The new tax law: minimal impact for retirement plans

Congress passes major tax overhaul, little effect on retirement savings policy

On December 20, 2017, the House approved HR 1, the "Tax Cuts and Jobs Act;" the Senate had approved the bill on December 19. President Trump signed the bill into law on December 22.

HR 1 includes these changes, which are generally effective for 2018:

1. a reduction in tax rates for most individuals
2. a reduction in the top corporate tax rate from 35% to 21%
3. a reduction in the tax rate on individual business income (providing a special 20% deduction from "qualified business income")
4. a nearly two-fold increase in the standard deduction
5. the elimination or limitation on a number of itemized deductions, most controversially, limiting the deduction for state and local taxes to $10,000

Bottom line: no significant change in retirement savings tax policy

With all these sweeping changes, however, generally the only HR 1 change directly affecting corporate retirement plans is an amendment of the rollover rules to allow an individual until their 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.

Under HR 1, taxes on investment income — capital gains and dividend taxes and the Medicare net investment income tax — are generally unchanged (from current law). Changes to income tax rates may, in some cases and to some extent, increase or decrease the value of income shifting (from a higher tax to a lower tax year) such as what 401(k) contributions allow. But for the most part, for retirement savings tax policy, the story is what most obviously did not happen: Rothification.

The one exception (to the "no change" story): increases in investment returns, stimulated by the corporate tax cut, will increase the retirement savings tax benefit, as this (in many cases significant) increase in value is not taxed if it's held in a retirement savings plan trust.

In what follows we consider some key elements of the bill bearing on retirement savings tax policy.

Background: retirement savings tax benefits generally

Generally speaking, under the current system, (non-Roth) contributions to a tax qualified retirement plan are excluded from taxable income; earnings accumulate tax free; and contributions plus earnings are taxed at ordinary income tax rates when distributed.

This system of taxation provides two direct tax benefits. First, assuming the participant's tax rate is the same at the time of contribution and distribution, the value of the retirement savings tax benefit is the value of the non-taxation of trust earnings. This point must be emphasized: the value of the 401(k) tax benefit is not the value of the tax exclusion, it's the value of the exemption from taxation of trust earnings.

Thus, if Congress had raised the tax on investment income, that would have increased the value of saving in a tax qualified retirement plan, because the tax the in-plan saver would be avoiding would have increased. Likewise, if it had reduced the tax on investment income, that would have decreased the value of in-plan saving.

Second, where the participant's tax rate is higher at the time of (a non-Roth) contribution than it is at the time of distribution, the value of the retirement savings tax benefit is also the difference between those two tax rates. This works both ways. If you are paying higher taxes in the year of contribution than in the year of distribution, then a non-Roth contribution shifts income from a higher tax rate year to a lower tax rate year. If you are paying lower taxes in the year of contribution than in the year of distribution, then a Roth contribution does the same thing.

With respect to this second retirement savings tax benefit, note that the value of this benefit depends not so much on the level of taxation but on the difference in tax rates between brackets. Thus, the value of income shifting is more dependent on the steepness of change between brackets than on the level of tax rates.

No change to investment taxes

Under HR 1, investment taxes — capital gains and dividends — are generally kept at current rates and at current (that is, "old law") income "breakpoints." And the 3.8% Medicare net investment income tax is unchanged. So there is no change with respect to the first retirement savings tax benefit — the non-taxation of investment income.

Change in individual income tax rates

The following table summarizes current law and HR 1 income tax rates/brackets for joint filers.

Current law (2018)		HR 1	
Taxable income ($)	Income tax rate (%)	Taxable income ($)	Income tax rate (%)
0 - 19,050	10	0 - 19,050	10
19,050 - 77,400	15	19,050 - 77,400	12
77,400 - 156,150	25	77,400 - 165,000	22
156,150 - 237,950	28	165,000 - 315,000	24
237,950 - 424,950	33	315,000 - 400,000	32
424,950 - 480,050	35	400,000 - 600,000	35
480,050 +	39.6	600,000 +	37

With respect to the value of income shifting, the changes made by HR 1 to individual income tax rates is a mixed bag. For some individuals, the value of income shifting will go up: consider an individual currently making $350,000, who expects to receive only $200,000 in retirement. Under current (pre-HR 1) rules, by saving in a qualified plan he gets a current tax exclusion at a 33% rate and then (on distribution) pays taxes at a 28% rate — a five percentage point difference in income tax rates. The same individual under HR 1 shifts income from a current 32% rate to (at distribution) a 24% rate — an eight percentage point difference in rates.

On the other hand, an individual currently making $200,000 and expecting to receive $100,000 in retirement, saves more (three percentage points) under current law by shifting from a 28% to a 25% rate than he does under HR 1 shifting from a 24% to a 22% rate (two percentage points).

These changes should probably be regarded as a wash.

More practically

Most participants, of course, don't do this sort of (pretty theoretical) analysis. Often, they simply focus on the size of the tax "deduction" they are currently getting. In that regard, the reduction in rates, at the margin, may marginally reduce the tax incentive to save, even if it doesn't reduce the ultimate tax benefit.

On the other hand, for participants with big state and local income tax bills, the HR 1 limit on their deductibility to $10,000 may provide an incentive to save in a tax qualified plan and avoid those taxes.

And, no Rothification

With regard to the income shifting tax benefit, however, the biggest thing about HR 1 is that it does not include any Rothification provision.

Roth contributions can shift income from a current low tax year to a future high tax year, advantageous for low-earners who expect to become high-earners. But only regular, non-Roth contributions can shift income from a current high tax year to a future low tax year, advantageous to those who expect to be in a lower tax bracket in retirement than they are currently.

Reduction in corporate tax will enhance the retirement savings tax benefit

Very generally (and oversimplifying), corporations pay taxes at the corporate level; dividends are not deductible; and shareholders pay taxes on (qualifying) dividends at capital gains rates. Thus, there are two taxes on corporate earnings: (1) one at the corporate level and (2) one at the shareholder level. This is sometimes called the double taxation of corporate earnings.

Tax qualified retirement plans/trusts are tax-exempt entities. As such, they do not pay the shareholder level tax. They do, however, indirectly pay the corporate level tax; that is, the earnings from their investment in a corporation are subject to tax, at the corporate level. The HR 1 reduction in taxes at the corporate level, from 35% to 21%, to the extent that it translates into increased returns to retirement plan investors, will increase the tax benefit of saving in a tax qualified retirement plan, simply because more earnings will go untaxed on the investment held inside the plan, that would otherwise have been subject to tax if the investment were held outside the plan.

There are a variety of questions about whether and to what extent the corporate tax reduction will translate into an increase in the rate of return to corporate investment. Most believe, however, that the increase in stock values since the beginning of the year to some degree reflects anticipation of the HR 1 corporate tax rate reduction. That increase itself results in an increase in the tax benefit of current 401(k) stock investors, who don't have to pay investment taxes on it.

Reduced individual business income tax may discourage small business retirement plans

The HR 1 20% deduction from individual income tax for qualified business income from a partnership, S corporation or sole proprietorship is likely to create a disincentive for some small businesses to establish or continue to maintain a tax qualified plan. Individuals who can elect individual business tax treatment may actually lose money on their retirement savings contributions, because distributions from the qualified plan will generally be taxed at an ordinary income tax rate (with no 20% deduction).

As an example, consider an owner who, in 2018, is considering whether to make an $18,500 contribution to a 401(k) plan or simply pay the qualified business income tax. Assume the owner is in the top (37%) bracket and must also pay the 3.8% Medicare tax on net investment income. The following tables compare how much the owner would have, under either alternative, assuming he or she invests for 10 years and earns 4% per year.

Comparison of in-plan vs. outside-the-plan savings for qualified business income

Income tax rate at contribution (%)	37
Capital gains/dividend tax rate (%)	20
Income tax rate at distribution (%)	37
Medicare investment income tax rate (%)	3.8
Amount available for saving ($)	18,500
Earnings rate (%)	4
Years in plan	10

	Inside the plan ($)	Outside the plan ($)
Beginning amount	18,500	18,500
20% deduction for qualified business income		3,700
Taxable income		14,800
Tax		5,476
Contribution to plan	18,500	13,024
Earnings (plan earnings are untaxed; outside the plan earnings are taxed @ 23.8%)	8,885	4,561
Total	**27,385**	
Tax on distribution @ 37%	10,132	
Net distribution	**17,252**	**17,585**

Thus, on these assumptions the owner actually does better saving outside the plan.

Provisions directly affecting tax qualified retirement plans

The House tax reform bill included provisions (1) addressing nondiscrimination issues presented by closed groups, (2) reducing the permissible in-service distribution age from 62 to 59 1/2, (3) eliminating the six-month contribution holdout rule for hardship withdrawals, (4) relaxing the hardship withdrawal rules and (5) extending the period for rollover of unpaid plan loans.

HR 1 (the final bill) includes only the last of these provisions, on plan loans. Most significantly (for affected plans/sponsors), it does not include relief for closed plans.

Generally, HR 1 leaves retirement savings tax incentives untouched. And that is (for the most part) good news. There was significant concern at some points in the process that, to generate revenues, Congressional Republicans would require either full or partial Rothification of 401(k) contributions.

The one exception—the one HR 1 change that may significantly affect retirement savings—is the reduction in corporate tax rates. To the extent that that change translates into increased investment returns, it will increase the value of, for example, 401(k) savings tax benefits. Participants may not understand the theory here—that higher corporate returns, including those already booked in 2017, stimulated by the corporate tax cut, translate into higher returns on their 401(k) plan investment that, because of the non-taxation of 401(k) earnings, translate into higher retirement savings tax benefits. But on a more intuitive level, many participants are very happy with what has happened to their 401(k) plan investments this year.

Contact us

1-844-266-3863

bmofunds.com

bmo-global-asset-management

BMO Global Asset Management