LEGAL UPDATE

Tax Reform Will Have Limited Effect on 401(k) Plans

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Prior to the enactment of the act formerly known as the Tax Cut and Jobs Act, there was a great deal of speculation, as well as consternation, in the weeks leading up to the release of the House and Senate bills on tax reform that Congress would seek to pay for the tax cuts under tax reform by reducing the pre-tax deferral amount to perhaps as low as $2,400, while providing that any additional contributions up to the statutory limit ($18,500 in 2018) would be Roth after-tax contributions—an approach that was referred to as Rothification. Whether this approach would generate any long term increase in revenue was questionable, but it clearly would have raised revenue in the 10-year period used to score legislation. However, neither the House Bill nor the Senate bill, nor the final conference agreement, contained any such language. Further, although both the House bill and the Senate bill contained provisions dealing with tax qualified plans, 403(b), and 457(b) plans, including seemingly beneficial provisions such as modifying the nondiscrimination testing requirements for soft frozen defined benefit plans and providing for in-service distributions from pension plans at age 591/2. None of these provisions made the final cut, and only two provisions directly affect tax-qualified plans, and one of which only applies to a limited subset. First, there is an extended rollover period for plan loan offset amounts, a useful provision for plan participants, but one that does not affect plan administration. Under pre-Act law, which provide that termination of employment is an event of default accelerating repayment of an outstanding plan loan, if the loan was not repaid to the plan, the participant's account balance was reduced by the amount of the unpaid loan balance; this amount is referred to as the loan offset. This loan offset amount is eligible for tax-free rollover to another eligible retirement plan within 60 days of distribution. Under the Act, for plan loan amounts which are treated as distributed in taxable years beginning after December 31, 2017, the period during which a qualified plan loan offset amount can be rolled over into an eligible retirement plan such as another tax-qualified plan or an IRA is extended from 60 days after the date of the offset, to the due date (including extensions) for filing the federal income tax return for the tax year in which the plan loan offset occurs. The second provision provides, among other things, for an exception to the 10 percent early withdrawal tax for an amount not in excess of $100,000 of qualified 2016 disaster distributions, defined as distributions from an eligible retirement plan in 2017 and 2018 to an individual whose principal place of abode at any time during 2016 was in a 2016 disaster area, and who has sustained an economic loss by reason of the events that gave rise to the Presidential disaster declaration.

The Code provision that permits a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA will not apply to Roth conversions, but will still be permitted with respect to other types of IRA contributions. For example, if a taxpayer makes a contribution to a Roth IRA, it can be recharacterized as a contribution to a traditional IRA, so long as it is done prior to the due date of a taxpayer's return, including extensions.

The portion of the tax reform legislation that may have the greatest impact upon 401(k) plans is a provision that on its face has nothing to do with 401(k) plans, namely, the provision providing for a 20 percent deduction on qualified business income for pass-through businesses-sole proprietorships, sub S corporations, and partnerships. As a result of that legislation, certain individuals may be in a more favorable federal income tax position if they can successfully terminate their employment relationship with their employer, and recast it as an independent contractor relationship to a service recipient. This will be easier to accomplish in some fields than in others, and it also assumes that tax considerations will be an individual's primary motivation and will offset what he or she loses by a change in status to an independent contractor, including protections under various federal statutes. However, if the change in status is recognized by the IRS he or she will no longer be able to participate as an active participant in a 401(k) plan, although unless he or she had a very small account balance that would be mandatorily cashed dirt under the plan, he or she could retain his or her investments in the plan.

To address the possibility that the IRS will not recognize the change in status, the plan should contain language excluding individuals whom the plan sponsor treats as independent contractors from the plan, even if a governmental agency such as IRS were to recharacterize them as employees.

A second possible result of the pass-through deduction and here too an unintended consequence is that, because the deduction for a sub-S corporation owner to a tax qualified plan is reduced because of the 20 percent deduction, and said individual will pay taxes at a higher rate upon distribution from the plan, that certain owners may freeze or terminate their 401(k) plans, notwithstanding the loss of compounding on a tax free basis under a 401(k) plan until the date of distribution. Those organizations that have lobbied Congress

with respect to this issue are likely overstating the negative effects of the current Code structure, if for no other reason than the owner of a sub-S corporation is in many instances maintaining a 401(k) plan to provide retirement income to others and maintain a compensation package that is market for his or her line of business, but it is possible that some small sub-S corporations will in fact freeze or terminate their 401(k) plans.

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