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GMS Flash Alert

Global Compensation Edition

2018-013 | January 18, 2018

United States - Tax Reform Takes a Bite Out of Employer Fringe Benefit Deductions

On December 22, 2017, H.R. 1 (the 2017 Act)[1] was signed into law, curtailing common benefit deductions under U.S. Internal Revenue Code section 274. In particular, the 2017 Act reduces or eliminates deductions related to meals, entertainment, recreation activities, and qualified transportation benefits paid or incurred beginning on or after January 1, 2018.

The following discussion provides a brief overview of these deduction limits as they relate to fringe benefits, followed by a frequently asked questions section to further illustrate the practical implications of the new rules. (For prior coverage addressing the section 162(m) limits, see GMS *Flash Alert* 2018-007 (January 12, 2018).)

WHY THIS MATTERS

The new law limits or eliminates numerous deductions. H.R. 1 includes revisions to section 274, which impacts deductions for meals, as well as for entertainment and recreation expenses that are directly related to the conduct of an employer's trade or business.

Meals

Unlike meals related to business travel (which are subject to a 50% limitation), prior to the 2017 Act, deductions for certain meals provided to employees were fully deductible (100%). These included de minimis meals, the provision of meals under section 132(e) at a qualified employer-operated dining facility on or near the employer's business premises that satisfy revenue requirements, or the provision of meals under section 119 for the convenience of the employer on the employer's business premises. In these circumstances, meal expenses were generally 100% deductible.

As a result, employers have historically deducted the full cost of employee meals in many situations, including but not limited to the following: employee cafeterias where meals are provided (1) for no charge as a convenience to the employers, (2) for a small charge that covers the direct operating cost, (3) on an infrequent bases, or (4) because of overtime work.

Effective January 1, 2018, the new provisions in section 274(n) generally limit to 50% deductions for expenses related to de minimis meals under section 132(e)(1), the operation of employer operated eating facilities under section 132(e)(2), and meals provided for the convenience of the employer under section 119, through 2025 and become non-deductible thereafter.

Entertainment, Amusement, or Recreation Activities

Under section 274, deductions for expenses related to the provision of entertainment, amusement or recreation activities for employees have historically been disallowed unless there's a valid business purpose for the business event that occurs before, during, or after the activity. If the expense was directly related to the conduct of the employer's trade or business, 50% of the expenses incurred was still deductible by the employer. This was also subject to exceptions such as for nondiscriminatory recreation; employee business meetings; and entertainment sold to customers; as well as stockholder, director, and business league meetings; which were 100% deductible.

The 2017 Act amends section 274 to eliminate the deduction, even if the activities (such as theater and sporting events, golf outings, etc.) are associated with business. However, the exceptions, which allow full deductions, for expenses related to business meetings of employees, stockholders, directors, and business leagues remain intact.

Qualified Transportation Fringe Benefits

Prior to the 2017 Act, expenses to provide qualified transportation fringes under section 132(f) were deductible as ordinary and necessary business expenses. Qualified transportation benefits include items such as transit passes, van pools, qualified parking benefits, and the bicycle commuting reimbursement. These benefits remain excludible from employee income, except for the bicycle commuting reimbursement, which is taxable through December 31, 2025.

Under the 2017 Act, section 274(a) was amended to expressly disallow deductions for "the expense of any qualified transportation fringe (as defined in Section 132(f)) provided to the employee of the taxpayer." Further, the newly added section 274(l) generally disallows deductions for any expense incurred for providing transportation, payment, or reimbursement to an employee relating to travel between the employee's residence and workplace.

The 2017 Act does include an exception for expenses that are "necessary for ensuring the safety of the employee" between the employee's residence and workplace.

Employee Achievement Awards

Section 274 previously provided employers an annual deduction up to $400 per employee for certain employer-provided length-of-service and safety achievement awards that satisfied certain conditions. Such awards had to consist of "personal tangible property" such as a watch, purse, etc. But, the term "tangible personal property" was otherwise undefined in the Code. The IRS provided a definition in Publication 15-B that excluded awards of cash, cash equivalents, and other items as tangible personal property.

The 2017 Act amends section 274(j)(3) to define tangible personal property as excluding cash, cash equivalents, gift cards, gift coupons or gift certificates (other than those entitling the individual to limited pre-selected tangible personal property items), vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items.

Settlements

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Under the 2017 Act, under section 162(q), no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement as of December 22, 2017.

Frequently Asked Questions

1. *Are employers reducing fringe benefits available to employees in light of deduction limits?*

   When associated costs change (in this case, the loss of deduction), employers must always consider whether to continue offering such benefits in light of there being no change in the taxation to employees, the employer's culture, as well as the employer's need to recruit and retain talent.

2. *Is depreciation limited by any of these deductions?*

   Additional guidance is needed to clarify the exact application of the deduction limits. Depreciation may limit deductions where the limitation specifically notes facilities.

3. *How does the deduction limit apply to employer-provided meals where the amount paid by employees equals or exceeds qualified direct costs?*

   Additional guidance is needed to understand how the deduction limit is calculated and whether it extends to reimbursed amounts as well as facilities.

4. *Are limited gift cards still permissible under the revisions to the employee achievement award?*

   Yes. Limited gift cards that provide for an item of tangible personal property are permitted.

5. *How is the disallowance applied when an employee makes a pre-tax election for qualified transportation benefits or, alternatively, the amount is reported as wages?*

   Additional guidance is needed to understand how the deduction disallowance is calculated and whether it extends to employee elective amounts or amounts reported as wages when those amounts may otherwise qualify as a qualified transportation fringe.

6. *Do I now need to report income for employer-provided meals because of the 2017 Act?*

   No, the rules related to income tax treatment (such as possible exclusion from income under sections 119 and 132) and reporting of employer-provided meals remain unchanged.

7. *Will employers need to change how they track certain expenses?*

   In many instances, the fringe benefits affected by the 2017 Act retain the individual tax implications, but change the employer implications such that existing tracking mechanisms were not designed with this in mind and are likely insufficient to fully capture such implications.

8. *Does the deduction disallowance apply to bicycle commuting benefits?*

   Because bicycle commuting benefits are taxable to employees until 2026, from 2017 through 2025, employers will be able to deduct expenses or payments or reimbursements to employees for bicycle commuting benefits because those expenses are included in employee income and are not qualified transportation benefits during this period.

9. *If settlements are disclosed, are there different rules?*

   New section 162(q) may effectively require taxpayers to choose between non-deductibility of the payment and non-disclosure of the settlement. These considerations could complicate settlement negotiations. Until and

unless a statutory change is made or the Treasury or IRS releases interpretive guidance otherwise, litigants should carefully consider the effect of the statute's plain text in their planning.

10. *How does the qualified transportation fringe deduction disallowance apply when the employer-provided parking is on a shared lot open to the public, on a lot limited to employees, or a building lot open to other tenants, etc.?*

    Guidance will be needed to understand the exact application of these rules in situations such as those outlined above. In particular, situations that are not a straightforward provision of benefits or reimbursements.

FOOTNOTES:

1 For the text and status of H.R. 1, click here.

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