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INSIGHT: 401(k) Plans During the Covid-19 Pandemic

BY DANIEL MORGAN

Now that it has become clear that the Covid-19 health crisis will result in significant economic disruption, including furloughs and job losses, employers should expect to confront challenges related to their 401(k) plans. Here are a several of the planning and operational concerns that are on the horizon.

EMPLOYER CONTRIBUTIONS

If, as anticipated, business disruptions produce a substantial loss of cash flow, employers may feel the need to reduce or eliminate the contributions that they make to their 401(k) plans. Employer contributions to 401(k) plans take one of two forms, nonelective contributions and matching contributions.

Discretionary Nonelective and Matching Contributions

Reducing or eliminating discretionary nonelective and discretionary matching contributions to a 401(k) plan is generally a relatively simple matter, inasmuch as there is no need to amend the plan. The primary concern is adequately communicating the changes to plan participants.

Safe Harbor Nonelective and Matching Contributions

Safe harbor contributions are matching contributions and nonelective contributions that an employer makes to a 401(k) plan, which allow the employer to forego nondiscrimination testing.

Generally, an employer may not suspend or reduce safe harbor contributions midyear. There are two exceptions. The first applies to an employer that is operating at an ''economic loss.'' Under the second exception, an employer must have included in the annual safe harbor notice, which is required to be delivered to employees, a statement that the plan may be amended in the upcoming year to suspend or reduce safe harbor contributions and that the suspension or reduction will not apply until at least 30 days after all eligible employees receive a supplemental notice of the suspension or reduction.

Under both exceptions, employees must receive the supplemental notice, and the suspension or reduction cannot take effect until no earlier than the later of the date the plan is amended or 30 days after the supplemental notice is provided. In addition, employees must have a reasonable opportunity after receipt of the supplemental notice to modify their elective contributions. Finally, the plan must be amended to require the nondiscrimination testing that the safe harbor contributions would have enabled the employer to avoid.

If an employer who desires to suspend or reduce safe harbor contributions in 2020 had not included a statement in this year's safe harbor notice that the employer was reserving the right to suspend or reduce safe harbor contributions, the employer will be required to rely upon the economic loss exception. For plan years beginning after Dec. 31, 2019, the SECURE Act eliminated the requirement that an employer who makes nonelective safe harbor contributions must disseminate an annual safe harbor notice. Guidance from the IRS will

need to be forthcoming as to how this change impacts the ability of an employer to suspend or reduce non-elective safe harbor contributions.

Non-Safe Harbor Mandatory Matching Contributions

Some 401(k) plans have what I refer to as ''embedded'' non-safe harbor matching contributions; that is, matching contributions that are not safe harbor matching contributions, which the plan document states that the employer will make. These are commonly described in the plan document as a percentage (or tiered percentage) of an employee's elective contributions. In order to reduce or stop these matching contributions, the employer is required to amend the plan and must make matching contributions for the portion of the plan year prior to the effective date of the amendment.

Missed Contributions

If an employer fails to make a safe harbor contribution or a promised matching contribution to its 401(k) plan, the plan's tax qualification may be jeopardized, and the employer may be found to have engaged in a prohibited transaction or a fiduciary breach.

PARTICIPANT LOANS

Most 401(k) plans allow plan participants to borrow against their plan benefits. Under IRS and Department of Labor regulations, participant loans must be repaid pursuant to payroll withholding over a five-year period (which may be for a longer period, if the loan is used to acquire a principal residence), with level amortization. If an employee fails to timely make a loan payment, the remaining balance of the loan is treated as a taxable distribution and generally will also be subject to an additional 10% tax if the employee has not attained age 59½ at the time that the loan default occurs.

A plan is permitted to have a cure period that ends on the last day of the calendar quarter following the calendar quarter in which a loan payment is missed. What this typically means is that if an employee with a plan loan terminates employment and does not repay the loan within the cure period (or a shorter period, if the plan's borrowing guidelines so specify), the remaining balance of the loan will be taxable.

In order to conform to IRS and Department of Labor requirements, the maximum amount that a participant may borrow may not exceed the lesser of $50,000 or 50% of the participant's vested plan benefits. Importantly, in view of the significant investment losses experienced by many 401(k) plan participants, the 50% requirement need only be satisfied at the time the loan is made and need not be periodically re-evaluated.

Workforce reductions, in the form of furloughs, and severance benefits raise planning issues with respect to participant loans.

Impact of Furloughs

Many employers have already begun to furlough employees rather than terminating them. Under IRS regulations, employees with plan loans who are placed on unpaid leave of absence may forego making loan payments during the leave of absence without triggering taxation of the loan as long as the following requirements are met:

1. The furlough period must not exceed one year.
2. The loan must be repaid by the end of the original term of the loan. The loan payments missed during the furlough period may be repaid by either continuing the original rate of repayment, with a balloon payment of the missed installments at the end of the term, or by ratably increasing the installments during the remainder of the repayment period. This requirement poses potential practical problems in the case of an employee who is furloughed near the end of the original term of the loan.

Loan Repayments From Severance Pay

In an effort to protect employees who have been laid off from having to fully repay a plan loan by the end of the cure period in order to avoid being taxed on the balance of the loan, employers may want to consider permitting terminated employees who are receiving severance payments to continue paying their loans by withholding loan payments from their severance pay. Such an arrangement is permissible—by way of contrast, it is not permissible to make 401(k) elective contributions from severance pay. Please keep in mind the following:

1. The plan's borrowing guidelines need to provide that loan payments may be made from severance pay.
2. Withholding loan payments from severance pay may create administrative difficulties, since employers often handle severance pay operationally in a different manner than payroll payments.
3. Care needs to be taken not to inadvertently create an IRS nondiscrimination problem, which might occur if severance pay is disproportionately provided to highly compensated employees.

IN-SERVICE DISTRIBUTIONS

Some employers may be interested in assisting employees who have had their hours reduced or who have been placed on furlough and would like to receive distributions of their 401(k) benefits, but who are not otherwise eligible for a distribution. This decision, however, needs to take into consideration that allowing workers greater access to their 401(k) benefits may cause them to realize outsized investment losses attributable to the recent sharp drop in the stock market. Here is a summary of some of the potential in-service distributions that a 401(k) plan could make available to plan participants.

Hardship Withdrawals of Employee 401(k) Contributions

Although as a general rule a participant's 401(k) elective contributions may only be paid to a participant upon a separation from service, an important exception is that a plan may provide that a participant can obtain a hardship withdrawal of elective contributions. Most 401(k) plans make hardship withdrawals available pursuant to an IRS regulatory safe harbor. Compliance with this safe harbor alleviates the need for a plan administrator to make potentially difficult determinations

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as to whether a participant has, in fact, suffered a financial hardship.

Under the IRS safe harbor, hardship withdrawals may only be made for certain categories of enumerated expenses and, therefore, cannot be made solely as a result of a reduction of hours or a furlough. Given the current circumstances, two potentially important safe harbor categories are:

1. *Expenses for medical care for the plan participant and the participant's primary beneficiary*. The IRS defines ''primary beneficiary'' for this purpose as ''an individual who is named as a beneficiary under the plan and has an unconditional right, upon the death of the employee, to all or a portion of the employee's account balance under the plan.''

2. *Payments necessary to prevent the eviction of an employee from the employee's principal residence or foreclosure on the mortgage on that residence*.

Before a participant may receive a hardship withdrawal, the participant must have taken all other available distributions from the plan (and certain other employer-sponsored plans specified in IRS regulations). Other hardship safe harbor conditions, including the requirements that a participant borrow the maximum amount under the plan and that the participant suspend elective contributions for six months after receiving the hardship withdrawal, have been repealed by legislation enacted in 2018.

Unlike plan loans, hardship withdrawals are taxable, and although hardship withdrawals are subject to the pre-age 59½ additional tax, the additional tax has a number of exceptions. Notably, the withdrawal will not be subject to the additional tax to the extent that the amount of the withdrawal does not exceed ''the amount allowable as a deduction under section 213 [of the Internal Code] . . . for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).'' Section 213 authorizes a deduction for ''the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent . . . to the extent that such expenses exceed 7.5 percent of adjusted gross income.''

Withdrawals of Matching and Other Employer Contributions

It is possible for a 401(k) plan to provide for in-service distributions of matching and other employer contributions, including, for example, in the form of hardship withdrawals. In addition, because in-service distributions of most employer contributions are not subject to the more restrictive rules applicable to in-service distributions of 401(k) elective contributions, a 401(k) plan could be amended to provide that a participant whose hours have been reduced or who has been furloughed, and who has completed a minimum specified period of service (at least two years), may withdraw all (or up to a stated percentage or dollar amount) of the vested portion of the matching or discretionary employer contributions held on the participant's behalf under the plan. If the amendment is structured to meet the IRS' ''window benefit'' rules, which primarily look to whether the right created by the amendment is temporary in nature, this in-service distribution right can be limited to hour reductions and furloughs occurring during a particular period of time.

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Author Information

Dan Morgan is a partner in the Washington, D.C., office of Blank Rome LLP.

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