The COVID-19 Crisis Raises Significant Issues for 401k Plan Sponsors

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Introduction

The Novel Coronavirus (COVID – 19) health crisis has deleteriously impacted the United States economy in a profound manner. The crisis has caused cessations and downturns of many businesses and massive job lay-offs and furloughs. This has raised challenges for employers in operating their 401k plans.

In addition to employers, to compensate for the difficulties experienced by employees caused by the COVID-19 crisis, on March 27, 2020, President Trump signed the Coronavirus Aid, Relief and Economic Security Act ("Cares Act") into law. The Act in pertinent part provides relief to 401k participants from the economic turmoil caused by the crisis. The Cares Act will affect how employers operate their 401k plans.

This article discusses the significant issues raised by the crisis in connection with 401k plans. In addition, the article will address how some of these issues are affected by the provisions of the Cares Act.

I. Reduction or Suspension of Employer Contributions

A significant issue with which employers are confronted is a lack of capital to operate their businesses caused by the crisis. In turn, this is causing employers to determine whether they can save money by ceasing to contribute to their 401k plans. Whether a plan sponsor may cease or reduce contributions depends upon the nature of the contributions. Specifically, this determination depends on whether the contributions are made on a "discretionary" or "mandatory" basis.

A. Discretionary Contributions

Under the Internal Revenue Code of 1986, as amended ("Code"), a "tax-qualified" retirement plan must be operated in accordance with its terms. [See I.R.C. § 401(a)(1); Treas. Reg. § 1.401-1(a)(2); see also TAM 8752001 (July 10, 1987); see also "A Guide to Common Qualified Plan Requirements" IRS On-line Publication] Thus, contributions to a plan can be ceased at any time if a discretionary matching contribution formula or a discretionary nonelective contribution formula is set forth in a plan document.

B. Mandatory (Including Safe Harbor) Contributions

1. Mandatory Employer Contributions

As mentioned above, a "tax-qualified" retirement plan must be operated in accordance with its terms. [See id.] Thus, if a matching or nonelective employer contribution is "fixed" for a plan year of a plan, the terms must be followed and the contributions must be made for the plan year.

In addition to having to operate a tax-qualified plan in accordance with its terms, the tax qualification rules of the Code provide that a retirement plan may not retroactively reduce benefits that have accrued. [IRC § 411(d)(6)] This requirement is known as the "anti-cutback" rule. With respect to a plan with a mandatory employer contribution formula, the rule requires that the participants of the plan receive contribution in accordance with the formula. For example, if a retirement plan provides for a mandatory employer nonelective contribution in an amount equal to 5 percent of compensation for a plan year, the plan could not be amended to remove the contribution during the plan year. This is because, in such a situation, any participant who was promised the 5 percent contribution and did not receive it because of the removal of the contribution would have had his or her benefit reduced after the fact. That is an impermissible cutback.

Allocation restrictions in a retirement plan may be very advantageous to an employer with respect to avoiding the anti-cutback rule in connection with employer contributions. By making the allocation conditional on events that cannot occur until the end of the year, there is no "accrual" of a right to a contribution during the year. This enables the amount or allocation formula for a contribution to be modified during the year without effecting a cutback. With regard to the aforementioned example, assume that an employer that sponsors a plan with a restriction that states that if a participant is not employed on the last day of a plan year, he or she will not receive an employer contribution (either matching or nonelective) for the year. In addition, assume the employer removes the mandatory employer contribution formula from the plan during a plan year. This is permitted because the allocation restriction prevented any participant from accruing a benefit under the plan until the last day of the plan year. Thus, during such year, the plan could be amended to change the formula.

2. Safe Harbor Contributions

Similar to mandatory employer contributions, safe harbor contributions are fixed. However, safe harbor matching or nonelective contributions may be suspended mid-year in one of two ways.

One method for suspending safe harbor contributions requires the provision of the annual safe harbor notice to include a statement that the plan may be amended during the plan year to reduce or suspend safe harbor contributions and the reduction or suspension will not apply until at least 30 days after all participants are provided notice of the reduction or suspension (This

notice is also known as a "maybe" notice.). [See Treas. Reg. § 1.401(k)-3(g)(1)(i)(A)(2); Treas. Reg. § 1.401(m)-3(h)(1)(i)(A)(2)]

Another method for suspending safe harbor contributions requires a plan sponsor to be "operating at an economic loss" for the plan year. [See Treas. Reg. § 1.401(k)-3(g)(1)(i)(B); Treas. Reg. § 1.401(m)-3(h)(1)(i)(B)] In determining if the plan sponsor has been operating at such a loss, the Treasury regulations refer to section 412(c)(2)(A) of the Code. However, there is no further guidance provided in this regard. Thus, the plan sponsor should make the determination based on generally accepted accounting principles.

With respect to either method for suspending safe harbor contributions, the following requirements must be met.

1) All participants must be provided a "supplemental" notice which explains: the consequences of the amendment which reduces or suspends future safe harbor contributions; the process for changing elective deferral elections, including after-tax elections; and the effective date of the amendment.

2) The reduction or suspension of safe harbor contributions may be effective no earlier than the later of the date the amendment is adopted or 30 days after participants are provided the supplemental notice.

3) Eligible employees are given a reasonable opportunity to change their elective deferral elections (generally the "30-day notice" requirement).

4) The plan is amended to provide that it must satisfy both the "actual deferral percentage" test ("ADP") and the "actual contribution percentage" test ("ACP") tests (These are the nondiscrimination tests applicable to elective deferral and employer matching contributions to a 401k plan, respectively.) for the entire plan year using the "current year" testing method.

5) The plan sponsor makes all safe harbor contributions through the effective date of the amendment.

[See Treas. Reg. § 1.401(k)-3(g)(1); Treas. Reg. § 1.401(m)-3(h)(1)]

II. Partial Plan Terminations

Section 411(d)(3) of the Internal Revenue Code of 1986, as amended, specifies that a retirement plan will not be tax-qualified unless it provides that, upon its partial termination, the rights of all "affected employees" to benefits accrued to the date of such partial termination, to the extent funded on that date, or the amounts credited to their accounts, are nonforfeitable. Thus, if a partial termination occurs, all participating employees who had a severance from employment during the applicable period must be fully vested in their accounts, to the extent

funded (Therefore, a plan sponsor could not use forfeitures of non-vested account balances for future employer contributions under the plan or to pay administrative fees in connection with the plan. In addition, these employees would be vested in their account balances if they are re-hired by an employer.). The term tax-qualified for purposes of the partial plan termination rule applies to tax-qualified 401k plans.

The facts and circumstances determine whether or not a partial plan termination occurred under section 411(d)(3) of the Code. [I.R.C. § 401(d)(3); Treas. Reg. § 1.411(d) 2(b)(1)] However, there is some guidance that exists in this regard. The following discusses this guidance.

The term affected employee is not defined in the Code or Treasury regulations. However, the Sixth Circuit Court of Appeals in Borda v. Hardy, 138 F. 3d 1062 (6th Cir.1998) at 1067, stated that an affected employee in pertinent part should be an employee who had "separated from service".

The term separated from service is not defined in the Code or Treasury regulations. However, an Internal Revenue Service ("IRS") website entitled "Retirement Plan FAQs regarding Partial Plan Termination" which appears to be used to inform employees of their "vesting" rights in connection with tax-qualified retirement plans states: "Your plan may have a partial termination if more than 20% of your total plan participants were laid off in a particular year.". Thus, a separation from service for purposes of the Partial Termination Rule would include a situation where an employer lays off its workforce, provided that the other requirements of the Partial Termination Rule were met.

Under Revenue Ruling 2007-43, the IRS set forth that a 20% or greater "turnover rate" in the "applicable period" creates a rebuttable presumption that a partial termination occurred. To calculate the turnover rate, all participating employees, both vested and non-vested, are taken into account. The turnover rate is determined by dividing the number of participating employees who had an "employer-initiated severance" from employment during the applicable period by the sum of all of the participating employees at the start of the applicable period and the employees who became participants during the applicable period. [Rev. Rul. 2007-43]

The applicable period is typically one plan year, but can be longer if there are a series of related severances from employment. [See id.] For example, assume some employees of a company were laid off in 2019. However, these layoffs did not concern the Coronavirus health crisis. Thus, these laid off employees will not be counted in determining whether the "20% threshold" will be met in 2020 because of the crisis. An employer-initiated severance includes events outside of the employer's control, such as depressed economic conditions.

The aforementioned rules can be shown in the following example. Assume that the number of participants in a plan on January 1, 2020 (the beginning of the plan year of the plan) was 1,500. Further assume that 380 participants were laid off in 2020 because of the Coronavirus health crisis. Thus, 25.3% of the plan's participants were terminated due to the crisis. Therefore, a partial plan termination would occur because the 20% threshold was exceeded.

Finally, please note that there has been a request has been made to the IRS and Department of Labor to exempt employer-initiated layoffs from the partial plan termination threshold because of the Coronavirus health crisis for six months until after the government's emergency declaration is lifted. The retirement plan relief rules of the Cares Act generally help employees, not employers. Thus, no laws assisting employers with the application of the "full vesting" provision of the partial plan termination rule may be forthcoming. However, under the Cares Act, certain minimum funding requirements in connection with defined benefit pension plans have been relaxed to permit plan distributions. This evidences that the federal government may be inclined to relax the partial plan termination rule to encourage employers to rehire laid off workers who would otherwise have been fully vested in retirement plans.

III. Distributions and Hardship Withdrawals

A. Coronavirus-related Distributions

1. General Rules

The Act permits tax-favored, penalty-free, coronavirus-related distributions ("CDRs") up to $100,000 between Jan. 1-Dec. 31, 2020. [Cares Act Section 2202(a)] Such a distribution is made to an individual: (1) who is diagnosed with COVID-19, (2) whose spouse or dependent is diagnosed with the virus, or (3) who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business owned or operated by the individual due to virus, or other factors as determined by the Secretary of the Treasury (together a "Qualified Individuals"). In this regard, a plan administrator may rely on a certification by the employee.

If CDRs are received, the 10% early distribution penalty is waived for distributions up to $100,000. The distributions may be repaid or contributed as a "trust-to-trust" transfer (i.e., indirectly rolled over) to a tax-qualified retirement plan or IRA, within three years of the distribution. The amount distributed may be included as income for tax purposes ratably over three years as well. In addition, the mandatory 20% withholding rules will not apply to the distributions.

2. Questions Regarding Spousal Consent Requirements, Wet Signatures, and Other Issues

Nothing in the Cares Act states that any spousal consent requirements concerning retirement plans are waived. Thus, it may still apply to CRDs. However, nothing is expressly stated in the Act that CRDs can be received, for example, from assets in an employer contribution account which may not be distributed while a participant is in-service or before age 59½ if a plan contains this restriction. However, it is reasonable to assume that these restrictions are overridden by the Act. Thus, the same argument could be made regarding the application of the spousal consent rules (i.e., that since the consent rules are not specifically discussed in the Act, they do not apply to CRDs). Therefore, more guidance is needed with regard to this issue.

Even if the spousal consent rules still apply to CRDs, the state "lockdown" orders and the necessity of social distancing may make it impossible for many participants to have their spouse's signature witnessed in front of a plan representative or notary. Thus, it is possible that as a practical matter some plan sponsors may not comply with the spousal consent requirement.

The regulatory agencies are aware of the fact that many participants and representatives of a plan sponsor have moved to a work-from-home environment, and therefore cannot provide wet signatures on forms or to witness participant signatures. Thus, hopefully, there will be some legislative or regulatory relief provided in this regard.

There are other issues about the application of the CRD rule which still need resolution. For example, can the amount to be distributed be limited to just employee contributions (as opposed to employer contributions) (or just to a specific type of contribution like rollover contributions)? If an amount equal to the amount of the CRD is repaid, does the participant file an amended tax return to claim a refund of the taxes paid from receiving the distribution? Does a plan have to permit the repayment of a CRD? If the repayment of CRD is treated as a rollover and a plan which allows in-service distributions of rollover assets at any time, may the amount paid back be eligible to be distributed at any time?

B. Hardship Withdrawals

The 401(k) regulations include a hardship withdrawal safe harbor for expenses and losses incurred by the participant of a disaster declared by the Federal Emergency Management Agency (FEMA), provided that the employee's principal residence or principal place of employment at the time of the disaster was located in an area designated by FEMA for individual assistance with respect to the disaster. [Treas. Reg § 1.401(k)-1(d)(3)(ii)(B)(7)] Currently, all states have been declared as a federal disaster zone by FEMA. This safe harbor provision must be implemented into a plan for distributions to be applicable. However, there has been no guidance issued regarding the documentation required to justify such a withdrawal.

Record keepers of 401k plans will probably have a FEMA disaster safe harbor hardship withdrawal process in place for those clients wishing to permit this type of distribution because of the Coronavirus health crisis. However, it is probably more advantageous for eligible participants to instead take CDRs. This is because, as mentioned above, they are not required to satisfy the stricter safe harbor hardship withdrawal requirements, are exempt from the 10% early withdrawal penalty, include an extended taxation period, and, importantly, may be repaid to the plan.

C. Required Minimum Distributions

The Cares Act waives the Required Minimum Distributions (RMDs) rules in 2020 (including for those participants who had not yet received their first distribution if they turned 70 ½ in 2019). [Cares Act Section 2203] In addition, a plan beneficiary receiving distributions over a 5-year period will be able to waive the distribution for 2020.

IV. Plan Loans

A. Cares Act

The Cares Act also applies to Qualified Individuals in connection with plan loans. [Cares Act Section 2202(b)] In this regard, the Act temporarily increases plan loan dollar limits to the lesser of $100,000 (less any outstanding loan amounts) or 100% of the participant's vested balance (applies to loans taken within 180 days of the enactment (March 27, 2020)). This doubles the pre-Act limits.

In addition to the maximums on the amount of a plan loan which may be received, the Cares Act permits a participant to suspend all loan repayments with scheduled due dates between March 31, 2020 and December 31, 2020 for up to a year. At the end of the suspension period, the loan must be re-amortized to include interest accrued over the suspension period. In addition, the length of the suspension is to be added on to the length of the loan term. Furthermore, the legal maximum term for a plan loan (five years from the original date of the loan for general purpose loans or the plan limit on primary residence loans (which could be up to 30 years)) may also be disregarded during this period, if payments are delayed.

B. Other Loan Relief not Involving the Cares Act

Under current Treasury regulations, in general, plan loan repayments may be suspended for not longer than one year if a participant has separated from service either through furlough or layoff and either without compensation or at a rate of compensation that is less then the loan repayment amount. [See I.R.C. § 72(p); Treas. Reg. § 1.72(p)-1 Q & A-9] However, this rule only applies to the extent that the furlough or lay off constitutes a bona fide leave of absence under the Treasury regulations concerning plan loans, and to the extent that it is allowed under a plan's loan policy. If this rule applies, the loan must be totally repaid, including interest accruing during the leave, within the legal maximum term.

There are also instances in which a participant may reduce his or her loan repayments by extending out the maturity date of the loan. [See I.R.C. § 72(p); Treas. Reg. § 1.72(p)-1 Q & A-20] In general, a plan loan may be re-amortized by extending the loan to the legal maximum period if a plan's loan policy allows for refinancing and the current loan is less than the legal maximum. However, participants in this situation would need to have the ability to increase the amount of their loan because refinancing involves a request for additional funds.

There is also relief under the Treasury regulations for employees who separate from service with an outstanding plan loan. [See I.R.C. § 402(c); Treas. Reg. § 1.402(c)-2 Q & A-9] In this regard, terminated participants have an extended period for making an indirect rollover contribution to their new employer's plan or an IRA in the amount of their qualified loan offset (This is the amount of the taxable distribution of the outstanding balance of the loan plus accrued interest.). This indirect rollover contribution may be made on or before a participant's deadline

for filing his or her federal taxes, including extensions, for the year in which the qualified offset occurs.

C. Consequences if a Plan Loan Is not Repaid

Under the normal default provisions of a plan, if loan repayments are not made by the end of the cure period (typically the end of the quarter following the quarter in which the payments were due), the outstanding balance of the loan, plus accrued interest, will be deemed to be a taxable distribution to the participant. [See I.R.C. § 72(p); Treas. Reg. § 1.72(p)-1 Q & A-10] Thus, these normal default rules will apply to any loan repayments owed by Qualified Individuals that were due before the Cares Act's effective date (i.e., March 27, 2020) and that are not current, or any payments due in general for participants that are not Qualified Individuals or on a bona fide leave of absence that are not current.

D. Discontinuing Plan Loan Repayments

It may be possible to discontinue loan repayments if an employee is not a Qualified Individual or on an authorized unpaid leave of absence. However, this can raise certain tax qualification issues. For example, certain nondiscrimination rules may require similarly situated employees to be treated in a similar manner in this situation. [See I.R.C. § 401(a)(4)] Thus, plan sponsors with participants in this situation should consult their own legal counsel with respect to this matter.

E. Spousal Consent and Wet Signature Requirements

Again, the Cares Act does not appear to have waived any spousal consent requirements concerning retirement plans. Thus, the requirement may also apply to plan loans. However, there are similar concerns as those that apply to the spousal consent and wet signature requirements as discussed above.

V. Cares Act Plan Amendments

Plan amendments for the aforementioned provisions of the Act (all of which are optional in nature) would be required by the last day of the plan year beginning on or after Jan. 1, 2022. [Cares Act Section 2202(c)] Thus, the provisions of the Act can be implemented immediately.

Record keeping firms for 401k plans are mixed on how the amendments should be made. Some companies have implemented an "opt out" system where the amendments permitted by the Cares Act automatically apply unless a plan sponsor states otherwise. Other record keeping companies have adopted an "opt in" approach to amending plans where the plan sponsor must choose the specific amendments that it wishes to make to a plan. Thus, the document checklists and notifications that are provided by a record keeper to a plan sponsor should be carefully examined so that any amendment that is made to a plan is in accordance with the plan sponsor's intent.

Conclusion

The decisions by employers to cease or reduce employer contributions to a retirement plan or to lay off or furlough employees because of the COVID-19 are difficult. In these situations, employers realize that employees must deal with having their employer compensation package either discontinued or reduced. The retirement plan provisions of the Cares Act will provide some relief to workers in these situations. However, the cost of this is high because a participant has to invade his or her retirement plan to obtain money. In addition, once a participant receives a distribution from a plan, he or she will "lock in" the investment losses that have occurred as a result of the crisis. Finally, the implementation of immediate and/or easy access to retirement plan funds, especially ones that emanate from employer contributions, could run afoul of an employer's philosophy of using 401k benefits solely for retirement.

Hopefully, the difficult times caused by the pandemic will end soon and our nation's economy, along with the safety net provided by retirement plans, will bounce back as a result.