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Tax Cut Law a Mixed Bag for Retirement Plan Sponsors

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Despite early indications that Congress was prepared to do much more, the Tax Cuts and Jobs Act (TCJA) that was passed in December largely left retirement plans unscathed, save for changes pertaining to plan loans and IRA conversions. Here's a quick review of areas that are affected, as well as what could be ahead.

Plan loan relief

The new law gives a break to plan participants with outstanding loan balances when they leave their employer. Ordinarily, participants with outstanding loans who fail to make timely payments after their separation from the employer are deemed to have received a distribution in the amount of that outstanding balance. Under pre-TCJA law, they could, however, roll that amount (assuming they have sufficient funds available) into an IRA without tax penalty if they do so within 60 days.

Under the TCJA, beginning in 2018, former employees in this situation will have until their tax return filing due date (including extensions) to move funds equal to the outstanding loan balance into an IRA or qualified retirement plan without penalty. They're given the same opportunity if they're unable to repay a loan due to the plan's termination.

Roth IRA recharacterization

The TCJA also restricts individuals' ability to recharacterize conversion contributions to a Roth IRA as if they were still making contributions to a traditional IRA. In other words, beginning in 2018, individuals can no longer convert a traditional IRA to a Roth IRA and then later recharacterize that Roth IRA contribution back to a traditional IRA contribution to essentially undo the conversion. However, taxpayers can still recharacterize new Roth IRA contributions as traditional contributions as long as they do it by the applicable deadline and meet all other rules.

While not immediately pertinent to plan sponsors, this provision may be a warning shot across the bow with respect to possible future restrictions on 401(k) plans. Roth 401(k)s are favored by revenue-seekers in Congress, because the after-tax nature of contributions to Roth plans — IRAs or 401(k)s — enables the federal government to collect more tax revenue in the present, pushing off into the future the drain on tax revenue due to the tax-free nature of withdrawals from Roth plans.

Higher costs for pass-through entities?

The American Retirement Association (ARA) expressed concern that the TCJA's tax-cutting features applicable to pass-through entities like S corporations could discourage 401(k) plan sponsorship. Specifically, allowing taxpayers to deduct 20% of qualified business income could make 401(k) plans, in effect, costlier to owners of S corporations on an after-tax basis, if they couldn't apply their tax deductions for their 401(k) contributions to their more highly taxed personal income instead of their qualified business income.

It's not clear, however, that increasing, by possibly a relatively small amount, the after-tax cost of maintaining a 401(k) plan to a business owner would warrant terminating a plan when weighed against other benefits to the business associated with sponsoring such a plan.

Looking ahead

The fact that several provisions detrimental to retirement plans made it to the debate stage and even into early drafts of tax reform bills could open the door to future efforts to restrict plans' tax benefits. The need for federal revenue will continue, with the government looking for places to collect that revenue.

One provision that cleared the Senate Finance Committee, but was ultimately dropped, would have required that all contributions to any defined contribution plan sponsored by the same employer (including mandatory employee contributions to a defined benefit plan) be aggregated when determining whether contributions to a participant's account satisfy IRC Sec. 415(c) limits. That change would have raised $1.7 billion over a 10-year period, the Committee's staff estimated.

Similarly, Congress considered imposing a low ($2,400) cap on pretax 401(k) contributions, requiring the balance of the total $18,000 limit on contributions to be made on an after-tax basis. Congress could revisit that concept and push employers to convert traditional 401(k) plans to Roth plans, if budget deficits balloon, the ARA warned, echoing the concerns also expressed by the American Benefits Council.

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