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Tax Reform Contemplates Changes to Employee Benefits

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The House Committee on Ways and Means publicly released a working draft of the Tax Cuts and Jobs Act for the first time on Thursday. In the weeks leading up to the release of the draft, speculation has swirled as to whether it would eliminate or otherwise limit the ability to make pre-tax employee deferrals into 401(k) plans. The current draft of the bill would *not* impact 401(k) deferrals, but would bring other changes to employee benefit plans and programs beginning in 2018, as described below. However, the bill is still a working draft and has not yet become law. The bill would also make significant changes with respect to executive compensation, which we will address in a separate blog post.

Elimination of Certain Income Tax Exclusions

The bill would eliminate the income tax exclusions currently available for the following types of benefits:

1. Employer-provided dependent care assistance programs (currently tax-free up to $5,000 per year or $2,500 per year in the case of married individuals who file separate tax returns);
2. Employer-provided adoption assistance programs (currently tax-free up to $13,570 per child);
3. Moving expense reimbursements by employers;
4. Tuition reimbursements provided by employers through qualified educational assistance programs (currently tax-free up to $5,250 per year); and
5. Qualified tuition reductions provided by educational institutions to employees and their spouses and dependents (currently tax-free for undergraduate tuition and, in the case of teaching and research assistants, graduate tuition).

Employees that receive such benefits or reimbursements would therefore need to include the value of the benefits or reimbursements in their gross income for tax purposes.

Loosen Restrictions on Hardship Distributions from 401(k) Plans

The bill would eliminate two restrictions that currently apply to hardship distributions from 401(k) plans. First, IRS regulations currently require 401(k) plans to prohibit participants who receive certain hardship distributions from making plan contributions for six months after the hardship distribution. The bill would force the IRS to eliminate this requirement. Second, under current law, hardship distributions from 401(k) plans cannot include qualified nonelective employer contributions (QNECs), qualified matching employer contributions (QMACs), or earnings on elective deferrals. The bill would allow employers to make such amounts available for hardship distributions. Finally, for purposes of determining a participant's eligibility to receive a hardship distribution, the bill would clarify that the participant is *not* required to take the maximum available loan available from the 401(k) plan to receive a hardship distribution.

Reduction in Minimum Age for In-Service Distributions from 457(b) Plans and Pension Plans

The bill would make in-service distributions available from 457(b) plans (deferred compensation plans available for employees of state and local governments and certain tax-exempt organizations) and tax-qualified pension plans beginning at age 59½. Under current law, in-service distributions are only available from 457(b) plans in the case of eligible hardships or the attainment of age 70½ and from tax-qualified pension plans beginning at age 62.

Extended Rollover Period for Plan Loan Offset Amounts

The bill would provide certain defined contribution plan participants with more time to roll over “plan loan offset amounts” to individual retirement account (IRA) or other eligible retirement plan. Specifically, if a participant would have a deemed distribution for failing to repay an outstanding plan loan following a termination of the plan or the participant’s employment, the participant could avoid the deemed distribution by contributing the outstanding loan balance to an IRA or other eligible retirement plan no later than the due date (with extensions) for filing the participant’s tax return for the year of the potential deemed distribution. This change is intended to help participants avoid having their outstanding loan balances treated as deemed distributions, which are subject to taxation (and the additional 10% penalty on early withdrawals if applicable) in the year of the deemed distribution. Currently, participants only have 60 days to do this from the date on which the participant receives a distribution of the participant’s outstanding account balance.

Modified Nondiscrimination Testing Rules for Frozen Legacy Plans

The bill would make technical changes to the nondiscrimination testing rules for tax-qualified pension plans and defined contribution plans sponsored by employers that close or freeze their pension plans for certain classes of participants (which is an increasingly common occurrence).

In particular, such pension plans will be deemed not to discriminate in favor of highly compensated employees solely due to the composition of the closed class of participants or the benefits, rights, or other features provided to the closed class if certain requirements are met, including that the plan is not discriminatory in the year of the plan closure and the following two plan years. Such pension plans could also be aggregated with certain defined contribution plans on a benefits basis for nondiscrimination testing and minimum coverage testing. For this purpose, testing could include the portion of the defined contribution plan(s) that provides matching contributions, 403(b) annuity contracts purchased with matching contributions or nonelective contributions, or that consists of an employee stock ownership plan.

The bill would also make similar changes with respect to nondiscrimination and minimum coverage testing for defined contribution plans that provide “make-whole” nonelective employer contributions that are intended to replace some or all of the retirement benefits a participant would have otherwise earned under a pension plan or other qualified cash or deferred arrangement if the change had not been made.

Additional Limitations on Archer Medical Savings Accounts (Archer MSAs)

The bill would limit the continued use of Archer MSAs by eliminating the deduction for employee contributions to Archer MSAs and the income tax exclusion for employer contributions to Archer MSAs. However, individuals could continue to roll over their Archer MSAs to HSAs on a tax-free basis. This change is expected to have a limited impact because Archer MSAs have largely been replaced by health savings accounts (HSAs) and new Archer MSAs could not be established after 2007 (although individuals who already had Archer MSAs are currently allowed to continue contributions to their Archer MSAs).

As noted above, the bill is still a working draft and has not become law. The Administration has indicated that it hopes to complete tax reform by the end of 2017, but it is too early to tell whether that will happen. In any event, we expect additional modifications to the bill as it is further reviewed by the House and introduced in the Senate.

For a summary of the other significant changes proposed in the bill, please see our Tax Talks blog post.

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