Tax Cuts and Jobs Act Brings Extensive Tax Changes

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H.R. 1 delivers opportunities and obstacles—as well as some familiar uncertainties—for PEOs and their clients.

On December 22, 2017, President Trump signed H.R. 1 (also known as the Tax Cuts and Jobs Act) into law with relatively muted fanfare following the whirlwind eight-week period in which Republicans ushered the massive tax bill through Congress without Democratic support. The flurry of activity and frequent changes that characterized H.R. 1's legislative progress meant that many employers and employees left work for the holidays before knowing which provisions would ultimately make it into the new law. Because most of the changes made by H.R. 1 were effective almost immediately on January 1, 2018, affected taxpayers began scrambling in the New Year to understand the law's provisions and determine what actions—if any—they should take in response.

This article highlights some of the key changes made by H.R. 1 that affect employers and employees, including PEOs, PEO clients, and worksite employees. In addition to the usual drafting errors that occur when a bill of this magnitude is passed so quickly, the legislative pace allowed little time to consider how some provisions could affect a broad spectrum of taxpayers. As such, the resulting uncertainty surrounding how some provisions of H.R. 1 apply overall, and in the PEO context specifically, is unsurprising. While the basis for some of these new uncertainties (including allocation of responsibilities between co-employers) are familiar to PEOs and their clients, the stakes with respect to certain H.R. 1 provisions could be significant.

Tax Rates

A primary driving force behind H.R. 1 was Republicans' desire to reduce income tax rates for both individuals and corporations. A particular point of emphasis was targeting tax reductions to job-creating entrepreneurs, including owners of pass-through entities.

Individual Income Tax Rates

Prior to H.R. 1, there were seven income tax brackets, with the top rate of 39.6 percent applying to taxable income over $480,050 (joint returns) in 2018. H.R. 1 retains the seven brackets, but it reduces several of the rates (including lowering the top rate to 37 percent) and raises the income thresholds at which some of the brackets apply. These changes apply beginning in 2018 and sunset after 2025, as shown in Table 1.

Capital Gains and Dividends

The tax rates (0, 15, and 20 percent) and income thresholds for capital gains and dividends taxation remain the same.

The IRS issued 'initial withholding guidance' in January and encourages employers to implement withholding changes in February. The guidance is expected to work with employees' existing Forms W-4. The withholding tables and systems for 2017 should be used in the meantime.

Corporate Income Tax Rates

H.R. 1 replaces the four corporate income tax brackets (35 percent top rate) with a single flat tax rate of 21 percent effective for taxable years beginning after 2017.

New Deduction for Pass-Through Entities

Business income received from a pass-through entity (such as a partnership, sole proprietorship, or S corporation) "passes through" to the individual business owner, meaning that no separate or different tax rate is applied to such business income. Although H.R. 1 retains this pass-through structure, it creates a new income tax deduction for certain business owners as a means of providing an even lower effective

Table 1. Comparison of 2017 and 2018 income thresholds and rates.

2017	Joint	Individual	2018	Joint	Individual
10%	$0	$0	10%	$0	$0
15%	$18,651	$9,326	12%	$19,051	$9,526
25%	$75,901	$37,951	22%	$77,401	$38,701
28%	$153,101	$91,901	24%	$165,001	$82,501
33%	$233,351	$191,651	32%	$315,001	$157,501
35%	$416,701	$416,701	35%	$400,001	$200,001
39.6%	$470,701	$418,401	37%	$600,001	$500,001

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individual income tax rate than the already reduced rates described above.

Beginning in 2018 (but sunsetting after 2025), H.R. 1 generally allows taxpayers to deduct (solely for federal income tax purposes) the "combined qualified business income amount" from a pass-through entity in an amount up to 20 percent of the taxpayer's taxable income (after the deduction of any net capital gain). The qualified business income amount of each particular qualified trade or business is generally 20 percent of the taxpayer's income attributable to that trade or business (subject to several limitations), but it generally cannot exceed the greater of 50 percent of the W-2 wages paid with respect to the trade or business or the sum of 25 percent of such W-2 wages and 2.5 percent of the unadjusted basis at acquisition of the business's "qualified property"(defined as tangible depreciable property). For this purpose, W-2 wages means, with respect to any person, the wages, elective deferrals, and Section 457 deferred compensation that are paid by the person with respect to non-owner employees. Note that other employer contributions to retirement plans (e.g., matching contributions) do not count as W-2 wages.

The W-2 limit described above does not apply to taxpayers with taxable income (from all sources) below $315,001 (joint returns) or $157,501 (individuals) in 2018, and the limit phases in for those with income between $315,001 and $415,000 (joint returns) or $157,501 and $207,500 (individuals) (all amounts indexed). In addition, business income from a "specified service trade or business" is generally not eligible for the new deduction unless the taxpayer's income is under the same thresholds. Such ineligible businesses include those performing legal, accounting, financial, or certain other specified services, and any other business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

Another area where there is some uncertainty involves the proper allocation between the client and the PEO with respect to the W-2 wages paid under the PEO's employer identification number (EIN) to worksite employees. H.R. 1, in new Internal Revenue Code (IRC) Section 199A, provides that for this purpose, W-2 wages means "with respect to any person for any taxable year of such person, the [total wages, elective deferrals, and Section 457 deferred compensation] paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year." That language, as is often the case, fails to adequately address tri-party employment relationships involving a PEO, but it also uses the phrase "paid by such person," which does not directly link the definition to the entity filing the W-2. Still, PEOs and their clients (and clients' tax advisors) will need to determine how to handle H.R. 1's new business income deduction until or unless further guidance is provided.

> The new business income deduction for pass-through entities will be advantageous for many PEOs and PEO clients that are organized as pass-through entities. However, the complex new provision leaves many questions that are not clearly answered. For example, a pass-through entity must determine whether it meets the definition of a 'specified service trade or business' such that the deduction is unavailable (unless the taxpayer's taxable income is below the relevant thresholds). Although it does not initially appear that a typical PEO would be treated as a specified service trade or business, PEOs that are organized as pass-through entities should nevertheless review the definition and consult with their tax advisors.

Fortunately, there is some directly analogous IRS guidance that may provide some insight into the proper application of the new business income deduction in the PEO context. The IRC Section 199 domestic manufacturing deduction (which was repealed by H.R. 1) was also limited based on wages paid, *using the same definition of W-2 wages stated above*. Regulations under IRC Section 199 subsequently clarified that taxpayers "may take into account any wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer."

In other words, the fact that a particular entity pays the wages is not necessarily dispositive of which entity should take those wages into account in claiming the deduction. Many PEO clients have, for many years (and seemingly without IRS complaint), counted W-2 wages paid by the PEO to worksite employees to calculate the Section 199 deduction claimed by the client. In this regard, it may also be significant that the IRS has (in regulations under IRC Section 3504) made clear that both the PEO and the client may have responsibility for the payment of wages by a PEO in a traditional PEO co-employment relationship. Moreover, for certified PEOs (that have sole employment tax liability), the IRS has specifically required quarterly Schedule R client-by-client reporting of wages paid to all worksite employees.[1]

Select Business Tax Provisions

In addition to the changes described above, PEOs and their clients may be affected by the following changes:

Qualified Transportation Fringe Benefits

Beginning in 2018, H.R. 1 disallows any employer deduction for almost all qualified transportation fringe benefits (including parking, transit benefits, and vanpools). Although the employee exclusion for receiving qualified transportation fringe benefits is generally retained,

1 Similar issues also were raised with respect to the application of the wage-based phase-out of the Small Business Health Care Tax Credit under IRC Section 45R, following enactment of the Affordable Care Act (ACA). In that instance, the legislative history confirmed that the client could count the PEO-paid wages in determining eligibility for the credit.

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the loss of the employer's deduction will substantially increase the employer's cost of maintaining these programs and could have a significant impact on the employer's decision to continue to provide these benefits.

Entertainment and Meals

H.R. 1 generally disallows any employer deduction for activities considered to be entertainment, recreation, or amusement (including certain meals) unless the activity qualifies for a specific exception under the Tax Code. Although the full scope of these provisions remains unclear, activities that could lose a tax deduction include employer-paid tickets to entertainment events and, in some cases, meals.

Employee Achievement Awards

Beginning in 2018, the employer deduction and employee exclusion for employee achievement awards is not allowed for cash or other similar items, though the deduction/exclusion remains available for some tangible property as well as gift certificates that allow the recipient to select from a limited array of items.

Other Changes

H.R. 1 contains a number of provisions that could be beneficial to PEOs and their clients, including the full and immediate deduction of 100 percent of the cost of certain qualified property for a limited period of time and expanded small business expensing. On the other hand, businesses that carry significant debts will be burdened with a new limit on the deduction of business interest expenses that will apply to all businesses with average annual gross receipts of $25 million or more.

Select Individual Tax Provisions

Some key changes that could affect worksite employees, PEO internal employees, and client company owners include:

State and Local Tax Deduction

Beginning in 2018, the deduction for state and local property and income taxes (or sales taxes in lieu of income taxes) is limited to $10,000 ($5,000 if married filing separately). (This limit does not apply to real or personal property taxes paid or accrued in carrying on a trade or business.)

Individual Health Insurance Mandate

The individual mandate penalty is set to zero beginning in 2019.

Moving Expenses

H.R. 1 suspends the employee deduction and exclusion for job-related moving expenses and reimbursements paid before 2026, except for members of the armed forces.

Individual AMT

For 2018, the alternative minimum tax (AMT) exemption is increased from $86,200 to $109,400 (joint returns), and the income level at which the exemption begins to phase out is increased from $164,100 to $1 million (joint returns).

At nearly 500 pages long, the new tax law is not easily summarized in a few pages. As the dust settles on H.R. 1, PEOs should familiarize themselves with any relevant changes made to the Tax Code, with an eye to both their own businesses and to the impact that such changes could have on their clients. In addition to the new deduction for pass-through entities, several provisions in H.R. 1 could ultimately affect how PEOs and their clients choose to operate, including the scope of benefits that are offered to employees. ●

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