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. If a tax-qualified plan provides for discretionary matching contributions or a discretionary nonelective contributions, contributions are not required to be made.

B. Mandatory (Including Safe Harbor) Contributions

1. Mandatory Employer Contributions

If a matching or nonelective employer contribution is "fixed" for a plan year of a tax-qualified 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 Section 411(d)(6) of the Code provide that a retirement plan may not retroactively reduce benefits that have accrued. This requirement is known as the "anti-cutback" rule. With respect to a plan with a mandatory employer contribution formula, employer contributions must be allocated to the accounts of plan participants in accordance with the formula. For example, if a retirement plan provides for a mandatory employer nonelective contribution in an amount equal to five percent of compensation for each plan year, the plan could not be amended to reduce the contribution during the plan year. Any participant who was promised the five percent contribution during the year and did not receive it because of a reduction of the contribution would have had a reduction or cutback in his or her benefit.

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. 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, allowing the plan to 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 regarding this method, so 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" ("ADP") and the "actual contribution percentage" ("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 Code 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. If a partial termination occurs, all participating employees who were affected by incurring severance from employment during the period in which it occurs must be fully vested in their accounts, to the extent funded (A plan sponsor could not use forfeitures of non-vested account balances for future employer contributions under the plan or paying administrative fees in connection with the plan. In addition, the affected employees would be vested in their account balances if they are re-hired by an employer.

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). The Treasury regulations set forth that one of these "facts and circumstances" is "the exclusion, by reason of … severance by the employer, of a group of employees who have previously been covered by the plan". Treas. Reg. § 1.411(d)-2(b)(1). There is some guidance that is helpful in determining whether a partial plan termination occurred.

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

With regard to partial plan terminations, 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 <u>laid off</u> in a particular year." Thus, a separation from service for purposes of a partial termination would include circumstances where an employer lays off 25% of its workforce, provided that other facts and circumstances are met.

Although the term separation from service with respect to partial plan terminations is not specifically defined in the Code or Treasury regulations, the term is defined with regard to non-qualified deferred compensation arrangements. The prime purposes of non-qualified deferred compensation plans and 401k plans concern the provision of retirement benefits. Thus, the guidance that applies to the former arrangements can be applied by analogy to 401k plans. The rules of section 409A generally cover non-qualified deferred compensation plans. Specifically, under the Treasury regulations that concern this statute provide a definition of separation from service. In this regard, an employee generally incurs a separation from service when the facts and circumstances indicate that an employee and employer both reasonably anticipate that either one of the following two conditions applies:

1) No future services will be performed after a certain date.

2) The level of bona services performed after such date will permanently decrease to no more that 20 percent of the average level of services performed in the prior 36-month period (or, if less, the full period of service with the employer).

Treas. Reg. § 1.409A-1(h)(1)(ii).

Under Revenue Ruling 2007-43, the IRS established 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. For example, assume some employees of a company were laid off in 2019. These layoffs did not concern the Coronavirus health crisis but layoffs associated with the virus in the United States did not occur until 2020. Thus, these laid off employees will not be counted in determining whether the "20% threshold" will be met in 2020 because of the crisis.

For 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, and 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, the 20% threshold would be exceeded.

An employer-initiated severance includes events outside of the employer's control, such as depressed economic conditions.

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 are for the benefit of employees participating in benefit plans. Consequently, employees would benefit from the application of the "full vesting" provision of a partial plan termination rule. However, under the CARES Act, certain minimum funding requirements in connection with defined benefit pension plans have been relaxed to permit plan distributions. The impact of COVID – 19 may be considered in the facts and circumstances regarding whether a partial plan termination has occurred.

III. Distributions and Hardship Withdrawals

A. Coronavirus-related Distributions

1. General Rules

The Act permits tax-favored, penalty-free, coronavirus-related distributions up to $100,000 on or after January 1, 2020, and on or before December 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 due to the virus, 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 (a "Qualified Individual"). A plan administrator may rely on a certification by the employee as to whether the employee satisfies the conditions for a Qualified Individual.

If a coronavirus-related distribution is made, the 10% early distribution penalty under section 72(t) of the Code does not apply for distributions up to $100,000. If a participant who receives the distribution also contributes an amount equal to the amount of the distribution to a tax-qualified retirement plan or IRA within three years of receiving the distribution, the amount distributed will be treated as having been received in a rollover contribution and having been transferred as a "trust-to-trust" transfer to a tax-qualified retirement plan or IRA. 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, Actual Signatures, and Other Issues

There are some issues that need clarification with regard to coronavirus-related distributions. Nothing in the CARES Act states that any spousal consent requirements concerning retirement plans are waived. In addition, nothing is expressly stated in the Act that coronavirus-related distributions 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. Therefore, more guidance is needed with regard to these issues.

Even if the spousal consent rules still apply to coronavirus-related distributions, 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 actual 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 coronavirus-related distribution 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 coronavirus-related distribution 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 coronavirus-related distribution? If the repayment of coronavirus-related distribution 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. 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) are not required to be made in 2020 (including for those participants who had not yet received their first distribution if they turned 70 ½ in 2019) under Section 2203 of the CARES Act. In addition, a plan beneficiary receiving distributions over the “five-year distribution” rule (i.e., full distribution of the account must be made by the 5th anniversary of the participant’s death).may extend their required distribution by one year (Thus, full distribution of the account must be made by the 6th anniversary of the participant’s death.).

IV. Plan Loans

A. CARES Act

Section 2202(b) of the CARES Act also applies to Qualified Individuals in connection with plan loans. Prior to the effective date of the Act (March 27, 2020), a participant could take a plan loan of up to the lesser of $100,000 (less any outstanding loan amounts) or 50% of the participant’s vested account balance. *See* I.R.C. § 72(p)(2)(A). 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. Thus, the Act doubles the pre-Act limits. This applies to loans taken within 180 days of the enactment (March 27, 2020).

In addition to the maximums on the amount of a plan loan which may be received, the CARES Act permits a participant to delay all loan repayments with scheduled due dates beginning on March 27, 2020, and ending on 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 “five-year” plan loan limit (five years from the original date of the loan for a non-principal residence loans) 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 than 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 (i.e., five years from the original date that the loan is made for "general purpose" loans or the plan limit on primary residence loans (*see* I.R.C. I.R.C. § 72(p)(2)(B)).

There are also instances in which a participant may reduce his or her loan repayments by extending out the maturity date of the loan (A similar situation could occur if a participant takes out another loan to repay an outstanding loan, provided that this does not violate the rules of the Code and the plan's loan policy). *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 "plan loan repayment" 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. These normal default rules will apply to any loan repayments owed by Qualified Individuals that were due before 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

A plan sponsor could discontinue loan repayments in a situation not involving the CARES Act or unpaid leave of absence. However, this will cause loans to default and eventually become taxable distributions. *See* I.R.C. §§ 72(p) and 402(c). In addition, the discontinuance of loan repayments in this situation 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).

E. Spousal Consent and Actual Signature Requirements

The CARES Act does not waive 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 actual signature requirements as discussed above.

V. CARES Act Plan Amendments

Plan amendments for the CARES Act (all of which are optional) would be required by the last day of the plan year beginning on or after Jan. 1, 2022. CARES Act Section 2202(c). Thhe provisions of the Act can be implemented immediately with the amendment to follow.

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 and 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.