NORTHERN TRUST

PLAN SPONSOR UPDATE

Retirement benefits provisions in HR 1

Sweeping revision of the taxation of deferred compensation rules – effect on excess plans

We are not deferred compensation taxation experts, and we are not going to discuss the HR 1 deferred compensation proposal's effect on the taxation of, e.g., executive compensation generally. But the issue of the taxation of deferred compensation does come up for ERISA retirement plans in one respect: many sponsors maintain non-qualifed deferred compensation plans for "excess benefits" under their tax qualified retirement plans.

Generally, these excess plans provide benefits that accrue under, e.g., a DB plan's benefit formula, that cannot be paid out of the tax qualified plan because of Tax Code dollar limits on contributions and benefits. Subject to a very elaborate set of rules, amounts accrued in an excess plan are not, under current law, taxed to the individual participant until distributed.

HR 1 changes that rule radically. Under HR 1, deferred compensation will generally be taxable when there is no longer a substantial risk of forfeiture – in other words, when the benefit vests. This could be years or even decades before distribution.

From the point of view of the tax-writers this proposal makes some sense. The difference under it between corporate and individual tax rates provides an incentive to leave deferred compensation at the corporate level for as long as possible.

From the point of view of the individual participant, however, it is problematic – she will be taxed on income that she does not literally have. Thus, she may face a tax bill without the funds to pay it. That is a problem that will have to be solved somehow.

Many were surprised by this provision, and we would expect to see significant debate about it.

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SUMMARY
In addition to the changes to basic tax policy included in the House Republicans tax reform proposal (HR 1), introduced November 2, 2017, the bill includes a number of proposals directly affecting retirement plans. In this article we briefly review them.

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Fix for nondiscrimination issues presented by closed groups

Where an employer closes a DB plan to new participants (sometimes called a "soft freeze"), Tax Code nondiscrimination issues may over time arise with respect to the grandfathered benefits of the closed class, even where that class of participants is nondiscriminatory at the time of the freeze. This happens when lower paid members of the closed class subsequently leave, are terminated or become higher paid. In addition, over time, the number of participants in the "old plan" may shrink below the minimum participant requirements of Tax Code section 401(a)(26) (the "50 participant rule"). Finally, where, e.g., in connection with a "hard freeze" of all DB plan benefits, the sponsor establishes or enhances a DC plan, the sponsor may provide for "make whole" benefits for a closed class of some or all of the participants in the "old" DB plan, and nondiscrimination issues may over time arise with respect to that class.

HR 1 includes a proposal to address these issues, modeled on a bipartisan proposal sponsored in the House by Congressmen Tiberi (R-OH) and Neal (D-MA). (An identical bill was introduced in the Senate by Senators Cardin (D-MD) and Portman (R-OH).) The proposal is very technical. Oversimplifying, the legislation provides relief from the nondiscrimination rules for DB plan closed groups, and for make-whole contributions to DC plan closed groups, where –

> For the plan year of the "closure" and the 2 succeeding plan years, the closed group meets applicable nondiscrimination requirements.
>
> After the closure, benefits to/members of the closed group are not increased in a way that discriminates significantly in favor of highly compensated employees.
>
> The closure took place before April 5, 2017 (the day the Tiberi-Neal legislation was introduced).

Relief with respect to the minimum participation issue is also provided.

Other retirement benefit provisions in the proposal

HR 1 also includes four proposals dealing, generally, with Tax Code rules applicable to retirement plan distributions.

> *Reduction of in-service distribution age from 62 to 59 1/2*. Under current rules, a DB plan cannot begin distributions to an employee-participant (who has not separated from service) prior to age 62. This rule has become an issue as sponsors and

participants have sought to explore options for partial or phased retirement. HR 1 would reduce this to age 59 1/2.

Elimination of the 6-month contribution holdout rule for hardship withdrawals. Under current regulations, a participant who takes a hardship withdrawal must generally be prohibited from making elective and employee contributions for 6 months. HR 1 instructs the Secretary of the Treasury to “delete” this rule.

Relaxation of hardship withdrawal rules. HR 1 would expand amounts that a participant may take in a hardship withdrawal and repeal the rule (under current regulations) that a participant must take all available plan loans before taking a hardship withdrawal .

Extension of period for rollover of unpaid plan loan. Under HR 1, an individual would have until his tax return due date (with extensions) to roll over the balance of a loan that is unpaid as of separation from service or plan termination.

HR 1 will now be taken up by the Ways and Means Committee. It is very early in the process. All agree that changes are likely.

We will continue to follow tax reform as it develops.

Not in the bill

We note that HR 1 does not include a number of retirement policy proposals that have received bipartisan support, e.g., with respect to Open MEPs, revision of 401(k) default contribution rules and safe harbors, electronic participant disclosure – there is a very long list.