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Tax Reform and Retirement: What Plan Sponsors Need to Know

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Tax reform, and its impact on retirement plans, has weighed heavily on the minds of many plan sponsors since the new administration took office. The developments over the past few weeks, as the plans have been released and revised, leave the heads of many plan sponsors spinning. Let's take a look at what has happened thus far, how the proposed changes could affect retirement plans, and what plan sponsors can expect moving forward.

WHERE ARE WE IN THE PROCESS?

On November 16, 2017, the House passed a tax reform bill, the Tax Cuts and Jobs Act. That same day, the Senate Finance Committee passed its markup of the Act, which was then modified to change several provisions of the initial markup.

The next step will be for the full Senate to debate the measure. If the Senate passes their bill they will need to reconcile it and the House's bill (which is substantially different), into a single piece of legislation that both the House and Senate can approve. This single bill would ultimately be signed into law with President Trump's approval.

SIMILARITY AND DIFFERENCES BETWEEN THE TWO BILLS

With respect to retirement plans, the House and Senate bills are dramatically different. The House bill makes some minor tweaks to retirement plan law, which will have little impact on the day-to-day operation of retirement plans. However, the Senate bill makes several more significant changes that will affect 403(b) and 457(b) plan sponsors considerably.

The House and Senate bills have just two retirement plan-related provisions in common, both of which are relatively minor:

- **Allowing employees, upon termination of employment, the option to no longer be "stuck" for the taxes on outstanding loans —** Some retirement plans do not permit the continued repayment of loans following termination of employment; for those plans, the outstanding loan, unless offset by the participant's account balance, will be taxable to the participant unless a contribution to an IRA is made within 60 days of termination of employment. The proposal extends this deadline to the due date of the tax return for the tax year of termination. This rule has always been a tough one for terminating employees, so this change should be welcomed.
- **Eliminating the ability to re-characterize traditional to Roth IRA conversions, or vice versa —** While not of significant concern for qualified retirement plan sponsors, this retirement-related provision is worth mentioning. Apparently, people were using this strategy as a means to

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avoid paying certain taxes. An example provided in the bill was someone converting to a Roth IRA, investing aggressively, benefiting from any gains (which are not subject to tax), and then retroactively reversing the conversion if the taxpayer suffered a loss, so as to avoid taxes on some, or all, of the converted amount. Most people are probably okay with this change, except for those who were taking advantage of the provision.

THE HOUSE BILL

Aside from the shared provisions listed above, the other retirement-related changes of the House's bill are not too difficult for plan sponsors to swallow and, in fact, may even be welcomed:

- **Allowing age 59½ in-service distributions in all retirement plans —** Previously, defined benefit plans and state/local government defined contribution plans, unlike other plan types, could only permit in-service distributions upon attainment of age 62. This seemed like a silly rule, and we suspect most people would be glad to have it reduced to 59 ½.
- **Directing the Treasury to eliminate the six-month suspension of elective deferrals following a hardship distribution —** This has always been an administratively burdensome and unpopular rule, so good riddance to it as well.
- **Allowing employers to permit hardship distributions of earnings, as well as employer contributions —** Limiting hardship distributions to only elective deferrals (without earnings) has also been a difficult rule to administer and explain to participants. Many plan sponsors may continue to prohibit the in-service distribution of employer contributions to preserve retirement assets; however, with this change, they would have the option to use the same hardship rules that apply to elective deferrals (and now earnings). We don't expect many objections to this change, either.
- **Permitting more flexible nondiscrimination testing rules, where both a defined contribution (DC) and a defined benefit (DB) plan are maintained by a plan sponsor —** This is another change that should be well received. Since many employers in scenarios such as this have closed their DB plans to new entrants, it can be easy to run afoul of the existing nondiscrimination testing rules.

THE SENATE BILL

However, unlike the House bill, the Senate markup adds some restrictive retirement plan rules that will directly affect tax-exempt and governmental plan sponsors:

- **Combining the 403(b)/401(k) elective deferral limit with the 457(b) limit —** Instead of separate limits for these plans, the Senate proposed a single elective deferral limit beginning in 2018. This would effectively eliminate the use of 457(b) plans at tax-exempt organizations, such as colleges/universities and healthcare institutions, as well as at public school districts (state/local governments are largely unaffected, since they often offer 457(b) as standalone plans for elective deferrals). The reason for this is that the vast majority of these entities sponsor 403(b) or 401(k) plans alongside their 457(b) plans. With one elective deferral limit, it wouldn't make sense to defer those dollars into a 457(b) plan instead of a 401(k) or 403(b) plan, so 457(b) plans would no longer be necessary.

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Now, the lofty separate limits were ripe for reduction (as discussed in a recent Top of Mind post); however, eliminating the extra deferral opportunity entirely, effectively doing away with 457(b) plans, seems excessive.

We should note that as the Senate bill is currently written, 457(b) limit aggregation with 403(b) would apply only to 457(b) governmental plans and not 457(b) plans of non-governmental entities, such as private tax-exempt and religious organizations. However, this may simply be an oversight, as private tax-exempt organizations' 457(b)s are not referenced in the markup, even in the explanation of current law.

This will likely be corrected, because, as written, the political optics are quite poor. The 457(b) plans of private tax-exempt organizations, which are currently excluded from this change, exclusively benefit "select management and highly compensated employees" (with the exception of faith-based colleges/universities and religious hospitals). The individuals affected are primarily public K-12 school teachers. Therefore, as written, the elective deferral limits would be reduced for teachers, but not for university presidents, college coaches, healthcare CEOs, etc.

- **Eliminating the separate 415 limits when a plan sponsor establishes both a 403(b) and a 401(a) plan —** Again, this limit was ripe for reduction, but eliminating the separate limit entirely is extreme. This change would likely result in a number of affected plan sponsors ditching their 401(a) plans, since the separate limit may be the primary reason for the 401(a) plan's existence.
- **Eliminating the 3-year catch-up for 457(b) plans —** There are few who actually use this provision, so it should not have too large of an impact on plan sponsors.
- **Eliminating the rule that allowed for contributions to a 403(b) plan for up to 5 years after retirement —** Utilization, again, is typically quite low; however, this is an unfortunate provision to lose.
- **Eliminating the 15-year catch-up election for 403(b) plans, which permits additional elective deferrals to 403(b) plans for certain employees —** As we have previously discussed, this complicated election is useless for the vast majority of participants. This particular change should be welcomed by plan sponsors.

The Senate bill contains some additional minor provisions that affect limited employee groups, such as public safety employees, individuals subject to IRS tax levies on their retirement plans, and those in the Mississippi River Delta flood disaster area.

CONCLUSION

Unlike the House's proposal, the Senate's bill includes changes that could negatively affect tax-exempt and governmental plan sponsors. Many of the tax benefits exist to help these employers attract and retain talent, since they are often not able to compensate employees as competitively as private-sector employers. Should the House's changes become law, they may worsen the problem.

The coming weeks will be important for plan sponsors of all types, as we watch the reconciliation of the two bills and ultimately, the President's actions. Stay tuned to Cammack Retirement for all of the imperative updates.

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