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How Tax Reform Will Change the Treatment of Fringe Benefits

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Several employer deductions will be reduced or eliminated, including the cost of business-related entertainment expenses and qualified transportation fringe benefits, but employers may be able to claim a credit for a percentage of wages paid to qualifying employees on family and medical leave. Among other changes, the law repeals the deduction of alimony payments, and employees can no longer exclude moving expense reimbursements they receive from employers or deduct moving expenses they pay themselves.

The recent tax reform legislation (HR 1 or the Act) makes significant changes to the treatment of fringe benefits under the Internal Revenue Code, most of which are effective for taxable years beginning on and after January 1, 2018. Some of the changes affect the employer deduction for fringe benefits, while others affect the tax treatment for employees. The Act includes miscellaneous additional changes, but some changes proposed in the original House and Senate bills were not included in the final legislation.

Employer Deductions

The Act will curtail or eliminate a number of employer deductions for employee benefits, except to the extent such amounts are treated as income to the employee.

- Employers may no longer deduct the cost of providing qualified transportation fringe benefits to employees (e.g., qualified parking, mass transit passes, van pooling), including benefits provided through direct payment, reimbursement, or salary reduction arrangements.

- Employers may not deduct any expense incurred for providing transportation, or any payment or reimbursement, for travel between an employee’s residence and place of employment, except to ensure employee safety or (for 2018 through 2025) to provide qualified bicycle commuting reimbursements.

- Employers may no longer deduct any business-related entertainment expenses, regardless of whether the item is associated with the conduct of the employer's trade or business. This change eliminates the 50% deduction that generally had been allowed for business-related entertainment. This may trigger an expansion of the deduction disallowance rules applicable to airplane travel (and use of entertainment facilities), which since 2005 have generally limited deductions for "entertainment flights" by top executives to the amount imputed or charged. Those disallowance rules historically have not applied to business entertainment flights.

- Employers will continue to be allowed a 50% deduction for food or beverage expenses directly related to the employer's business (e.g., consumed by traveling employees). For now, this 50% deduction will be available for expenses associated with providing food and beverages in cafeterias and snack rooms on employers' business premises that (a) are provided for the convenience of the employer or (b) qualify as *de minimis* food or beverages, but this deduction will be disallowed for any such expenses paid or incurred on or after January 1, 2026. The law does not include the House bill's proposal to disallow deductions for any *de minimis* expenses, e.g., for food and beverages, that are paid under a reimbursement arrangement with a tax-exempt organization. Under Code Section 274(e)(4), there continues to be an exception from the 50% disallowance for food and beverages for holiday parties and social events.

- New Code Section 162(f) generally prohibits employers from deducting settlement payments to the government and certain quasi-governmental entities, subject to exceptions for payments that are attributable to restitution or compliance and are specifically designated as such. The government party to the settlement is required to issue an information return to the employer and to the Internal Revenue Service (IRS), stating the amount of the overall settlement and what portions of the overall settlement are attributable to deductible restitution and compliance costs. Settlement negotiations, therefore, must now address these new requirements in order for a taxpayer to be able to later deduct any part of a settlement payment. These rules will apply to employment-related settlements that involve government agencies. For further reading on this topic, see our previous post.

Employee Exclusions

The new legislation also affects employees by changing the individual tax treatment of certain fringe benefits.

- The exclusion for qualified moving expense reimbursements is suspended for taxable years 2018 through 2025. Correspondingly, the deduction for moving expenses is suspended for the same period. (In both cases, there is an exception for active duty members of the Armed Forces). This means that employees cannot exclude moving expense reimbursements they receive from employers, and cannot deduct moving expenses they pay themselves. However, employers may deduct moving expense reimbursements that are treated as taxable compensation to employees. The regulations under Code Section 217 raise questions as to when a moving expense is "paid or incurred," which creates uncertainty about the tax treatment of moves completed in 2017 but for which the underlying expenses are not paid until 2018.

- The exclusion for qualified bicycle commuting reimbursements is suspended for taxable years 2018 through 2025.

- Earlier provisions that would have eliminated other exclusions do not appear in the final legislation and thus remain in effect, including educational assistance benefits, tuition assistance benefits, employer contributions to Archer Medical Savings Accounts, employer-provided dependent care assistance, and employer-provided adoption assistance.

- The Act maintains, with only a minimal change, the current exclusion for employee achievement awards, essentially codifying the proposed regulations that have been applicable since 1987. The exclusion is limited to “tangible personal property.” The regulations provide that this term does not include any cash, cash equivalents, gift cards, gift coupons, or gift certificates, nor any vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. The Act clarifies that the general prohibition on any awards of gift cards, gift certificates, or coupons does not apply to “arrangements conferring the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer.” The conference report accompanying HR 1 notes that “no inference is intended that this is a change from present law and guidance,” presumably to indicate that this provision does not retroactively approve generous awards programs that may have been implemented under the proposed regulations.

Other Changes

The legislation creates a new credit for employers but suspends or repeals other deductions, including for tax preparation expenses and alimony payments.

- For wages paid in 2018 and 2019, new Code Section 45S provides employers with a general business credit of up to 25% of the amount of wages paid to qualifying employees during the period employees are on family and medical leave, subject to certain conditions.

- The conference report removes “any computer or peripheral equipment” from the definition of “listed property” (under Code Section 280F), relieving taxpayers of the heightened requirements for substantiating the expense and business usage of such property under Code Section 274 and the accompanying regulations. This change applies to property placed in service after December 31, 2017.

- The itemized deduction for tax preparation expenses is suspended for taxable years 2018–2025 as part of a broader suspension of miscellaneous itemized deductions subject to the 2% floor.

- The Act repeals the deduction for alimony payments, effective for divorce and separation agreements executed after December 31, 2018, or modified after this date to expressly be

subject to this repeal. This provision will have significant ripple effects, with the payment of alimony from after-tax dollars effectively reversing the current treatment of alimony in multiple contexts, including a potential reversal of the IRS guidance (in place since 2004) providing that stock options and deferred compensation earned by an employee and transferred to the employee's former spouse are taxable and reportable to the former spouse. However, since those rulings deal not with alimony, but instead with marital property subject to equitable division in the event of divorce, it is not entirely clear whether, under the new rules, the stock option and deferred compensation income would necessarily revert to being taxable to the employee

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