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Flashpoint: The CARES ACT: Do We Have To?

Much of the confusion around the CARES Act ("CARES" or the "Act") centers on what is mandatory and what is voluntary. This has produced a lot of controversy, mostly because CARES is not written in a manner that directly addresses that key question.

For those of you who are in the retirement plan business, the confusion is reminiscent of when the catch-up contribution rules were enacted, and we all wondered what elections had to be made by the participant to make a catch-up contribution. We were a little bamboozled by the fact that certain deferrals would become catch-up contributions by virtue of something other than employee intent, such as when an ADP test was failed and a deferral by the HCE was reclassified. The CARES rules are analogous. There are times when the employer has to authorize certain distributions, loans, or required minimum distributions to be "covered" by CARES … and there are times when it happens automatically.

(If you are unfamiliar with the CARES provisions, please check out our earlier FlashPoint that goes over this information **here**.

The CARES Distribution Rules

Does the plan need to authorize Coronavirus-Related Distributions ("CRDs")?

CARES defines a CRD to be "*any* distribution … *to an individual*…" that meets certain requirements. It does not require that the plan so permit. It does not require that the individual be employed at the time of the distribution. It simply requires that the person have the virus, have a spouse or dependent who has the virus, or suffer adverse financial effects from the virus. (For a more exacting definition of a Qualified Individual ("QI"), see our earlier FlashPoint **here**.)

This means that, regardless of what the plan says or the employer intends, any distribution from the plan to a QI will qualify that individual for the favorable tax treatment afforded by CARES: exemption from the 10% premature distribution tax, the three-year spread of the income tax, and the ability to re-contribute the distribution within three years to the plan or another eligible retirement plan.

What does CARES mean, then, when it outlines the plans that are *permitted* to provide CRDs?

If any distribution to a QI is a CRD, what's with the special language in the law that authorizes 401(k), 403(b), and governmental 457(b) plans to make a CRD?

That language *permits* a willing employer to amend its plan to provide for a special distributable event in the enumerated plans for a CRD. So, if you have an employee who does not otherwise qualify for a distribution, such individual may nonetheless request and receive a distribution from the plan if s/he is a QI. (Note that the employer has until the end of the 2022 plan year to adopt this amendment.)

> *Example*. Marguerite is a participant in the Lettuce Help You 401(k) Plan. She is an active employee, who is on a paid leave due to the Coronavirus. Therefore, she is not suffering any financial hardship. However, she has contracted the virus, so is a QI. She is not eligible for a distribution from the 401(k) plan, which permits the normal distribution events of termination of employment, attainment of age 59½, death, disability, and hardship. Lettuce Help You decides it will amend its plan by the end of 2022 to permit a special distribution event that will enable QIs to take a distribution. This enables Marguerite to get a distribution from the plan, which will be a CRD.

Plans other than those enumerated are not able to create this special event. However, a person who is otherwise eligible for a distribution from the pension plan and is a QI will enjoy the tax benefits of the CRD.

> *Example*. Lettuce Help You would be willing to amend the cash balance plan it also sponsors to permit Marguerite to take a distribution of her benefit from that plan. However, the law does not let it do so.

> *Example*. Leonard also works for Lettuce Help You and he is over age 59½. In accordance with the law, Lettuce Help You amends its cash balance plan to permit participants to take in-service distributions at age 59½. Leonard may now take a distribution from the cash balance plan. If Leonard is a QI, that distribution will be a CRD.

There is one other plan type that may be amended to permit CRDs, notwithstanding a lack of special authorization in CARES. Profit-sharing plans are authorized by the Code and related regulations to permit distribution upon the occurrence of a stated event. A sponsor of a profit-sharing plan, therefore, may amend its plan (notwithstanding the lack of formal authorization in CARES) to declare the Coronavirus pandemic to be a "stated event" permitting distribution. This will permit distributions to QIs from those plans, if the employer so desires.

So, employers can amend plans to permit CRDs from nonelective (i.e., profit-sharing) contributions and matching contributions (even those held in 403(b) custodial accounts), as well as from elective deferrals, QNECs, QMACs, and safe harbor contributions.

In sum, an employer that does not want to acknowledge CRDs does not have to amend its plan to permit them. Participants who are eligible for a distribution under the plan's normal terms, however, may still treat those distributions as CRDs and get the CRD-related tax benefits if they are QIs under the law.

But, must an employer that does not want to amend its plan for CRDs still identify when someone qualifies for a CRD?

The answer to this question is not clear at this time. CARES provides that, for certain purposes, a CRD is not an eligible rollover distribution. Oddly enough, a CRD may be rolled over either in a direct rollover from the trustee of the distributing plan to the trustee of a recipient plan, or in a 60-day rollover. Furthermore, CRDs may be repaid to the distributing plan or another plan that can accept rollovers within three years.

However, a CRD is not an eligible rollover distribution for purposes of determining what withholding rules apply. Distributions that are not eligible rollover distributions are not subject to the 20% mandatory withholding that normally applies for plan purposes, nor does the employer need to provide the "Special Tax Notice" (a.k.a., the 402(f) Notice) to the recipient. Instead, a waivable 10% rate of withholding applies, and a different notice must be provided to the recipient.

If the plan provides for CRDs, complying with the appropriate withholding regime is critical, and penalties apply if the proper notice is not given to the participant.

However, what is the appropriate action by the Plan Administrator of a plan that is not affirmatively permitting CRDs but has a participant payout that nonetheless qualifies as a CRD for tax purposes? And how is the Plan Administrator to know that the participant is a QI so that the distribution is a CRD?

CARES does not address this issue. There have been other times that the IRS permitted similar penalty-free distributions to victims of hurricane disasters (e.g., after Katrina). In those circumstances, the IRS provided guidance that an employer that chose not to affirmatively provide such distributions did not have to comply with the alternate withholding and notice rules. (*See, e.g.,* Notice 2005-92.)

Assuming that the IRS follows this practice for CARES, Plan Administrators that make distributions from plans that do not specifically adopt the CRD rules may continue to withhold on those distributions at the 20% rate.

How can the Plan Administrator know whether the distribution is a CRD?

CARES permits Plan Administrators to rely on an employee's certification that s/he is a QI. Therefore, if the Plan Administrator provides the requesting participant with a certification form and the participant provides it to the Plan Administrator, the proper withholding treatment may be afforded the distribution.

There is one thing that concerns us, and that is the fact that the wording of CARES permits self-certification only by employees. Did Congress intend to require substantiation from non-employees, such as terminated employees, alternate payees, and death benefit beneficiaries, who are QIs? No one knows, but we all hope not. It is certainly safer to require additional documentation from someone who is not a current employee to treat the distribution as a CRD. A Plan Administrator may choose to allow all QIs to self-certify, but should understand that this method carries some risk that the plan will be deemed to permit an improper distribution or to fail to take appropriate withholding if the IRS strictly enforces CARES's terms.

The CARES Loan Rules

<u>Do we need to authorize Coronavirus-Related Loans (“CRLs”)</u>?

Does a plan need to have a specific provision to permit CRLs or to permit participants to delay their repayment of existing loans?

Not necessarily.

First, let’s recap the normal loan rules and how they are changed by CARES.

CARES amends Code section 72(p), which normally provides for taxation of loan proceeds if certain conditions are not met:

i. the plan permits loans;
ii. loans are properly documented with a promissory note;
iii. the loan principal does not exceed the lesser of 50% of the participant’s account or $50,000;
iv. the loan is fully amortized with payments at least quarterly and over a term of not more than five years (unless it is for a home purchase); and
v. payments are made as required or late payments are made up within a certain grace period.

Under CARES, these rules are modified so that a taxable event does not occur if the loan amount or the repayment scheme follows the Act’s structure. In particular, CARES permits QIs to:

i. take a larger loan (100% of the participants account, up to a maximum of $100,000); and
ii. delay payments on existing loans for up to one year (with all later payments similarly extended so that the loan is essentially “put on hold” for one year). Interest on the loan accrues during the one-year delay.

Now, let’s talk about what the plan’s sponsor must do and what is voluntary.

To grant loans, a plan must expressly permit them. So, if the plan does not so permit, a participant may not take a loan from the plan, even a CRL. An amendment to the plan to permit loans must be adopted by the end of the plan year in which a new loan is made.

<u>The expansion of available loan amounts</u>

If the plan already allows for loans, but neither the plan nor the loan procedure is amended, then the plan will likely violate its terms if it provides a loan in excess of the non-CARES limits, i.e., 50% of the account up to a maximum of $50,000. As a result, an employer that is unwilling to permit CRLs is not required to expand the loan availability. This means that a participant will not be able to take a larger loan than the plan normally permits, notwithstanding that the law has been modified. Any amendment to permit the modification of the loan limits may be adopted up until the end of the 2022 plan year.

On the other hand, if the plan incorporates the limits on loans by reference (for example, says in its terms that the plan may permit loans “up to the limitation provided in Code section 72(p)”), the

modification of that Code section automatically modifies the plan, as well. So, no amendment is needed, and the plan permits CRLs.

The modified repayment schedule

If a participant does not repay the loan as documented, the Plan Administrator is normally required under Code section 72(p) to recognize a taxable event, commonly referred to as a "deemed distribution." Under CARES, however, there is no taxable event if the individual is a QI and the loan payment was due during the one-year delay period under the Act. Therefore, whether the employer modifies the plan or loan procedure, there is no taxable event for a QI who suspends his or her loan payments.

A different event occurs, however, if the borrowing participant incurs a distributable event under the plan (generally, a termination of employment).

Most plan documents or loan procedures provide that the employer either must or may offset the loan, which creates an *actual distribution* of the loan to the participant; this is always a taxable event. (See, Treas. Reg. §1.72(p)-1, Q&A-13(b), which provides that a plan loan offset "is an actual distribution for purposes of the Internal Revenue Code, not a deemed distribution under section 72(p).") If the plan does not provide for an offset at termination of employment, it is likely that actions by the participant to take a distribution of the balance of his or her account after termination will result in a loan offset under the plan.

Sometimes, the plan is not so straightforward. It might provide that the loan "goes into default" when the participant terminates employment. Does this mean that the loan offset is required? It is not clear. The Plan Administrator is tasked under most plans with the responsibility of interpreting the plan document. Therefore, service providers in that event should discuss this issue with the Plan Administrator. It couldn't hurt to put that interpretation in a written memo or, even better, modify the plan or the loan procedure to clarify what that phrase means for this plan.

So, how does this play out?

Check out the following example.

> *Example.* The Ebenezer Scrooge 401(k) Plan is not amended to provide for a CRL. Bob Cratchit, a Scrooge employee and a QI, has an outstanding loan. Bob stops making loan payments upon being put on unpaid leave due to the Coronavirus crisis. The Plan Administrator wants to consider the loan in default and taxable.

At the time that Bob stops making his loan payments, there is no taxable event. Section 72(p), as amended by CARES, permits Bob an additional year to make a loan payment. As a result, there is no deemed distribution during the one-year delay. If Bob returns to work after the Coronavirus crisis is over, and begins making his loan payments under the extended rules of CARES, he never suffers a deemed distribution or taxable event. There is no taxable event, as the relevant Code section was amended due to CARES, and the plan is not permitted to consider the loan to be taxable to Bob.

On the other hand, if Bob is actually terminated by the company during the crisis, and the plan so provides, the Plan Administrator may offset his loan, creating a taxable distribution that is not forestalled by CARES.

If Bob were put on *paid leave*, rather than unpaid leave, nothing in CARES prevents the company from continuing to remove loan payments from Bob's paycheck.

Note that a loan offset to a QI (which, as noted above, is a bona fide distribution) could be a CRD, qualifying for special treatment, including the possibility of repaying the funds to an IRA or a retirement plan. But, for the offset to qualify as a CRD, the offset must take place before December 31, 2020.

The Required Minimum Distribution (RMD) Waiver

Do we need to suspend RMDs?

CARES provides that the requirements of Code section 401(a)(9), which mandates RMDs, "shall not apply for calendar year 2020" for defined contribution plans, governmental 457(b) plans, and IRAs.

Whether the plan stops distributions to people who would ordinarily be required to take them depends on the plan's language:

- If the plan provides that distributions required under Code section 401(a)(9) (in effect incorporated 401(a)(9) by reference) will be made, no distribution should be made, as there is none required for 2020.
- If the plan specifies required distributions after age 70½ without reference to Code section 401(a)(9), then it is possible that the distributions must still be made; not to do so would violate the plan's terms. Prototype and volume submitter qualified plans are not allowed to incorporate 401(a)(9) by reference, and so likely fall into this category. (As an aside, this age 70½ rule was changed to age 72 for people who did not attain age 70½ before 2020.)

Of course, the law permits an amendment of the plan to "act in accordance with" CARES by the last day of the 2022 plan year. So, the plan could be amended to suspend any language requiring or prohibiting an RMD when the law does not so require.

Can a participant receive his or her RMD, even though the law does not require?

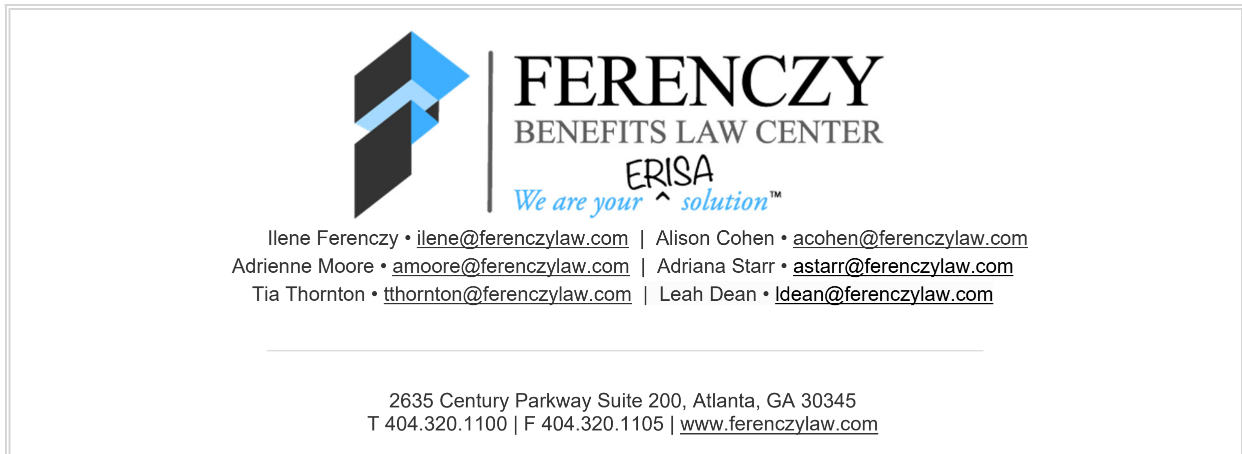
Again, you must read the plan document. If the plan provides that there is a distributable event notwithstanding the requirements of Code section 401(a)(9), then a distribution may be made to the participant. If the plan does not so require, it is possible that no such distribution may be made. Most defined contribution plans permit participants to take distributions long before age 70½, so it is not hard to imagine that participants wanting to take money can do so. (That said, there are plans where RMDs represent the only in-service distribution option.) The only issue at that point will be whether the plan permits a partial distribution or requires that such a participant take the entire balance.

It is helpful to look at how the IRS handled this issue with WRERA in 2009, our only other RMD "holiday." Notice 2009-82 provided a model amendment that allowed the plan to distribute RMDs normally unless the participant elected not to receive them, and another model that said the plan would not distribute RMDs unless the participant requested them. These amendment alternatives permitted plan sponsors to adopt the practice that they preferred. Whether this will be similarly permitted under CARES is yet to be seen.

Again, however, the broad language of the Act should permit you to amend the RMD section of the plan by the end of 2022 to accommodate the approach taken by the plan in this regard.

Keep Good Records

Remember that the plan will be considered to operate in violation of its terms if the ultimate 2022 amendment does not reflect the actions taken in the interim. Therefore, it is critical that the plan sponsor and the recordkeeper and TPA all work together to keep good records, so that the ultimate amendment is prepared correctly.



Ilene Ferenczy • ilene@ferenczylaw.com | Alison Cohen • acohen@ferenczylaw.com
Adrienne Moore • amoore@ferenczylaw.com | Adriana Starr • astarr@ferenczylaw.com
Tia Thornton • tthornton@ferenczylaw.com | Leah Dean • ldean@ferenczylaw.com

2635 Century Parkway Suite 200, Atlanta, GA 30345
T 404.320.1100 | F 404.320.1105 | www.ferenczylaw.com