Employee Benefits Corner

Tax Reform Brings Some 2018 Changes for Qualified Plans

By Elizabeth Thomas Dold and David N. Levine

On December 22, 2017, President Trump signed into law a comprehensive tax reform bill, H.R. 1, known as the Tax Cuts and Jobs Act. This law brings with it the most comprehensive changes to the Internal Revenue Code (the "Code") since 1986, impacting businesses and individuals, including compensation and benefit practices for a variety of employers. But what is notable for qualified plans is the provisions and relief that did not make the final cut, because what did remain has far less reaching impact for plan sponsors and third-party administrators. This lack of changes comes to a relief to many, particularly in light of the fact that the majority of the law became effective as of January 1, 2018. Without any lead time, the fewer the changes help retain the tax-favored status of these plans. But that said, Congress is not done with pension reform, and a number of bills are coming on the scene that may well pick up steam, particularly without the legislative limitations that are placed when a bill, like H.R. 1, comes through the budget reconciliation process.

What Changes Were Not Made

Some of the noteworthy provisions that did not make the final cut include:

- *Rothification*. Is that a word? Well yes, this term refers to a pay-for provision (*i.e.*, it raises quite a bit of revenue) that would require at least some portion of a participant's elective deferral to a 401(k) or 403(b) plan to be made as a Roth contribution (*i.e.*, immediately subject to income tax). A change from our long-standing tax deferral benefit program is not something that is entered into lightly.
- *Nondiscrimination and Minimum Participation Coverage for Frozen Defined Benefit Plans*. The bills had a number of helpful provisions designed to facilitate continue plan qualification for certain frozen defined benefit plans (and related make-whole payments under a defined contribution plan). As time passes, these frozen plans have more difficulty continuing to pass various nondiscrimination provisions under the Code (including benefits, rights, and features testing), which the bill would have provided helpful relief. The IRS has issued proposed regulations that provide some relief for frozen plans, but these rules are not yet effective, and do not provide any relief under Code Sec.

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401(a)(26) that requires plans to provide minimum coverage that at some point as participant's retire and commence their benefits, the provision at some point will be violated, raising plan qualification issues.

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- *Relaxed Hardship Provisions*. The bills had various provisions designed to facilitate hardship distributions, including (1) expanding availability of hardship withdrawals to qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), 401(k) safe harbor plan contributions, and all earnings of various contributions (2) eliminating the six-month suspension period for contributions following a hardship distribution, and (3) eliminating the need to first take all available plan loans prior to taking a safe harbor hardship withdrawal. These provisions would have been welcomed relief by plan sponsors and plan participants.
- *Lowering the In-service Distribution Age for Pension Plans*. The bill would have lowered the optional in-service distribution age under Code Sec. 401(a)(36) from age 62 to age 59-1/2, consistent with 401(k) withdrawal restrictions. (The bill would have made a similar change to certain 457 plans, allowing an in-service distribution at age 59-1/2 rather than age 70-1/2.)

What Changes Were Made

The key changes include:

- *Indirect Rollover Period Extended for Certain Loan Offsets*. A plan loan that is properly repaid is typically not a taxable event. However, if a participant terminates employment while a loan is still outstanding, many plans provide a participant a period (*e.g.*, 30–90 days) to repay the outstanding balance, and if not repaid, the loan will be treated as a default and a loan offset, which is eligible for rollover. In such an event, the outstanding loan balance is treated as a taxable distribution on Form 1099-R, and the participant has 60 days to come up with funds to roll to another eligible employer plan or IRA and avoid the tax hit. The law has extended this typical 60-day rollover period to the tax filing deadline (plus extensions) for the year of the loan offset. The law provides this same relief if the loan offset is due to the plan being terminated. This provision is effective as of January 1, 2018. Therefore, plan sponsors and recordkeepers should update their 402(f) notice and review their loan policies and procedures to facilitate this extended rollover period.
- *Change in Hardship Withdrawals*. Although the law does not directly make any changes to the hardship withdrawal provisions, these provisions are impacted indirectly as a result of a change in the casualty loss deduction under Code Sec. 165. Specifically, effective January 1, 2018 (through 2025), a casualty loss is not deductible unless it is attributable to a Presidentially declared disaster. And as one of the deemed safe harbor withdrawal reasons is for damage to the participant's principal residence that qualified as a casualty deduction under Code Sec. 165 (without regard to the income limit threshold), this change also extends to hardship withdrawals. Therefore, plan sponsors and recordkeepers should update their safe harbor withdrawal procedures to take into account the Presidentially declared disaster limitation.
- *Eliminate the Ability to Recharacterize Roth Conversion*. For some years now the Code permitted participant's to roll over their qualified plan benefit to a Roth IRA, and if through the tax filing date (plus extensions) the participant wanted to change their mind and recharacterize the conversion to a traditional IRA and avoid the immediate tax hit, they could. This was common in the event that the IRA lost value from the date of the rollover, as no one likes to pay taxes on income that no longer exists. The law now prohibits recharacterizations of Roth conversions on or after January 1, 2018.
- *Additional Disaster Relief for Certain Plan Distributions*. The law provides retroactive relief for Presidentially declared disaster for 2016, which includes various storms, fires, and flooding throughout the country. This relief is similar to the relief provided recently to Hurricanes Harvey, Irma, and Maria, but does not provide similar loan relief (which makes sense as this is retroactive guidance). Specifically, for distributions made in 2016 and 2017, plan sponsors

and participants may elect the following special tax relief for "qualified 2016 disaster distributions":

- No 10% early distribution tax (Code Sec. 72(t)),
- Not eligible for rollover treatment,
- Not subject to 20% mandatory withholding,
- Permissible in-service distribution,
- Taxed *pro rata* over a three-year period, and
- Can be recontributed to an eligible retirement plan within three years.

This relief is available to disaster victims resident in any area with respect to which a major disaster has been declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act during calendar year 2016 of up to $100,000 from a 401(a), 403(b), IRA or governmental 457(b) plans on or after January 1, 2016, through December 31, 2017. Such individuals must have had a principal place of abode at any time during 2016 in a disaster area and have sustained an economic loss by reason of events giving rise to a Presidential disaster declaration.

Plan sponsors electing to make such distributions are generally required to amend the plan by the end of the 2018 plan year (unless a later date is indicated by the Secretary).

- *Changes to Definition of Plan and Testing Compensation*. A plan may have a number of definitions of compensation used in the plan, from benefitable compensation for benefit accruals and contributions, to 415 compensation (for Code Sec. 415 benefit limitation purposes), to nondiscrimination testing compensation. And while the new law did not change any of these Code requirements, it did make a number of changes to various fringe benefits and the deductibility of the same. For example, qualified moving expenses are no longer tax-free. Therefore, after the impact of the fringe benefit changes is determined, plan sponsors should also review their plans to ensure that any changes are properly reflected under the qualified plan's definitions of compensation. Taking into account the proper payroll earnings codes is critical to avoid costly corrections, and is high on the IRS's list of areas to review in audits, so careful attention is in order.

Conclusion

Plan sponsors and recordkeepers should properly take steps to comply with the new law, and stay tuned for more comprehensive pension changes to come.