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Republicans Propose Tax Reform Legislation

Yesterday, House Republicans introduced their long-anticipated tax reform bill, which proposes huge changes in the executive compensation arena but would not lower the 401(k) plan pretax contribution limit. The bill would modify certain retirement plan distribution, loan, and nondiscrimination rules, as well as eliminate several welfare benefit programs. Additionally, the reduced corporate tax rates the bill proposes might spur activity in the pension plan area.

Tax Cuts and Jobs Act

The House Republican tax reform bill – the "Tax Cuts and Jobs Act" – was released on November 2, along with a summary of its provisions. While the bill includes significant changes in areas such as deductions for mortgage interest and state and local taxes, it does not include provisions, which had been considered, that would limit pretax contributions to 401(k) plans, or delay or repeal any ACA taxes or provisions – including the individual mandate. But the bill would impact some benefit programs, including by making some major changes to the taxation of executive and nonqualified deferred compensation.

Executive and Nonqualified Deferred Compensation

Deferred compensation is generally taxable to the employee upon distribution from nonqualified plans of for-profit entities (subject to Section 409A) and is taxable to the employee upon vesting in 457(f) ("ineligible") plans of tax-exempt entities. Other rules apply to 457(b) ("eligible") plans of tax-exempt entities. Non-qualified stock options and equity appreciation rights are taxed upon exercise. Section 162(m) currently excludes a covered employee's performance-based compensation and commissions from the calculation of the $1 million limit on remuneration for corporate deduction purposes. Tax exempt organizations are not subject to the limit on remuneration nor are employees of those organizations subject to the 20% excise tax on excess parachute payments that apply to publicly traded companies. The bill would make the following changes to these rules:

- Effective for services performed after 2017, eliminate 457(b) and (f) plans for non-governmental tax-exempt entities and subject deferred compensation, non-qualified stock options, and stock appreciation rights of for-profit entities to taxation upon vesting. It would also eliminate Section 409A. However, the current rules would continue to apply to existing deferred compensation arrangements (including non-qualified stock options and stock appreciation rights) until the last tax year beginning before 2026, when such arrangements would become subject to the provision. The idea behind this proposal is to simplify the rules and to accelerate the taxation of a benefit that applies mainly to highly compensated employees.

409A

It's not clear what the elimination of 409A means for future deferred compensation. Do the old rules apply to elections on the time and form of payment? On re-deferrals? What rules apply to tax-exempt entities?

- Effective for tax years beginning after 2017, amend Section 162(m) to include a covered employee's performance-based compensation and commissions in the calculation of the $1 million limitation on employee remuneration for corporate deduction purposes. Covered employees would include the CEO, the chief financial officer and the three other highest paid employees – and, once a covered employee, the individual always remains a covered employee if still receiving pay from the corporation. This proposal is intended to address the shift by corporations from cash compensation to performance-based pay, such as stock options, in order to avoid the limitation.
- Also effective for tax years beginning after 2017, subject tax exempt organizations to a 20% excise tax on compensation paid (including wages, but not Roth contributions) in excess of $1 million plus any excess parachute payment made to a covered employee. Covered employees include the organization's five highest paid employees for the tax year – and once a covered employee, the individual always remains a covered employee if still receiving pay from the organization. Individuals could not skirt this rule by performing services other than as an employee. This proposal is intended to discourage excess compensation in the tax-exempt arena, similar to publicly traded companies.

Retirement

The bill would make the following changes to certain retirement plan distribution, loan and nondiscrimination rules, generally effective for plan years beginning on or after December 31, 2017:

- Lower the minimum age for in-service distributions from defined benefit plans and defined contribution plans sponsored by state and local governments to 59½ – in line with the current minimum age for in-service distributions from defined contribution plans generally. This change is designed to discourage earlier retirement dates by participants who cannot otherwise access their retirement accounts.
- Make it easier for participants to take hardship distributions by:
  - Directing the Department of Treasury to eliminate the six-month suspension from making contributions following the hardship distribution
  - Broadening the sources available for hardship distributions to include account earnings and employer contributions in the form of qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs), in addition to elective deferrals
  - Getting rid of the requirement that a participant first take out a loan before taking a hardship distribution

- Extend the 60-day period that participants have to contribute an outstanding loan balance to an IRA to qualify as a rollover in the case of a terminating plan or a termination of employment. Participants in these circumstances would have until the due date for filing that year's tax return to contribute the loan balance to an IRA and thereby avoid being taxed as a distribution (and potentially being subject to the 10% penalty for early withdrawals). This provision is intended to provide some relief for individuals who may lose their job and not have the financial means to make an immediate loan repayment, and therefore would not otherwise be able to defer taxation through a rollover.
- Effective the day of enactment, change the nondiscrimination testing rules for closed (soft-frozen) defined benefit plans by allowing the plans to pass testing (1) if they meet certain requirements before and after the freeze date and any subsequent amendment to a benefit, right or feature does not favor highly compensated employees, or (2) by expanding cross-testing between an employer's defined benefit and defined contributions plans. The IRS has proposed regulatory changes to address the problem of closed defined benefit plans that can no longer meet testing requirements and, in the meantime, has extended temporary relief in these situations. (See our September 5, 2017 *FYI Alert*.)

Roth IRA Contributions

The bill would repeal a rule that permits the recharacterization of Roth IRA contributions as traditional IRA contributions. Currently, an individual can make this recharacterization by October 15 of the year following the conversion, and the individual is treated for tax purposes as not having made the conversion. The idea behind this proposal is to prevent gaming the system by retroactively reversing a conversion to avoid taxes in the case of an investment loss.

Health and Welfare

The bill proposes the following changes to health and welfare programs that appear to be designed to raise revenue:

- Eliminate the tax exclusion for dependent care assistance programs (DCAPs, also known as dependent care flexible spending arrangements, or FSAs). Currently, employers can pay or reimburse up to $5,000 (tax-free) for qualified dependent care expenses. This benefit is usually offered through a cafeteria plan and is funded through salary reduction. The elimination of this tax exclusion will increase taxes paid by employers and employees.
- Eliminate the tax exclusion for adoption assistance programs. Generally, amounts paid by an employer (subject to dollar limits and other requirements) for qualified adoption expenses incurred in connection with the adoption (or in certain cases, the attempted adoption) of a child are excludable from an employee's gross income if furnished pursuant to an employer's adoption assistance program. The benefit can be offered through a cafeteria plan. As with the elimination of the exclusion for DCAPs, the elimination of this provision will also increase the employee's taxable income, and thus incrementally increase taxes paid by the employee and employer.

Exclusion for Qualified Tuition Reduction Eliminated

Note that the legislation also eliminates the exclusion for qualified tuition reductions provided by educational institutions to their employees, spouses or dependents. Under current law, such payments, provided either in the form of reduced tuition or cash, are excluded from income. The legislation would eliminate that exclusion.

- Eliminate the exclusion for employer-provided education assistance programs. Under current law, tax-free education benefits, up to $5,250, may be offered to employees, for a given calendar year, through a qualified educational assistance program. These amounts are funded strictly by the employer. The program may not be offered under a cafeteria plan and salary reduction is not permitted. The elimination of this exclusion would also raise revenue.

The bill does not include any provisions directly addressing the ACA, such as the repeal or modification of the 40% excise tax on high-cost health plans (Cadillac tax) or the repeal of the individual or employer mandates. The exclusion for employer-provided health coverage remains intact.

Corporate Tax Rates

The bill would reduce the graduated 15 to 35% corporate tax rate to a flat 20% rate beginning in 2018. This, along with other recent Treasury and PBGC rules on mortality tables and premiums (see our October 20, 2017 and October 4, 2017 *FYI Alert* publications) might cause some retirement plan sponsors to consider taking proactive measures to reduce liabilities, reduce premiums and obtain larger deductions before the tax rates change, such as:

- Purchasing annuities for retiree populations with small benefits
- Discretionary funding to a pension plan to reduce variable premiums – and perhaps borrowing money at low interest rates to do so
- Pre-funding retiree life and medical insurance and making other discretionary qualified plan contributions this year, since the higher corporate rates means larger deductions (though note that VEBA contributions must generally be made by December 31, 2017 for calendar year plans)

Plan sponsors would not have much time to take these actions if tax reform legislation passes before the end of the year, as the administration hopes it will. However, if that timetable proves too aggressive, plan sponsors would have more time. Regardless, quick action may be needed, and plan sponsors should start planning now if they would like to take advantage of the opportunity for higher deductions before any changes are put into effect.

In Closing

The Ways and Means Committee is scheduled to revise the bill next week, with House leadership aiming to pass it later this month. In the meantime, the Senate is working on its own tax reform bill, which it would have to reconcile with the version that the House passes before the bill can go to the president’s desk and become law.

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