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The Tax Cuts and Jobs Act's Impact on Retirement Plans and IRAs

The Tax Cuts and Jobs Act was signed into law by President Trump on December 22, 2017, and is generally effective for tax years beginning after 2017. While many of the rumored provisions that would have affected retirement plans and individual retirement accounts (IRAs) were ultimately not included in the final bill, the new law does include some changes. Let's break down how retirement plans and IRAs may be impacted.

What Changed?

Rollovers of Outstanding Plan Loans:

When retirement plan participants leave a job with an outstanding loan balance in their workplace retirement plan, the loan balance will be offset against their account balance and be deemed a taxable distribution, unless they repay it in full. Under prior law, if a participant took a distribution without paying off the loan, the participant had 60 days to roll over the loan offset amount to another qualified plan or an IRA to avoid federal income taxes and penalties – a challenge for many individuals. Under the new tax bill, this time frame has been extended to the due date for the individual's federal income tax return (including extensions), a clear benefit to the individual responsible for repaying the loan. This provision is intended to decrease the likelihood that departing employees will default on their loans because they are unable to raise the funds to repay them in a short amount of time and, in turn, help keep more of their money invested for retirement.

Pass-through Entity Tax Deduction:

Pass-through entities are businesses whose profits 'pass-through' their books directly to owners (unlike corporations, which parcel out profits through dividends to stockholders). Examples of pass-through entities are sole proprietors, owners in partnerships, and other non-corporate enterprises. Under previous law, pass-through entities paid the individual tax rate on their profits (not the corporate rate). In the new bill, the top individual income tax rate is 37% while the corporate rate is slashed to 21%. To address this disparity, a provision was included which creates a 20% business income deduction, with limits, for pass-through entities. This means pass-through businesses will pay a lower tax rate by excluding as much as 20% of their business income from taxation. As a result of the pass-through deduction, it is anticipated that qualifying business owners may decide to deduct their retirement contributions against their business income rate, instead of their personal income at the individual rate. Thus, the attractiveness of the deduction is decreased because the business income rate will be much lower. Therefore, this provision may undermine incentives for small business owners to not only save for retirement themselves, but to set up a plan for workers, and could impact whether or not small businesses sponsor retirement plans at all.

Repeal of Roth IRA Recharacterization:

Current IRS rules allow individuals who would not be eligible to contribute directly to a Roth IRA due to the applicable income limits to convert all or part of a traditional IRA to a Roth IRA as a means to enjoy the benefits of a Roth IRA's tax-free growth and tax-free qualified withdrawals. Income taxes must be paid for the year of the conversion on any pre-tax contributions and earnings that are converted. Under a special rule, individuals could undo the conversion (i.e., "recharacterize" the Roth IRA as a traditional IRA) up until the due date for their federal income tax return, if they determined it would be advantageous for them to do so (e.g., if their tax bracket was higher than expected or they couldn't raise the cash to pay the taxes). The special rule permitting recharacterization to unwind a Roth IRA conversion has been repealed for taxable years beginning after 2017.

Special Rule for Disaster Areas:

A special rule was included in the tax bill which allows distributions up to $100,000 taken from retirement plans and IRAs during 2016 and 2017 by individuals living in 2016 presidentially declared disaster areas to be exempt from the 10% early withdrawal tax, included in income pro rata over three years, and eligible for repayment within three years. A plan amendment to implement these provisions generally is required by the end of 2018.

What Stayed the Same?

Elective Deferral Limit:

Throughout the drafting of the tax reform bill in both the House and the Senate, rumors persisted that a portion of tax cuts would be offset by lowering the limit on how much employees could save in their pre-tax accounts under 401(k), 403(b) and 457(b) retirement plans from 2018's cap of $18,500 to only $2,400. Any additional contributions would be made into an after-tax account. These provisions were not included in the final bill – and the 2018 cap on elective deferrals remains $18,500.

Non-Qualified Deferred Compensation:

The initial House bill included a provision that would have immediately taxed compensation set aside in non-qualified deferred compensation plans. This was not included in the final bill.

Catch-up Contributions:

A proposal was discussed in which any catch-up contributions made after age 50 would be funneled into an after-tax Roth account instead of a traditional pre-tax account. This was not included in the final bill.

Hardship Withdrawal Distributions:

Plans that permit hardship withdrawals may not include investment earnings on participants' elective deferrals in such withdrawals and participants cannot make new contributions to the plan for six months after they take a hardship withdrawal. The House bill proposed allowing participants to potentially withdraw all of their own contributions and the earnings on those contributions in the event of a hardship, and also would have allowed participants to continue to contribute to their plan even after taking a hardship withdrawal (and still receive their company match, if applicable). This was not included in the final bill.

If you have further questions, please contact your PNC Retirement Solutions representative or visit www.pnc.com/retirementsolutions.

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