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The CARES Act and 401(k) Plans: Options for Plan Sponsors and Participants

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Inside This Issue:

WITH THE SPREAD OF THE CORONAVIRUS (COVID-19) AND ITS FINANCIAL IMPACT OF BUSINESSES, INCLUDING THE LAYOFFS, furloughs, and cutbacks for employees, plan sponsors may need to preserve cash flow by reducing their 401(k) contributions, and employees may need money from their 401(k) accounts for the necessities of life.

This article discusses some of the available options—both under pre-existing (or "regular") rules and the special rules in the new CARES Act and IRS guidance for the coronavirus impact. The article focuses on the options available for employers to help employees whose hours and compensation have been cut back or who have been furloughed. Employees who have been laid off or terminated can receive distributions from their plan accounts, although those distributions will be taxable and, if an employee is under age 59½, the distribution will be subject to an additional 10% penalty.

As a precautionary note, this article is a general discussion of the rules. The purpose of this article is to give advisors ideas for helping plan sponsors and their employees. These rules are complicated. As a result, before plan sponsors act on any of these options, they should consult with their retirement plan administrators and attorneys.

Participant Plan Loans

Under the regular tax rules, and if a plan permits, participants can borrow 100% of their vested account balances up to $10,000 or, if greater, 50% up to $50,000 (e.g., up to 50% of $100,000).

Under special and temporary coronavirus rules, participants may now borrow 100% of their vested account balances, up to $100,000.

To ease the compliance burden, plan sponsors who want to allow their employees to make these larger loans can do it automatically and won't need to amend their plans to add the enhanced loan provisions until next year.

Also, participants who have loans will be allowed to delay their loan repayments by up to one year.

Hardship Withdrawals

Most 401(k) plans permit hardship withdrawals of participants' vested account balances for "immediate and heavy financial needs." Unfortunately, that regular rule does not directly apply to loss of earnings due to the coronavirus. Two examples of permissible "needs"

that might apply are: a hardship withdrawal for medical expenses and to prevent eviction from, or foreclosure on, a participant's principal residence.

Unfortunately, though, those hardship distributions are subject to a 10% premature distribution penalty for participants under 59½, and are taxable as ordinary income.

The CARES Act provides options for both plan sponsors and participants

Under the new legislation, the 10% tax on early withdrawals of up to $100,000 will be waived for certain circumstances (for example, for a participant who is diagnosed with COVID-19, or whose spouse or dependent is diagnosed with COVID-19, or if a participant suffered losses due to being quarantined, furloughed, laid off, having work hours reduced, unable to work due to lack of child care). This special withdrawal provision applies to both qualified retirement plans and IRAs.

The CARES Act allows participants to pay the income tax on the withdrawal over 3 years or, if desired, to pay it back to the plan tax-free over 3 years.

Employers can implement the new hardship withdrawal provision immediately without amending their plans. But, the plans must be amended next year to reflect that action.

Required Minimum Distributions

IRA owners who turned 70½ in 2019 or earlier must take required minimum distributions (RMDs) from their IRAs this year. That RMD is calculated based on the value of the IRA on December 31, 2019. With the dramatic drop in the stock market, the December 31, 2019 valuation date results in a liquidation of investments and a distribution much larger than the current account balance would, but the rules say that the 2019 value must be used. To make matters worse, if the distribution is not taken on time, a 50% tax penalty is charged.

Fortunately, the coronavirus relief legislation suspends the RMD requirement and waives the 50% tax penalty for 2020. The suspension and waiver apply to RMDs from IRAs and defined contribution plans, including 401(k), 403(b) and 457(b) plans

As a result, those who can afford to delay receipt of the money should consider doing so.

Reducing 401(k) Contributions

While participants can always stop deferring from their paychecks, it is more complicated for employers.

- **Discretionary Contributions:** If a 401(k) plan says that the employer has discretion to decide how much to contribute for matching and/or employer contributions, the employer can decide, without legal restrictions, to reduce or eliminate its contributions. This would apply where, for example, a small employer can wait until the end of the year to decide on its level of contributions.
- **Required Contributions:** Some plans have built-in contribution formulas, e.g., a 3% employer contribution or a 25-cent match for each dollar deferred. Where the contribution rate is built into the plan, it can be amended out. However, to the extent that participants have "earned" the right to the match or contribution, the money must be paid to the plan. For example, if the match is hardwired in the plan document, then it must be made for participant deferrals prior to the effective date of the amendment. For

employer contributions, most plans say that employees have accrued, or earned, the contribution when they complete 1,000 hours of work in the year.

- **Safe Harbor Plan Contributions:** Employers who sponsor safe harbor 401(k) plans have only limited ability to suspend the matching or employer contributions. To suspend the contributions, either (1) the employer must be operating at a loss, or (2) the safe harbor notice given to the participants must specify the right to suspend contributions during the year.

  In addition, the participants must be given a 30-day notice of the suspension and the suspension cannot be effective before the end of the 30 days. As a word of caution, there are detailed rules about what has to be in the notice. Even then, the matching and employer contributions must be made for the period before the effective date of suspension, that is, before the end of the 30-day notice period.

  Unfortunately, the CARES Act did not include any relief for the commitment to make safe harbor matching or employer contributions. However, a number of trade associations representing employers and retirement plan service providers are urging Congress to include relief in a widely anticipated follow up bill. Stay tuned; there may be additional relief.

- **But, Proceed with Caution:** In all of these cases, the plans will be subject to other rules that could still impact contributions in the event of suspension of contributions. For example, if a plan is top heavy, an employer will be required to make contributions sufficient to satisfy the top heavy rules. And, the plans must perform discrimination testing on the amounts of contributions. For example, if the highly compensated employees are deferring significantly more than the rank-and-file employees, the suspension may cause the plan to fail the ADP test and excess deferrals may need to be refunded to the highly compensated employees.

Conclusion

These are trying times. Many employers are being adversely affected by financial losses and need to conserve money to continue their operations and, possibly, to stay in business. Many employees are being furloughed or having their hours cut back. But the financial demands of living are unforgiving and employees also need to conserve cash and, in some cases, to raise money.

This article gives advisors ideas that they can discuss with plan sponsors, and that plan sponsors can implement to help their companies and employees through this difficult and hopefully temporary period.

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About the Author:

Fred Reish is an ERISA attorney whose practice focuses on fiduciary responsibility, retirement income, and plan operational issues. He has been recognized as one of the "legends" of the retirement industry by both PLANAdvisor magazine and PLANSPONSOR magazine. Fred serves as a member of his firm's Retirement Income Team and is a member of the Institutional Retirement Income Council (IRIC), which focuses on retirement income issues and products, and he has written extensively about retirement income issues. Fred also received awards for: the 401(k) Industry's Most Influential Person by 401kWire; one of RIABiz's 10 most influential individuals in the 401(k) industry affecting RIAs for 2012; the Commissioner's Award and the District Director's Award by the IRS; the Eidson Founder's Award by the American Society of Professionals & Actuaries (ASPPA); the Institutional Investor and the PLANSPONSOR magazine Lifetime Achievement Awards; and the ASPPA/Morningstar 401(k) Leadership Award. He has written more than 350 articles and four books about retirement plans, including a monthly column on 401(k) fiduciary issues for PLANSPONSOR magazine. Fred co-chaired the IRS Los Angeles Benefits Conference for more than 10 years, served as a founding Co-Chair of the ASPPA 401(k) Summit, and has served on the Steering Committee for the DOL National Conference.

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