Flashpoint: The New Tax Bill Is Enacted- What Does This Mean for Retirement Plans?

The Tax Cuts and Jobs Act—actually the name the Senate Parliamentarian insisted on is "An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018"— ("New Law") was passed by both houses of Congress and signed by the President on December 22,2017.

Those of us who have been in the benefits biz for a long time have a lot of experience with the changes that a new tax bill normally wreaks on retirement plans. This bill, however, is different. It makes very few benefits changes directly, although the change in the tax structure contained in the bill may affect retirement plan formation and maintenance.

Here is our initial take on the New Law's effect on retirement plans. The provisions we discuss are effective in 2018.

No Significant Changes to Retirement Plan Contributions or Benefits

If you followed the discussions about retirement plans during the New Law's infancy, you know that there were many proposals that would have reduced retirement savings ability. From reduction of limitations on contributions to proposed "Rothification" of plans that would have converted contributions from tax-deferred to taxable, the proposals caused us all to hold our collective breath with anxiety. The good news is: there were no major changes to the general structure of qualified plans, including 401(k) plans, nor reductions in the amounts that can be contributed. Let's all say together: "Whew!"

Nonetheless, retirement plans were not unscathed.

The Effect of the New Pass-Through Income Rules on Business Owners Who Sponsor Plans

The feature of the New Law that is likely to have the most impact on retirement plans is not a retirement plan provision at all, but one that affects the taxation of owners of pass-through entities, such as S-corporations, partnerships, and sole proprietorships.

We should note at the outset that this section does not apply to people in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services with income above a certain amount (which depends on personal tax filing status). In addition, amounts paid to an S-corporation shareholder that are on the Form W-2 (i.e., constitute reasonable compensation for services) do not get the treatment discussed below. This means, of course, that the disincentive that is discussed below will not affect all of your professional clients.

Anytime that tax rates are lowered, the value of the tax deduction for plan contributions goes down. So, suppose Marco, a business owner, contributes $100,000 to the plan and is in the 39.6% tax bracket under the current rules. Under current law, he saves $39,600 in taxes by making that contribution. If Marco is subject to the 32% tax bracket under the New Law, that deduction goes down to $32,000, so is $7,600 less valuable to Marco than under the old rules.

However, the New Law throws another ingredient into the mix. Under the new rules, owners of unincorporated entities are given a deduction equal to 20% of their "qualified business income," which is (generally) their net income from the business.

Let's look at the effect on Marco. This 20% deduction means that the effective tax rate on the income from the business is 32% x 80% (i.e., the portion of the income that is subject to tax after the 20% deduction), or 25.6%. This means that the value of Marco's tax deduction for the $100,000 contribution has now been reduced to $25,600—that is, $14,000 less than under current rules, and $6,400 less than it would have been under the New Law without the application of the pass-through deduction.

Okay, that is one disincentive for a business owner to contribute to a plan—the deduction is less valuable to him because of the lowered tax rate.

But, that's only part of the issue. The real problem arises because personal income unrelated to business—which includes a distribution from a retirement plan or IRA—does not receive the deduction on business income, but is subject to taxation at the full individual rate. In our example, this means that Marco would pay $32,000 in taxes when he ultimately retires and takes distribution of the $100,000 that he contributed to the plan—that is, $6,400 more than the tax savings he experienced at contribution. In other words, he doesn't just defer taxes by contributing to the plan; he actually increases his taxes in the long run by more than 20% (all other things being equal).

There are, of course, other reasons to have a retirement plan, including attracting and retaining staff, helping people prepare for retirement, and the sheltering of the funds from creditors. Furthermore, Marco would still benefit from the tax-free accumulation of his account in the plan. Nonetheless, if a business owner's main motivation for having a plan was his or her personal tax deferral and savings, the new tax structure for pass-through businesses acts as a disincentive to have a plan—an unfortunate result.

Other Retirement Plan Provisions of the New Law

Other provisions of the New Law that affect qualified retirement plans:

1. Extension of Time to Roll Over Plan Loan Offsets. This new rule will help participants who have borrowed money from their employer's plan to avoid unexpected taxation if they terminate employment or if the plan terminates.

Under current rules, if you have an outstanding participant loan and you terminate employment or the plan terminates, the plan administrator will generally offset your participant loan against your account and pay you what is left. When this happens, you are taxed on the value of the loan. You could also be taxed on the outstanding loan because your payments on the loan cease when you stop having payroll from which to deduct the payment. Either way, you are taxed on the loan balance, which is called an "offset."

Example. Joan has an account in her employer's 401(k) plan worth $30,000. She also has a participant loan from the plan of $10,000. Joan terminates employment with the employer and requests a distribution of her benefit under the plan. The plan offsets the $10,000 amount Joan has borrowed against the 401(k) account, and pays Joan the balance of $20,000. Joan is taxed, however, on the full $30,000, as the loan forgiveness is taxable income to her. (If she rolls over the cash part of her distribution, $20,000, she is still taxed on the $10,000 loan offset.)

There are two ways that Joan can avoid this taxation. First, she can repay the loan to the plan before her distribution occurs, permitting the plan to pay her the full $30,000 amount (and then she can roll over the total to an IRA or other plan). The second option is that Joan may receive the $20,000 net amount from the plan, add $10,000 of her own assets to the amount, and roll over the $30,000 taxable distribution from the plan to an IRA or another employer's plan. Under current law, she has only 60 days from the date on which the loan is offset to do this, and that is often too little time for a participant to come up with the money to make this happen.

The new law gives the participant more time. A participant who "receives" a loan offset will have until his or her tax return due date (including extensions) for the year during which the loan offset occurred to roll over the taxable amount of the borrowed funds to an IRA or other employer plan. So, if Joan experienced the loan offset sometime during 2018, she would have until her tax return due date of April 15, 2019 (or, if she extended her return, until October 15, 2019), to deposit the offset funds to an IRA or other employer plan.

This extension of time is available only if the loan becomes taxable due to a termination of employment or a termination of the plan (and not, for example, just because the participant had defaulted on the loan repayment while employed).

2. Denial of Recharacterization of Roth Contributions and Rollover. Under the current rules, if you make a contribution to a normal IRA and decide that you really intended it to be a Roth IRA (or vice versa), you may ask the trustee of your IRA to transfer the funds to the trustee of the other type of IRA. If you do this before your tax return due date, it is treated as if you made the initial contribution to the plan that the money ends up in. (In other words, you've "mulliganed" your deposit to be to the type of IRA that you wanted.) Under old law, this recharacterization ability applied to a rollover and conversion of pretax money to a Roth. (Of course, you must pay taxes on the amount moved to the Roth account in the year of conversion.)

Under the new rules, you cannot reclassify a conversion rollover once it has occurred. This means that, if you moved money from a conventional IRA or a pretax plan account to a Roth IRA in 2017, and were planning to reevaluate the decision by October 15, 2018, your deadline to

complete the recharacterization is now December 31, 2017. You will not be able to recharacterize rollover amounts after this year.

3. Relief for distributions made before January 1, 2018, to someone whose principal residence was located at any time during 2016 in a federally-declared disaster area and who sustained an economic loss due to the disaster. Under this relief, the amounts paid out up to $100,000 (less any other distributions previously taken for the 2016 disaster) have access to four advantages not normally available:

- o They are not subject to mandatory withholding or the 10% premature distribution penalty.
- o They are permitted even if such distribution would normally be prohibited under the Code's operational rules (e.g., 401(k) money that is normally not eligible for in-service distributions prior to age 59½). (Amendments to permit this may be adopted after the fact, but must happen before the end of the plan's 2018 year.)
- o The income tax bite on the distribution may be spread over three years, rather than totally payable in the year of distribution.
- o The amount distributed (or a lesser amount) may be deposited within three years of the date of the distribution to an IRA, qualified plan, 403(b) plan, or 457(b) plan, in which case it is treated as a nontaxable rollover to the recipient plan. In other words, no tax will be due on the amount that was distributed and then re-contributed.

Big Changes at FBLC

A lot is happening at year end for us.

First, we are very pleased and proud to announce that Alison Cohen is becoming a shareholder of the Firm, effective January 1, 2018. Anyone who has worked with Alison knows that this is well-deserved, as she is a terrific lawyer, a great manager, and a wonderful asset to the Firm.

Second, we have a new attorney named Adrienne Moore. Adrienne was a fellow student with our associate, Aaron Moody, at UGA Law, and joins us after practicing general law at King & Spalding here in Atlanta. We are very pleased to have Adrienne join us and look forward to converting her to be a true ERISA nerd in the days to come.

Third, we have a new office manager. Lori Coffey joined us this month. Lori has a long and proud history of being in office management roles at other law firms, and we are happy to have her with us.

We have another attorney who will be starting sometime in January, once she leases an apartment in Atlanta and moves from her native Texas. Tiffany Santhavi comes to us from British Petroleum in Houston, where she has worked in-house on the BP retirement plans for several years.

(In case you've lost track, that will mean we now have six lawyers, including Derrin Watson, who is of counsel to the Firm.)

And, last but not least, we have converted from an LLP to an LLC, and have removed the "LLP" suffix from our name. So, we are plain ol' Ferenczy Benefits Law Center now.

We want to wish everyone Happy Holidays and a Wonderful and Prosperous New Year! We'll see you in 2018!

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