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Tax Reform and Retirement Savings

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In the fourth quarter of 2017, as the Republican Congress and the Trump Administration resolutely pushed forward with tax reform legislation proposals, many people associated with the 401(k) and retirement industry were justifiably concerned. Oftentimes in the past when Congress has moved to “reform” the Internal Revenue Code the result has negatively affected retirement savings programs. In particular, 401(k) plans have often been used as a means to offset tax cuts that benefited taxpayers in other sections of the Code, and it seemed that this might be happening again. Indeed, during the 2017 tax reform discussion, concepts such as reducing the 401(k) deferral limit, freezing the annual cost-of-living adjustments, and something called *Rothification* were advanced as revenue-raising ideas. Rothification is an all-inclusive term that covered a number of proposals that would have compelled the conversion of some or all defined contribution plan contributions to Roth-type arrangements, thereby accelerating the taxation of those contributions.

Ultimately the Tax Cuts and Jobs Act of 2017 (TCJA) left retirement savings policy pretty much unchanged, but this is not to say that the recent tax bill will not affect retirement savings. While there are a few minor direct changes to retirement plan rules, the most significant impact this bill is likely to have will be the indirect effect of corporate and individual tax rate reductions on retirement savings and investment earnings.

Direct Changes in the Code

The only change made by TCJA that directly affects corporate retirement plans is an amendment to extend the rollover period for participants with loan proceeds that were reported as a taxable distribution due to (1) the participant’s separation from service or (2) the plan’s termination. Previously participants had only the standard 60-day rollover period from the date of the loan default to complete a rollover and avoid immediate taxation and penalties; this change gives participants until the due date of their tax return (including extensions) to complete a rollover. Plan sponsors will likely want to review all plan communications and the special tax notice as it pertains to this change.

It is also worth mentioning that although the original House tax bill included a number of changes to 401(k) hardship withdrawal rules that did not make it into the final version of TCJA signed by President Trump, some of those provisions did enter the Code as part of the Bi-Partisan Budget Act of 2018. These changes to the hardship withdrawal rules include the following three items:

- Effective for plan years beginning after December 31, 2018, the IRS requirement that participants be precluded from making salary deferral contributions for six months following the receipt of a hardship withdrawal is eliminated.
- Effective for plan years beginning after December 31, 2017, the requirement that plan participants take advantage of available plan loans before qualifying for a hardship withdrawal has been eliminated.
- Effective for plan years beginning after December 31, 2017, the types of benefit accruals eligible for a hardship withdrawal have been expanded to include qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), and earnings on these contributions.

Impact of Tax Rates on Savings and Investments

As mentioned above, the biggest impact that the TCJA is likely to have on retirement savings is the effect of the reduction in individual and corporate tax rates. Whether this is a good thing or a bad thing depends on the individual taxpayer’s situation.

It is also worth mentioning that although it was discussed, the TCJA did not ultimately change the tax rate on investment income. A change in the tax rate on investment income and the value of saving in a retirement plan move in tandem. Simply stated, if the capital gains tax rates increases, then the value of saving within a retirement plan increases as a means of avoiding that additional tax. Conversely, if the tax on investment income decreases, then the value of saving within a retirement plan also decreases.

Impact of individual tax reduction

Tax-qualified retirement savings plans, except for Roth-type arrangements, are primarily tax-deferral vehicles. This means that any change in ordinary tax rates will affect the value of the tax deferral; however, the effect will not be the same for every 401(k) saver. Contributions made by or on behalf of an individual taxpayer to a tax-qualified retirement savings plan (except for Roth contributions) are excluded from taxable income when they are made. These contributions also accumulate earnings on a tax-free basis, but the earnings are taxed as ordinary income when distributed.

There are a few things that can be gleaned from this tax treatment if you want to think about your own 401(k) participation. If your tax rate decreases, then

- the value of pretax contributions to your 401(k) plan decreases
- the value of the tax deferral on earnings within the tax-qualified plan decreases
- a Roth contribution may be more attractive as the up-front taxation is at a lower rate

A big part of the evaluation of how tax rates affect savings within a tax-qualified plan is dependent on what your tax rate will be when you take a distribution. Hint—you want your tax rate to be lower when you take the money out unless you had chosen the Roth contribution option, which is not taxed when distributed.

Impact of corporate tax rate reduction

While the corporate tax rate deduction under TCJA is significant for many corporate entities, its impact on retirement savings plans is not something that can be clearly substantiated. In theory, when the top end corporate income tax rate drops from 35 percent to 21 percent, the affected corporations should become more valuable, stock prices should increase, the value of mutual funds holding those shares should increase, and all of this should be reflected in the future investment earnings of retirement savings plans. But of course, anticipating investment earnings is more complicated than that.

Another aspect of lower corporate income tax rates is that they may encourage more businesses to incorporate. The possible implication is that business owners may decide that it is more beneficial to invest in their businesses rather than their retirement savings plan.

Impact of 20 percent pass-through deduction for qualified business income

One thing that the TCJA does to attempt to even out the competitive impact of the deep cuts to corporate income tax rates (as compared to the more modest individual tax rate reductions) is to provide a new type of tax deduction for pass-through qualified business income to sole-proprietors, partnerships, and S-Corporations. The deduction can be as high as 20 percent of a business's pass-through income; however, the details can make the actual deduction calculation extremely complicated. While the details are beyond the scope of this article, generally the amount of the deduction will vary based on factors such as the nature of the business's activity, whether it pays wages, and the total income of its owner. In some cases, this pass-through deduction may create a disincentive for a small business to fund a tax-qualified retirement savings plan. Business owners who can take advantage of this pass-through deduction may choose not to put money into a retirement plan because they do not get the 20 percent deduction on plan contributions. Additionally, any plan distributions are taxed at ordinary rates with no 20 percent deduction.

Conclusion

Although many changes were discussed in the buildup to passing the Tax Cuts and Jobs Act of 2017, in the end, retirement savings plans are basically left unchanged. Because tax-qualified retirement savings plans are, at their core, nothing more than income tax deferral vehicles, any change in tax rates will affect how these plans are used. It will be interesting to see how businesses respond to the new rules of the tax game.

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