changes will be needed to comply. Companies will need to track the potentially expanding group of covered employees subject to the $1 million compensation deduction limitation. In addition to adding the CFO to the covered employee group beginning in tax year 2018, over time, the affected group will grow beyond the current covered top five officers as a consequence of the "once a covered employee, always a covered employee" rule.

Companies that are not currently subject to IRC §162(m) should monitor the proposed expansion of the definition of businesses that may become subject to the compensation deduction limitation. In particular, companies primarily operating outside of the US may need to consider the extent to which the deduction limit practically affects their tax returns in the US even if they are treated as a publicly traded company for purposes of IRC §162(m). For example, potential covered employees could be employed in non-US jurisdictions (so no US deduction limits their compensation). Further guidance should be reviewed to confirm the specific application of IRC §162(m) to these companies.

Finally, companies will need to reconsider how they desire to structure their senior executive compensation programs in light of the demise of the performance-based compensation exception under IRC §162(m). Undoubtedly, performance-based programs will continue in effect for many non-tax reasons; they may not, however, need to include some of the more rigid or process-oriented provisions that were needed to preserve the compensation deduction under the Section 162(m) definition of a performance-based compensation plan. Companies may also want to give further attention to potential structures that could preserve more of the compensation deduction. For example, in lieu of lump-sum payments over $1 million on termination of employment, compensation payments made over time that are less than $1 million per year would allow a corporate deduction.

Action steps: executive compensation

- **Speak to your compensation and benefits advisor.** It will be important to speak to your compensation and benefits professional about the mechanics of the business deduction limit for executive compensation and how changes may affect your compensation policies going forward.
- **Speak to your exempt-organization tax advisor.** It will be important to speak to your exempt-organization tax professional about the new requirement to include nondeductible executive compensation in unrelated business income.

Family and Medical Leave — paid leave (business tax credit)

Current law

The Family and Medical Leave Act (FMLA) of 1993 requires that covered employers provide time off of up to 12 workweeks for any 12-month period for a broad range of family and medical-related reasons. In general, the FMLA does not require that employees be compensated for leave provided under this Act.

Changes under the TCJA

Effective January 1, 2018, and through December 31, 2019, under new IRC §45S, eligible employers are allowed to claim a general federal business tax credit of 12.5% of the wages paid to qualifying employees during any period in which such employees are on FMLA if the rate of payment under the program is 50% of wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

An eligible employer is one that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and allows all less-than-full-time qualifying employees a commensurate amount of leave on a pro rata basis.

A "qualifying employee" is one who has been employed for one year or more, and who for the preceding year had compensation not in excess of 60 % of the compensation threshold for highly compensated employees.

If an employer provides paid leave in the form of vacation, personal leave, or other medical or sick leave other than leave paid pursuant to the FMLA, such paid leave is not eligible for this credit.

The law also states that any leave that is paid by a state or local government or that is required by state or local law is not taken into account in determining this credit.

Currently, several states have laws requiring that employers, employees or both make contributions into a state fund for the payment of paid family leave benefits (e.g., California, New York and Washington). Most states also allow employers to purchase this insurance through a private insurance provider or to operate a self-insured plan. IRS regulations will be needed to clarify the extent to which benefits paid from a mandatory self-insured paid family leave plan are eligible for the credit. (*TCJA §13403*.)

For more information on the state paid family leave insurance requirements, see our special report.

Action steps: Family and Medical Leave — paid leave business tax credit

- **Policy considerations.** In light of the availability of this federal tax credit, businesses will need to determine the extent that they will modify their paid-leave policies.
- **Payroll system tax configuration.** It will be important that employers have unique earnings codes to differentiate types of paid leave (e.g., paid leave under a self-insured paid family leave plan, state/local-mandated paid leave and mandatory paid leave). These unique earnings codes will be beneficial not only in computing this federal tax credit but in arriving at the correct federal, state and local taxability.
- **Contact us for assistance.** For information on how our experienced professionals can assist you in claiming the paid family and medical leave business tax credit, see our brochure.

Length-of-service awards for public safety volunteers (IRC §457 plans)

Current law

Under IRC §457, special rules apply to deferred compensation plans of state and local government and private, tax-exempt employers. However, an exception to these rules applies in the case of a plan paying solely length-of-service awards to bona fide volunteers (or their beneficiaries) on account of qualified services performed by the volunteers.

For this purpose, qualified services consist of firefighting and fire prevention services, emergency medical services, and ambulance services. An individual is treated as a bona fide volunteer for this purpose if the only compensation received by the individual for performing qualified services is in the form of (1) reimbursement or a reasonable allowance for reasonable expenses incurred in the performance of such services, or (2) reasonable benefits (including length-of-service awards) and nominal fees for the services, customarily paid in connection with the performance of such services by volunteers.

The exception applies only if the aggregate amount of length-of-service awards accruing for a bona fide volunteer with respect to any year of service does not exceed $3,000.

Changes under the TCJA

Effective January 1, 2018, IRC §457 is modified to increase the aggregate amount of length-of-service awards that may accrue for a bona fide volunteer with respect to any year of service to $6,000 and adjusts that amount in $500 increments to reflect changes in cost-of-living for years after the first year the provision is effective.

In addition, if the plan is 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. Actuarial present value is to be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation. (*TCJA §13612*.)

Action steps: length-of-service awards for public safety volunteers

- **Policy considerations.** Exempt organizations with IRC §457 plans that cover public safety volunteers should consider if they will increase length-of-service awards in light of the higher aggregate limit that applies.

Moving expenses (repeal of payroll tax exclusion)

Current law

IRC §132(g) allows an exclusion from wages for FIT, FITW, FICA and FUTA purposes for moving expenses reimbursed or paid directly by the employer to the extent those moving expenses are deductible under IRC §217. Under IRC §217, the exclusion applies to the cost of moving household goods and personal effects from the former residence to the new, the first 30 days of storage for a domestic move, and lodging and mileage expenses incurred during the period of travel from the former residence to the new place of residence. Special rules apply to foreign moves. Nontaxable moving expense reimbursements paid directly to employees are reported on Form W-2, box 12, code P. (See *IRS Publication 521*.)

Changes under the TCJA

Reimbursements for moving expenses made to employees or paid directly to third parties on and after January 1, 2018, and through December 31, 2025, are included in wages subject to FIT, FITW, FICA and FUTA. An exception to this provision applies to members of the Armed Forces on active duty moving pursuant to a military order and incident to a permanent change of station. (*TCJA §11048*.)

Action steps: moving expenses

- **Benefits provided on and after January 1, 2018.** Except for moving expenses related to Armed Forces members on active duty, employers will need to change their tax configuration settings for earnings to reflect the inclusion in wages subject to FIT, FITW, FICA and FUTA effective January 1, 2018. Reporting in Form W-2, box 12, code P will not apply except for the Armed Forces where nontaxable moving expense payments still apply. A corresponding change is also required for state and local income tax and withholding purposes for those states that conform to the IRC as of January 1, 2018.

Settlements — sexual harassment (business deduction rules)

Current law

Under IRC §162, businesses are allowed a deduction for amounts paid in connection with a legal settlement pursuant to employee complaints such as discrimination and sexual harassment.

Changes under the TCJA

Effective with amounts paid or incurred after December 22, 2017, and under new IRC §162(q), no business deduction is allowed for settlements, or attorney fees related to such settlements, paid pursuant to sexual harassment or sexual abuse if payment is contingent on a nondisclosure agreement. (*TCJA §13307*.)

Note that there is no change in the federal payroll tax treatment of employee settlement awards.

Action steps: settlement awards for sexual harassment

- **Policy considerations.** In light of the deduction disallowance for sexual harassment awards, businesses should consider the extent to which award recipients will be required to enter into a nondisclosure agreement.
- **General ledger accounts.** It will be important that employers have a unique general ledger account or other mechanism for identifying nondeductible settlement awards.

Transportation fringe benefits (business deduction rules)

Current law

Businesses are allowed to deduct all of the expenses they incur in providing transportation fringes under IRC 132(f). Specifically, IRC §132(f) allows for an exclusion from wages for qualified van pools, qualified parking at or near the workplace and transit benefits. For 2018, the exclusion from taxable wages subject to FIT, FITW, FICA and FUTA is $260 per month for van pools/transit passes and $260 for parking.

Under IRC §132(f)(3), employers may establish a system whereby employees can purchase their transportation fringes with pretax dollars up to the statutory monthly limit. Pretax contributions for transportation fringe benefits are excluded from wages subject to FIT, FITW, FICA and FUTA.

Changes under the TCJA

Effective January 1, 2018, IRC §274 is amended to reflect that no deduction is allowed for any expense incurred for providing any transportation, or any payment or reimbursement for transportation fringe benefits in IRC §132(f) except as necessary to ensure the safety of the employee. (*TCJA §13304*.)

The deduction disallowance does not apply to bicycle commuting benefits as defined in IRC §132(f)(5)(F) incurred on and after January 1, 2018, and after December 31, 2025. This exception is made because under the TCJA, bicycle commuting benefits are included in wages subject to FIT, FITW, FICA and FUTA effective January 1, 2018, through December 31, 2025. (*See bicycle commuting benefits in this report*.)

Note that there is no change in the federal payroll tax treatment of employee parking, van pool and transit benefits.

In Publication 15-B the IRS explains that no deduction is allowed for qualified transportation benefits, whether provided directly by the employer, through a bona fide reimbursement arrangement, or through a compensation reduction agreement (pretax contribution) incurred or paid after December 31, 2017. Also, no deduction is allowed for any expense incurred for providing any transportation, or any payment or reimbursement to employees in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee, or for qualified bicycle commuting reimbursements as described in IRC §132(f)(5)(F) (even though the exclusion from federal taxable wages for qualified bicycle commuting reimbursements is suspended, as discussed above). (*Publication 15-B*, *page 20*.)

IRS guidance will be necessary as follows:

- **Parking – customer and employee shared lots.** IRS guidance is needed to determine the deduction disallowance for parking lots offered at or near the business premises that are made available to both employees and customers.
- **Parking – free lots.** IRS guidance is needed to confirm if a deduction is disallowed pursuant to parking lot expenses incurred by the employer where parking spaces are available at no cost to employers and customers.

Action steps: transportation fringe benefits

- **Policy considerations.** In light of the deduction disallowance for transportation fringe benefits, businesses will need to decide if they will continue to provide transportation fringe benefits to their employees. In this decision-making process, keep in mind that some localities require that employers provide transportation fringe benefits to their employees. See our alert for more information.
- **Exempt organizations.** Exempt organizations should consult with their tax-exempt-organization advisor about the requirement to include transportation fringe benefit costs in unrelated business income. See our tax alert on exempt organizations.

Wage advances and repayments (individual deduction rules)

Current law

Under the claim-of-right doctrine, special tax rules apply when a taxpayer has an obligation to repay certain wage amounts received in a prior tax year. These special tax rules can sometimes have the effect of increasing the federal income tax the employee would otherwise pay.

Specifically, if an employee is paid wages in one tax year that are repaid to the employer in subsequent tax years, and if that wage repayment is $3,000 or less, or the employee knew there was an obligation to repay the wages regardless of the amount, the employee is allowed an adjustment (i.e., credit) to his or her federal taxable income only to the extent that the repayment exceeds 2% of the employee's adjusted gross income (i.e., the 2% floor).

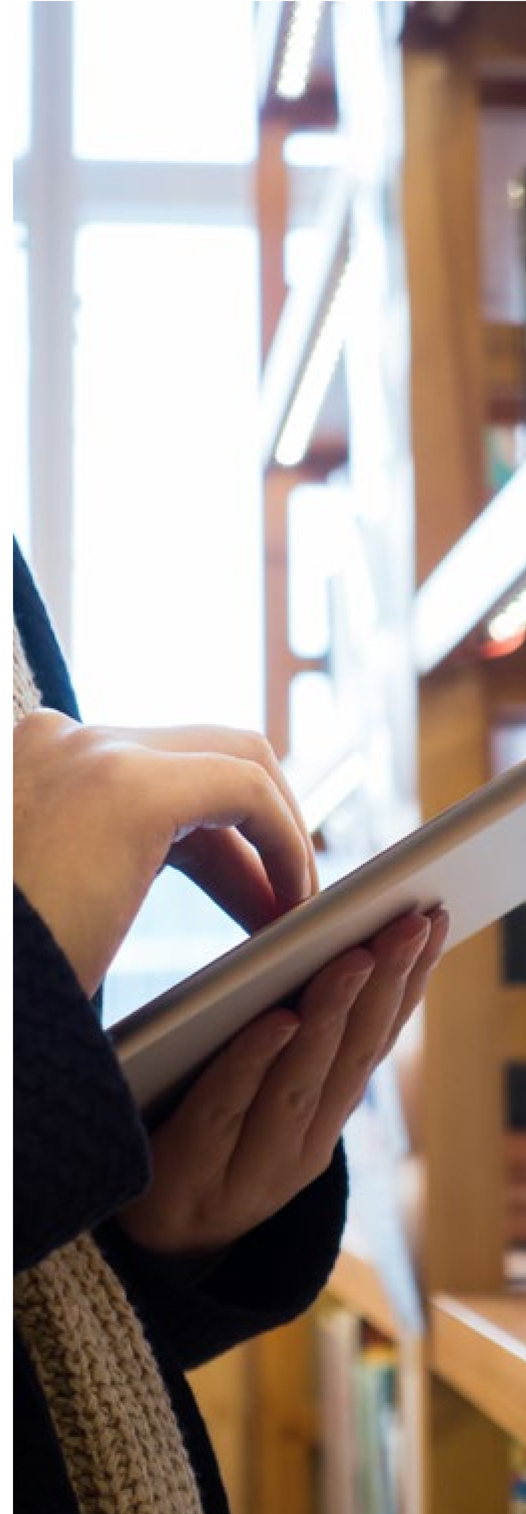
If the wage repayment is more than $3,000 or the employee was unaware of the obligation to repay, the employee can claim a federal income tax refund by claiming an itemized deduction in the year of repayment subject to the 2% floor, or a federal tax credit, whichever is most beneficial. (*IRC §1341*, *IRC §67(b)(10)*.)

Changes under the TCJA

Effective January 1, 2018, and through December 31, 2025, IRC §67 is modified such that all miscellaneous itemized deductions available to individual taxpayers for employee unreimbursed business expenses (e.g., uniforms, tools of the trade and wage repayments subject to the claim-of-right doctrine), currently subject to the 2% floor, are disallowed entirely. (*TCJA §11045*.)

Action steps: wage advances and repayments

- **Policy considerations.** Businesses should examine their wage advance policies as they pertain to employee repayments that will not be made in the current year. At a minimum, employees should be made aware of the federal income tax implications of wage advance repayments made in years subsequent to when the advance was paid.



Fringe benefit inflation adjustments for 2018

In Rev. Proc. 2018-18, the IRS has updated the 2018 annual limits that apply to certain fringe benefits and the penalties that apply to Forms W-2/1099 that are late or incorrect. These updates are a result of a change in the inflation calculation under the Tax Cuts and Jobs Act (TCJA). (*Rev. Proc. 2018-18 is printed in IRB 2018-10, 3-5-2018*.)

Pursuant to the revised limits on fringe benefits, employers will need to adjust their payroll and other systems to reflect these revised caps and determine if adjustments are needed to 2018 employee contributions made prior to this IRS guidance.

Background

Many provisions of the tax law are adjusted for inflation to protect taxpayers from the effects of rising prices. Prior to January 1, 2018, many of these inflation adjustments were based on annual changes in the level of the Consumer Price Index for All Urban Consumers ("CPI-U") that measures prices paid by typical urban consumers on a broad range of products, and is developed and published by the U.S. Department of Labor.

Effective January 1, 2018, the TCJA requires the use of the Chained Consumer Price Index for All Urban Consumers ("C-CPI-U") to adjust those tax provisions that were previously indexed by the CPI-U. The C-CPI-U, like the CPI-U, is a measure of the average change over time in prices paid by urban consumers. It too is developed and published by the U.S. Department of Labor, but differs from the CPI-U in accounting for the ability of individuals to alter their consumption patterns in response to relative price changes. The C-CPI-U accomplishes this by allowing for consumer substitution between item categories in the market basket of consumer goods and services that make up the index, while the CPI-U only allows for modest substitution within item categories. (*TCJA §11002*.)

Following are the employment tax provisions affected by the change in the inflation adjustment calculation for 2018.

Adoption assistance, health savings accounts and medical savings accounts

Effective January 1, 2018, Rev. Proc. 2018-18 revised the 2018 annual limits originally published in Rev. Proc. 2017-37 for adoption assistance, health savings accounts and medical savings accounts as highlighted in yellow below.

- **Adoption assistance.** The limit on qualified adoption assistance (including special needs children) under IRC §23(a)(3) for 2018 is $13,810, up from $13,570 in 2017.
- **Health savings accounts.**

Health savings account limit type	2017	2018
Contribution *		
Self (IRC §223(b)(2)(A))	$3,400	$3,450
Family (IRC §223(b)(2)(B))	$6,750	$6,850
Out-of-pocket		
Self (IRC §223(c)(2)(A))	$6,550	$6,650
Family (IRC §223(c)(2)(A))	$13,100	$13,300
Deductible (high-deductible health plan)		
Self (IRC §223(c)(2)(A))	$1,300	$1,350
Family (IRC §223(c)(2)(A))	$2,600	$2,700

* Additional contribution of $1,000 is permitted for individuals age 55 and older. Those enrolled in Medicare are not eligible to participate.

- **Medical Savings Account (MSA) limits.** Summarized below are the 2018 limits that apply to MSAs under IRC § 220(c)(2)(A).

Provision	Self-only coverage	Family coverage
High deductible health plan: annual deductible	Not less than $2,300 (up from $2,250 in 2017) and not more than $3,450 (up from $3,350 in 2017)	Not less than $4,550 (up from $4,500 in 2017) and not more than $6,850 (up from $6,750 in 2017)
Annual out-of-pocket (other than for premiums)	Not to exceed $4,600 (up from $4,500 in 2017)	Not to exceed $8,400 (up from $8,250 in 2017)

- Penalties for late or incorrect information statements and information returns. Following are the penalties for failure to file correct and timely Forms W-2 and Forms 1099 effective for returns required to be filed on and after January 1, 2019 as updated for inflation.
  - $50 per Form W-2 if you correctly file within 30 days of the due date, a maximum penalty of $545,500 ($191,000 for small businesses)
  - $100 per Form W-2 if you correctly file more than 30 days after the due date but by August 1, 2019; maximum penalty of $1,637,500 per year ($545,500 for small businesses)
  - $270 per Form W-2 if you file after August 1, 2019, or you do not file required Forms W-2 at all; maximum penalty of $3,275,500 per year ($1,091,500 for small businesses)
  - The penalty for providing an incorrect W-2 to the employee is $270 per incorrect Form W-2, to a maximum of $3,275,500 per year ($1,091,500 for small businesses).
  - The penalty for intentional disregard is the flat amount of $540 per form or 10% of the amount not reported. There is no limit on this penalty.

  Note that the correction will be considered to have been filed in a timely manner if made within 30 days of (1) discovering the failure or (2) removing the impediment to correcting the failure. (*IRC §6721(b); IRC 6721(d); IRC §6722.*)

An employer's guide to the Tax Cuts and Jobs Act of 2017

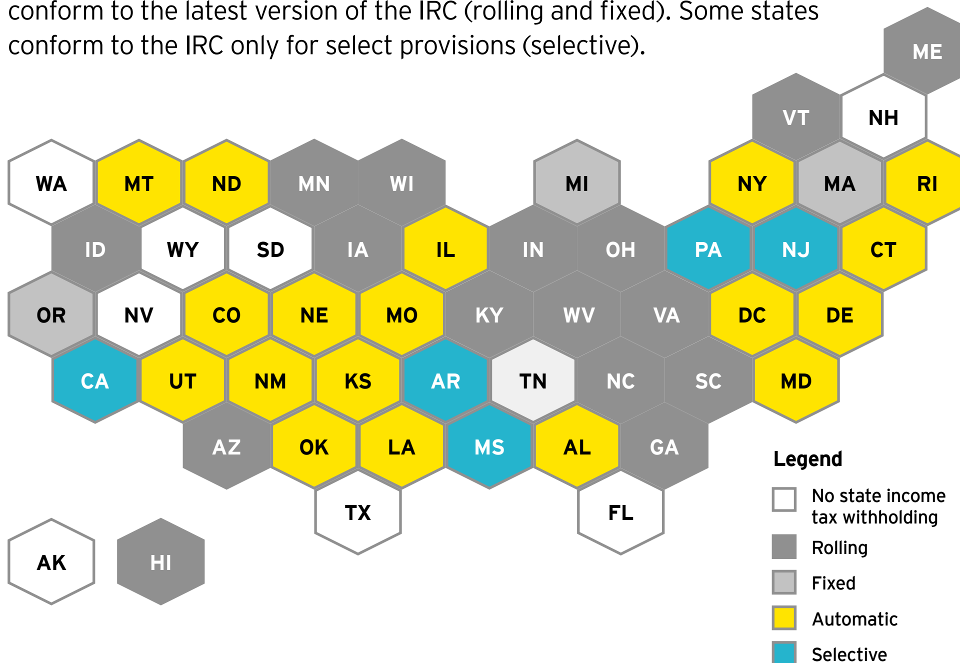
Continued

Prepare for state and local tax changes

The greater administrative burden lies ahead as states (and localities) grapple with conformity to the TCJA. As of January 8, 2018, close to half the states requiring income tax withholding on wages were automatically coupled with the federal Internal Revenue Code (IRC) while other states will consider their course of action in upcoming legislative sessions.

State conformity with the federal Internal Revenue Code as of January 8, 2018

Some states automatically update their tax laws with changes to the IRC (automatic). Other states conform to the IRC as of a specific date and legislation is needed to conform to the latest version of the IRC (rolling and fixed). Some states conform to the IRC only for select provisions (selective).



Unlike the federal TCJA provisions that generally took effect January 1, 2018, state tax changes will have varying effective dates as called for by their legislative and regulatory bodies. For instance, the earlier Form W-2 filing due date of January 31 enacted in 2015 under the federal PATH Act has gradually been adopted by the states with only six of them maintaining their original filing due dates for tax year 2017.[1]

Form W-4 withholding allowance certificates

Under the TCJA, and effective January 1, 2018, through December 31, 2025, the personal exemption deduction is suspended; however, the law provides that the IRS may administer the income tax withholding rules under IRC §3402 without regard to this provision for tax years beginning before January 1, 2019. Whether the wage withholding rules pursuant to the personal exemption remain unchanged for 2018 is at the discretion of Treasury and the IRS. (*TCJA §11041*.)

[1] For tax year 2017, six states – Hawaii, Michigan, New Jersey, New Mexico, Oklahoma and West Virginia – are the only states that have not adopted the earlier due date for filing Forms W-2 under the 2015 federal PATH Act.

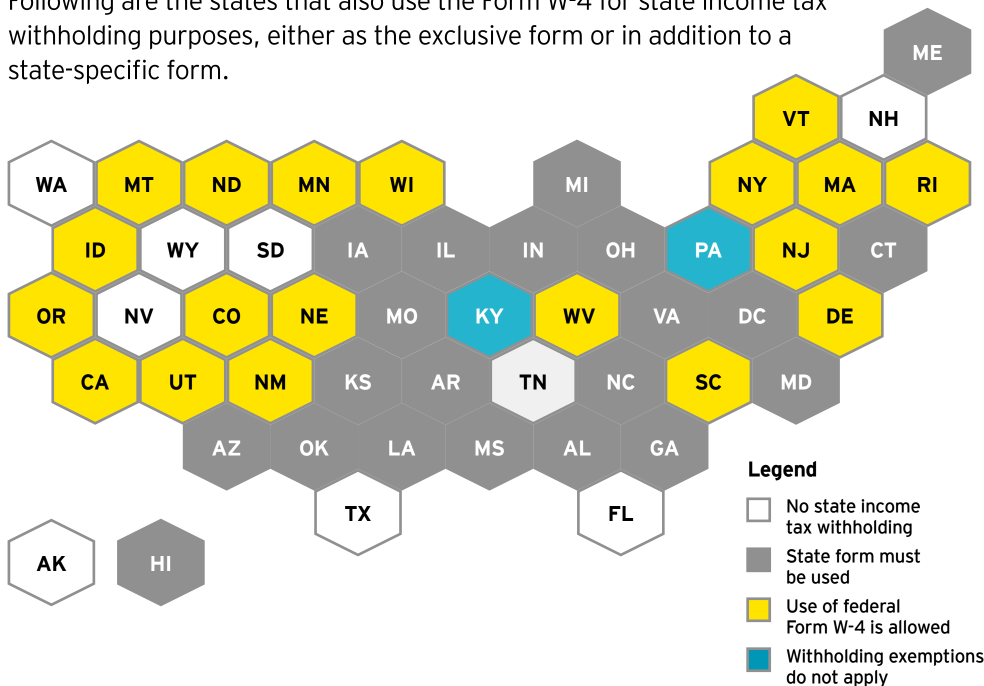
For 2018, the federal income tax withholding tables continue to take into account personal allowances and employees are not required to submit a new Form W-4. The IRS plans to release a Form W-4 for tax year 2019 that more closely conforms to the TCJA. This decision delays the inevitable decision states will need to make concerning their continued use of the federal Form W-4.

For our 2017 state survey of Form W-4 requirements, see our special report.

States that use the federal Form W-4

Overview as of June 1, 2018

The Tax Cuts and Jobs Act temporarily suspends the deduction for personal allowances effective January 1, 2018, and through December 31, 2025. The IRS will likely update the federal Form W-4 in the future to reflect this change. Following are the states that also use the Form W-4 for state income tax withholding purposes, either as the exclusive form or in addition to a state-specific form.



Moving expenses and bicycle commuting benefits

Two provisions of the TCJA affect the payroll tax treatment of fringe benefits, and these too can affect state taxability for income tax, income tax withholding, unemployment insurance and other state employment taxes (e.g., disability insurance). The impact on state payroll taxes is immediate in those states that conform automatically to the IRC and will change over time as other state legislatures consider conformity with these federal provisions. (See the heat map on page 26.)

Here are the state taxability provisions to watch out for.

1. **Bicycle commuting benefits.** Bicycle commuting benefits under IRC 132(f) received by employees on and after January 1, 2018, and through December 31, 2025, are included in wages subject to FIT, FITW, FICA and FUTA. (*TCJA §11047*.)
2. **Moving expenses.** Reimbursements for moving expenses made to employees or paid directly to third parties on and after January 1, 2018, and through December 31, 2025, are included in wages subject to FIT, FITW, FICA and FUTA. An exception to this provision applies to members of the Armed Forces on active duty moving pursuant to a military order and incident to a permanent change of station. (*TCJA §11048*.)

Business deductions

Effective January 1, 2018, the TCJA lowers or disallows a business deduction for several fringe benefits and work-related expenses (see the list below). Businesses may respond to some of these changes by including these expenses in federal taxable wages, and if they do, consideration will need to be given to the state income and employment tax treatment of these items. For instance, if reimbursed entertainment expenses are included in federal taxable wages so that the business may claim a deduction on its federal income returns, these reimbursements may be excluded from wages subject to tax in those states that do not conform to the IRC.

Reduction or disallowance of the business deduction under the TCJA

Provision	Effective date	Impact
Eating facilities – meals for employer's convenience	January 1, 2018	100% deduction is lowered to 50%
Eating facilities – meals for employer's convenience	January 1, 2026	50% deduction is lowered to 0%
Entertainment expenses	January 1, 2018	50% deduction is lowered to 0%
Executive compensation	January 1, 2018	Various changes limiting the deduction for executive compensation
Settlements for sexual harassment and related legal fees if nondisclosure is part of the agreement	December 23, 2017	100% deduction is lowed to 0%
Transportation fringe benefits (parking, van pools and transit passes)	January 1, 2018	100% deduction is lowered to 0%

Ernst & Young LLP insights

The federal, state and local tax implications of the TCJA will create several administrative challenges for employers in the months and years ahead. Accordingly, businesses should consider taking the following action steps.

- Create a TCJA governance committee that includes payroll, human resources, tax and finance executives to evaluate policies and procedures and develop/monitor a work plan.
- Be vigilant in monitoring federal, state and local developments.
- Consider how compliance with the gathering of state withholding allowance certificates will be achieved in the event state requirements are changed.
- Closely review payroll system tax configuration settings for earnings and deduction codes and timely update federal, state and local jurisdiction settings for changes.
- Develop an employee communication plan that explains federal, state and local tax changes and the actions required of employees.
- Evaluate if current payroll and human resources staffing is sufficient in light of the workload added by the TCJA.

Tax Cuts and Jobs Act: Employer considerations

Tax Cuts and Jobs Act provision	Employer considerations
Affordable Care Act — repeal of the individual mandate ▸ Effective date: January 1, 2019	▸ The TCJA's repeal of the individual mandate does not affect current ACA employer reporting requirements or the 0.9% Additional Medicare Tax.
Federal income tax withholding, supplemental wages and backup tax ▸ Effective date: January 1, 2018, through December 31, 2025	▸ **Income tax withholding on regular wages, including those paid to US nonresident aliens.** By February 15, 2018, employers must implement the 2018 income tax withholding tables contained in Notice 1036. ▸ **Supplemental wages.** Employers may optionally use a flat income tax withholding rate of 22% (down from 25%) on supplemental wages of up to $1 million provided income tax was withheld from regular wages in the current or previous year and supplemental wages are separately identified. A flat federal income tax rate of 37% must be used for supplemental wages paid to an employee in excess of $1 million (down from 39.6%). The 37% flat rate applies even if the employee claims exemption from federal income tax withholding on the Form W-4. ▸ **Backup withholding.** For nonwage amounts paid on and after January 1, 2018, and through December 31, 2025, a backup withholding rate of 24% applies. ▸ **Forms W-4.** The IRS states that there is no requirement at this time that employees submit a new Form W-4; however they are encouraged to check their withholding since the 2018 income tax withholding tables continue to include personal allowances. The IRS expects to issue a Form W-4 for tax year 2019 that more closely incorporates changes under the TCJA. See the IRS frequency asked questions here. ▸ **Employee communications.** Many employees are likely anticipating a reduction in their federal income tax withholding in 2018 and may also have questions about when and how to change their Forms W-4. For these reasons, employers should consider employee communications that explains their need to check their withholding in light of the changes under the TCJA. For an explanation of the individual income tax changes under the TCJA, consider sharing Ernst & Young LLP's tax alert with employee.
Federal tax levies (suspension of personal allowance deduction)	▸ **Federal tax levies received before January 1, 2018.** Because personal exemptions are not factored into the amount exempt from levy effective January 1, 2018, the IRS will need to clarify the extent that employees with active federal tax levies are required to submit a revised statement of filing status to their employers. For this purpose, the IRS would need to revise the employee statement contained in the Form 668-W to reflect only the standard deduction. IRS guidance is also needed as to the deadline for employee submission of the Form 668 statement of filing status and the employer deadline for implementing changes in the amount exempt from levy.

Tax Cuts and Jobs Act provision	Employer considerations
Bicycle commuting benefit (repeal of payroll tax exclusion) ‣ Effective date: January 1, 2018, through December 31, 2025	‣ **Benefits provided in 2017.** Keep in mind that absent IRS guidance otherwise, benefits paid on and after January 1, 2018, are included in wages subject to FIT, FITW, FICA and FUTA, even if related to benefits earned in 2017. ‣ **Benefits provided on and after January 1, 2018.** Employers will need to change their tax configuration settings for earnings to reflect the inclusion in wages subject to FIT, FITW, FICA and FUTA effective January 1, 2018. A corresponding change is also required for state and local income tax and withholding purposes for those states that conform to the IRC as of January 1, 2018.
Eating facilities (business deduction rules) ‣ Effective date: January 1, 2018; no business deduction for eating facilities after December 31, 2025	‣ **Eating facilities.** In light of the reduction in the business deduction to 50% for expenses incurred through December 31, 2025, and the loss of the business deduction effective January 1, 2026, employers will need to consider if there will be any change in policy concerning free meals provided to employees for the employer's convenience and in the operation of their on-premises eating facilities in general. IRS guidance will be necessary to understand how the business deduction is computed when revenues from the on-premises eating facility meet or exceed its actual operating costs. ‣ **De minimis meals (e.g., supper money and overtime meals).** IRS guidance will be necessary to fully understand the implications of the TCJA overtime meals and supper money.
Employee achievement awards (clarification) ‣ Effective date: January 1, 2018	‣ **Review length-of-service and safety achievement policies.** If you are currently providing items of intangible personal property (e.g., gift cards, vacations, gift certificates), determine if you will continue to allow them going forward. ‣ **Prior-year adjustments.** If you have, for years prior to 2018, been giving employees items other than tangible personal property and you have not included them in federal taxable wages, consider if you will protect yourself from future IRS audit assessments by disclosing the taxable wages and paying the tax owed using Form 941-X and issuing/filing Form W-2c. Consider also state and local voluntary disclosures. ‣ **Manager and supervisor communications.** Consider communicating your policy of allowing only items of tangible personal property for length-of-service and safety awards to all managers and supervisors to prevent inadvertent taxable awards.
Equity compensation-stock and RSUs (election to defer income tax) ‣ Effective date: January 1, 2018	‣ **Speak to your compensation and benefits advisor.** Discuss with your compensation and benefits professional the pros and cons of making this election available to employees. ‣ **Payroll system tax configuration.** Should the business decide to make the income tax deferral available, new earning codes will be needed to accommodate the federal income tax withholding and Form W-2 requirements.

Tax Cuts and Jobs Act provision	Employer considerations
Entertainment expenses (business deduction rules) ‣ Effective date: January 1, 2018	‣ **General ledger accounts.** It will be necessary to establish general ledger accounts that are sufficient in identifying entertainment expenses where the business deduction is disallowed, those that are subject to the 50% deduction limit, and those where a 100% deduction is allowed. For example, separate general ledger accounts are needed for (1) a theater event provided to an employee where a 100% business deduction is allowed (meeting the requirements of IRC §132), (2) a theater event for a customer where no business deduction is allowed and (3) meal expenses incurred for a business meeting or as a travel expense where a 50% deduction limit applies under IRC §162. ‣ **Entertainment policy.** Businesses will need to consider how the deduction disallowance for entertainment events and related facilities will alter their business expense policy as it pertains to business entertainment. ‣ **Inclusion of entertainment expense reimbursements in taxable wages.** If entertainment expense reimbursements will be included in the employee's taxable wages (and a 100% deduction allowed for compensation expenses), consider if income and FICA taxes will be paid on behalf of employees (gross up). Also consider adding an earnings code to the payroll system for capturing reimbursed of entertainment expenses because while you may have included them in wages subject to FIT, FITW, FICA and FUTA, they may be exempt from state and local income tax (e.g., those states that don't conform to the IRC as of January 1, 2018).
Family and Medical Leave — paid leave (federal tax credit) ‣ Effective date: January 1, 2018, through December 31, 2019	‣ **Policy considerations.** In light of the availability of this federal tax credit, businesses will need to determine the extent that they will modify paid-leave policies. ‣ **Payroll system tax configuration.** It will be important that employers have unique earnings codes to differentiate types of paid leave. For instance, paid leave under a self-insured paid family leave plan, state-mandated paid leave and mandatory paid leave. These unique earnings codes will be beneficial not only in computing this federal tax credit but in arriving at the correct federal, state and local taxability.

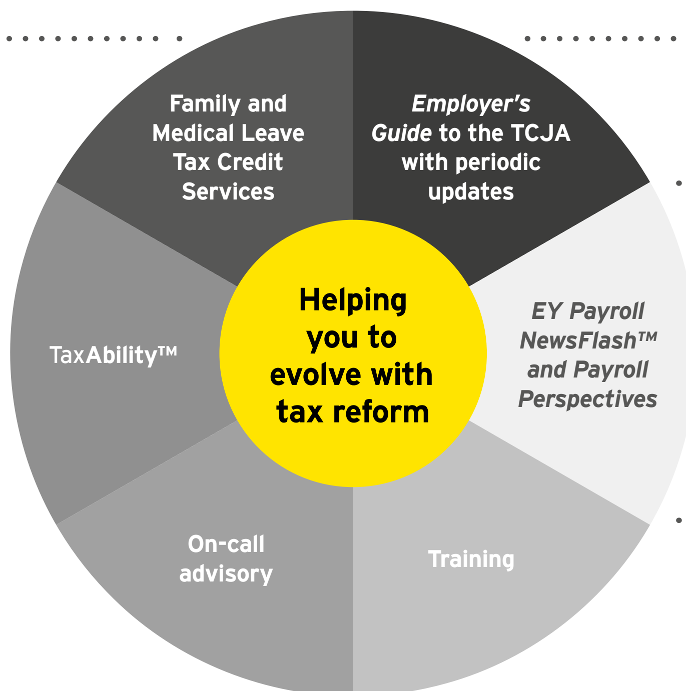
An employer's guide to the Tax Cuts and Jobs Act of 2017

Continued

Tax Cuts and Jobs Act provision	Employer considerations
Length-of-service award programs for bona fide public safety volunteers (§457 plans) ‣ Effective date: January 1, 2018	‣ **Policy considerations.** Exempt organizations with IRC §457 plans that cover public safety volunteers should consider if they will increase length-of-service awards in light of the higher aggregate limit that applies.
Moving expenses (repeal of payroll tax exclusion) ‣ Effective date: January 1, 2018, through December 31, 2025	‣ **Benefits provided in 2017.** Keep in mind that absent IRS guidance otherwise, moving expense reimbursements and third-party relocation payments made on and after January 1, 2018, are included in wages subject to FIT, FITW, FICA and FUTA, even if related to expenses incurred in 2017. ‣ **Benefits provided on and after January 1, 2018.** Except for moving expenses related to Armed Forces members on active duty, employers will need to change their tax configuration settings for earnings to reflect the inclusion in wages subject to FIT, FITW, FICA and FUTA effective January 1, 2018. A corresponding change is also required for state and local income tax and withholding purposes for those states that conform to the IRC as of January 1, 2018.
Settlements — sexual harassment (business deduction rules) Amounts paid or incurred after December 22, 2017	‣ **Policy considerations.** In light of the deduction disallowance for sexual harassment awards, businesses should consider the extent to which award recipients will be required to enter into a nondisclosure agreement. ‣ **General ledger accounts.** It will be important that employers have a unique general ledger account or other mechanism for identifying nondeductible settlement awards.
Transportation fringe benefits (business deduction rules) ‣ Effective date: January 1, 2018	‣ **Policy considerations.** In light of the deduction disallowance for transportation fringe benefits, businesses will need to decide if they will continue to provide transportation fringe benefits to their employees. This decision will be particularly important should the IRS confirm that salary reductions for transportation fringes are subject to deduction disallowance.
Wage advances and repayments (individual deduction rules) ‣ Effective date: January 1, 2018, through December 31, 2025	‣ **Policy considerations.** Businesses should examine their wage advance policies as they pertain to employee wage advance repayments that will not be made in the year the wage advance was paid. At a minimum, employees should be made aware of the federal income tax implications of wage advance repayments made in years after the wage advance was paid.

Tax Reform Employer Support Services

Helping businesses administer changes under the Tax Cuts and Jobs Act (TCJA)



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Ernst & Young LLP – Employment Tax Advisory Services contacts

Bryan De la Bruyere
bryan.delabruyere@ey.com
+1 404 817 4384

Kristie Lowery
kristie.lowery@ey.com
+1 704 331 1884

Debbie Spyker
deborah.spyker@ey.com
+1 720 931 4321

Julie Gilroy
julie.gilroy@ey.com
+1 312 879 3413

Chris Peters
christina.peters@ey.com
+1 614 232 7112

Ken Hausser
kenneth.hausser@ey.com
+1 732 516 4558

Debera Salam
debera.salam@ey.com
+1 713 750 1591

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