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# Tax Reform's Impact on Qualified Retirement Plans

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House Republicans this week released much-anticipated legislation to reform individual and corporate income taxation. Titled the "Tax Cuts and Jobs Act," the legislation proposes substantial revisions to the Internal Revenue Code, including provisions that may impact qualified retirement plans as well as nonqualified deferred compensation and certain health and welfare benefits. Highlighted here are the significant proposals relating to qualified retirement plans that, if enacted, would benefit qualified plan sponsors and participants alike.

One anticipated proposal was not included in the legislation that would have reduced or eliminated the pre-tax deduction for elective deferrals to individual account plans under Code section 401(k). Instead, retirement savings would become primarily or solely subject to the Roth form of taxation where contributions are made after tax and withdrawals of those contributions plus any investment earnings are usually tax-free. Pre-tax contributions, on the other hand, are excluded from income when made but are included in income when contributions, and any earnings on those contributions, are withdrawn. The purpose behind this "Rothification" of retirement savings is to accelerate the taxation of traditional 401(k) retirement savings (and forego future taxation on Roth contribution earnings) to offset other changes made by the legislation that reduce revenue. While not part of the initial draft, these provisions could be added as the legislation works its way through Congress.

The retirement plan proposals that made it into the first draft of the legislation include:

- *Permanent "Closed Plan" Nondiscrimination Testing.* The proposed legislation would codify temporary guidance issued by the Internal Revenue Service and make additional revisions that would provide much-needed nondiscrimination testing relief to "closed" or "frozen" defined benefit pension plans. Many pension plan sponsors have frozen their defined benefit plans to participation by newly-hired employees, and replaced that benefit with a defined contribution retirement benefit. Over time, the closed defined benefit plan has difficulty meeting current nondiscrimination testing requirements as the number of highly compensated employees grows and is not offset by a constant supply of new hires, who are now participating in the defined contribution plan. The legislation provides relief by allowing the two plans to be "cross-tested" by converting the defined contribution accruals to defined benefit accruals, and then testing the benefits provided under both plans as though it were a single plan. Other proposed changes include relief from the requirement that defined benefit plans have at least 50 participants, relief from certain benefits, rights, and features testing requirements, and more favorable testing treatment for matching contributions

and equalization contributions to defined contribution plans.

- *In-Service Withdrawals from Defined Benefit Plans.* Currently, participants in defined benefit plans cannot begin receiving retirement benefits before reaching age 62 unless they terminate employment. Participants in defined contribution plans, however, can begin receiving in-service distributions upon reaching age 59-1/2. The proposed legislation would eliminate this disparity and allow defined benefit plan participants to receive retirement benefits beginning at age 59-1/2 as well. The change would also apply to participants in 457(b) plans sponsored by state and local governments and certain tax-exempt organizations. Among other things, this change would allow plan sponsors to adopt so-called "phased retirement" structures enabling employees to continue working, usually at a reduced schedule and salary, while supplementing their income with retirement benefits.

- *Hardship Withdrawals from Individual Account Plans*. The proposed legislation would expand the funding sources for hardship withdrawals to include qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs), as well as investment earnings on permitted withdrawal accounts. The legislation would also permit qualified plan participants to continue making contributions to individual account plans following the receipt of a hardship distribution. The current tax code prevents recipients from making further plan contributions for six months following a hardship distribution.

- *Extended Rollover Period for Plan Loans*. Many individual account plans require participants to repay any outstanding loan balance upon termination of employment or termination of the plan. If not repaid, the balance becomes a taxable deemed distribution and, in some cases, subject to the additional 10% early withdrawal penalty. The proposed legislation would allow participants in these circumstances additional time—up to the due date for filing his or her tax return for the year in which the plan termination or termination of employment occurs—to rollover the loan into another qualified plan or an IRA. Participants currently must rollover distributions within 60 days or include the distribution as income.