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Flashpoint: The IRS Cares! (Who'd Have Thunk?) Expanded List of Qualified Individuals and More Info!

On Friday, June 19, 2020, the IRS issued Notice 2020-50 (the "Notice"), which provides expanded guidance on Coronavirus-Related Distributions ("CRDs") and the CARES participant loan rules.

Expansion of Definition of Qualified Individual

You may recall from the prior Flash, "Coronavirus Relief from Congress – The CARES Act," that the following individuals were considered to be Qualified Individuals ("QIs") under the CARES Act for purposes of access to the liberalized distribution and loan rules:

- A participant who is diagnosed with the virus;
- A participant whose spouse or dependent is diagnosed with the virus; or
- A participant who has suffered financial loss from the pandemic because he or she:
    - Was laid off, furloughed, quarantined, or had reduced hours;
    - Cannot work due to the unavailability of childcare because of the pandemic; or
    - Owns or operates a business that has had to close its doors or reduce hours.

Many observed that these categories left out several types of participants who could be suffering financially, most notably those whose spouse experienced the negative financial effects listed above, or those whose hours were the same but whose income was significantly lower due to the pandemic. The Notice grants relief to these individuals, adding the following to the definition of QI:

- A participant whose pay or self-employment income is reduced due to the pandemic, or who has had a job offer rescinded or a new job's start date delayed due to COVID;
- A participant whose spouse or a member of his/her household has suffered the following financial effects due to the pandemic:
    - Layoff, furlough, quarantine, reduced hours, or reduced pay or self-employment income;
    - Cannot work due to childcare unavailability; or
    - Has had a job offer rescinded or the start date of a new job delayed;
- A business owned or operated by the participant's spouse or a member of the participant's household has closed or reduced hours.

For this purpose, a “member of the household” is someone who shares the QI’s principal residence. Presumably, this could include a significant other, roommate, other relative, or anyone else with whom the individual is sharing a home.

Additional Guidance on Employer Reliance on Employee Certification

Many practitioners were concerned at earlier information provided by the IRS that indicated that employee certifications of QI status could be relied upon only if the employer had no contrary actual knowledge. The question arose whether this produced some responsibility on the part of the employer to investigate the status. The Notice clarifies that “actual knowledge” means, in this context, that the employer “already possesses sufficient accurate information to determine the veracity of the employee’s certification.” There is no duty to inquire further. With the expanded definition of QI, it will be extremely rare that an employer would have that knowledge (other than a situation in which the QI is the business owner).

While CARES provides that the Employer can rely on the certification with regard to CRDs, the Notice clarifies that the Employer can also rely on it for loan relief and for recontributions. It applies to all QIs, not just current employees.

The Notice also contains a sample Certification that is deemed to be acceptable. The Certification simply provides “I certify that I meet one of the following conditions …” and then outlines the categories of QIs. There is no need for the participant to specify which category applies to him/her. The lack of specification of this certification as to the reason why someone is qualified may also be considered to avoid any HIPAA privacy concerns about asking about the QI’s health.

Reporting CRDs

The Notice goes into significant detail about the tax reporting and payment rules relating to CRDs.

What Is a CRD?

The Notice clarifies that a CRD is almost any distribution to a QI (not to exceed $100,000). It is possible that the employer and the participant may have different thoughts about whether a given distribution is a CRD. An employer may choose not to amend its plan to provide for CRDs, in which case the employer may not treat any distribution as a CRD. Alternatively, an employer may believe that a given distribution is a CRD, because the employer does not know that the amount paid by the plan, when added to amounts the QI has received from other plans or IRAs, exceeds $100,000. The participant is not constrained on his or her tax reporting by the way in which the plan treated the distribution. Therefore, there must be mechanisms whereby the QI is able to designate an amount as a CRD for his or her taxes. These are discussed below.

From the Employer’s Perspective

A plan must report any CRD in Box 7 of Form 1099-R whether or not the amount is recontributed. There are two choices available to the plan: (1) Code 2 (early distribution, exception applies); or (2) Code 1 (early distribution, no known exception). Needless to say, the first option is more consistent with an employer that recognizes that the distribution is a CRD.

Furthermore, if a plan acknowledges that the distribution is a CRD, it is not an eligible rollover distribution from the plan’s perspective (even though the participant actually can roll it over). This means that the amount is not subject to the 20% mandatory withholding (waivable 10%

withholding applies), and the participant does not need to receive a "Special Tax Notice Regarding Plan Payments" pursuant to Code Section 402(f).

Participant Designations of CRDs

A QI designates a distribution as a CRD by reporting the distribution on his or her 2020 tax return and filing Form 8915-E (which the IRS indicates will be available before the end of this year). If you want a preview, check Form 8915-B, which is used for 2017 disaster relief distributions.

A CRD reported on Form 8915-E qualifies for the waiver of the 10% premature distribution tax under Code section 72(t), the spreading of the income from the distribution over three years (if desired), and the ability to recontribute any portion of the distribution to an eligible retirement plan within three years and have it treated like a nontaxable trustee-to-trustee transfer of the funds. Form 8915-E is also used to report amounts includible in income or recontributed in years subsequent to 2020.

The Three-Year Spread of Income

The QI may choose to include the total income from the CRD in 2020 (i.e., when received) or ratably over 2020, 2021, and 2022. Once the QI timely files his or her 2020 taxes reflecting one of those two methods, it cannot later be changed. All CRDs received must be treated the same for this purpose.

Recontributions

Amounts recontributed prior to the tax return due date (including extensions) for a given year may be reflected on that return. For example, a participant who recontributes a CRD on or before his/her extended 2020 tax return due date of October 15, 2021, may reflect the reduction in taxable income from the recontribution on that return.

IRA owners are normally permitted to make only one IRA rollover per calendar year. The recontribution of CRDs to an IRA, notwithstanding the fact that they are to be treated for tax purposes as rollovers, does not count against that one-per-year limitation.

Recontributions are treated as follows for tax purposes:

1. <u>1-year income inclusion method, recontribution made by that year's tax return due date</u>: The entire CRD is shown as income in 2020; the entire repayment is shown on Form 8915-E for 2020. The QI recognizes no taxable income (or only that amount of CRD in excess of the recontribution) for 2020 from the CRD.
2. <u>1-year income inclusion method, recontribution made in a later year</u>: The entire CRD is shown as income in 2020. When the recontribution is made, the taxpayer must file an amended 2020 return with attached Form 8915-E, and the income from the CRD on the 2020 return will be adjusted accordingly.
3. <u>3-year income inclusion method, recontribution of all or a portion before 2020 taxes are filed</u>: The 2020 tax return will reflect taxable income equal to one-third of the CRD received during the year (up to the $100,000 maximum). Form 8915-E that is filed with the 2020 return will reflect any recontribution up to the tax return due date. If the recontribution equals or exceeds the amount of income for 2020, there will be no net taxable income from the CRD in 2020. If the recontribution exceeds the 2020 income, the offset to income will be applied in 2021 (or, if necessary, 2022).

4. <u>3-year income inclusion method. Recontribution made in years after 2020 taxes are filed</u>: If repayments occur after income from CRDs has been claimed (and appropriate taxes paid), the QI has a choice of carrying the income offset forward or backwards. This is best illustrated by example:

   Example: Tammy receives a CRD of $90,000 in 2020. She includes $30,000 in income on her 2020 tax return. In late 2021 (after the 2020 return was due and filed), she recontributes $45,000 to her IRA. The first $30,000 of the $45,000 repayment will offset the income Tammy would otherwise be claiming in 2021. That leaves an additional $15,000 of recontribution to use. Tammy may either:

   - Amend her 2020 return with the filing of Form 8915-E and reduce her 2020 income by $15,000. If she does that, and makes no further recontribution, she will claim the last installment of $30,000 as income in 2022. Therefore, she will have claimed (on an amended basis) $15,000 of income in 2020; $0 in income for 2021, and $30,000 in income for 2022; or
   - Carry the $15,000 forward to be used to offset the $30,000 she will be including in income on her 2022 return. In that case, she will have claimed $30,000 as income in 2020, $0 in 2021, and $15,000 in 2022.

<u>CARES Loans and Repayment Structures</u>

CARES also amended Code section 72(p) to provide that a QI may suspend loan repayments during a period beginning on or after March 27, 2020, through the end of the year, and that repayment of such amount would be delayed for a year. It has been somewhat up-in-the-air, however, how the repayment of the loan is supposed to occur, with most practitioners looking to the rules that applied for loans to Hurricane Katrina victims. If anyone reading this has heard our Ilene Ferenczy and Derrin Watson speak on a webcast about this, you know that there is some disagreement about the correct method and whether the Katrina-like method makes sense. (Incidentally, Derrin and Ilene will be giving a free webcast about Notice 2020-50 on Wednesday, June 24. To register, visit ERISApedia.com.)

The Notice discusses this issue and reaches something of a middle ground. First, the Notice provides a safe harbor that is, of course, deemed to be permissible. It also permits other "more complex" methods, if the QI desires to use them.

The Employer vs. the Employee

The CARES language provides that any loan to a QI with payments due during the March 27-December 31, 2020, period is subject to the repayment extension. However, the Notice clarifies that a plan sponsor does not need to permit the delay in repayment; it can treat the loan as a deemed distribution notwithstanding the potential that it qualifies for this extension of time. The Notice fails, however, to clarify how the loan is then administered after that point by the plan, or how the affected participant deals with the tax impact of the sponsor's decision.

The Notice confirms that a QI can treat a loan offset as a CRD; it does not permit that treatment for a deemed distribution.

This all begs the question: does the participant have any way to reflect the loan as not being in default for purposes of his or her own taxes, even if the plan treats the loan as a deemed distribution? If so, how?

Historically, the regulations to Section 72(p) indicate that a failure to follow the loan document terms creates a deemed distribution, even if the loan terms are less generous than the language of the Code and regulations. If we look at the violation in this case to be of the loan documents, rather than the Code, it makes sense that the loan is taxable income unless the plan – through use of the CARES provisions – chooses to relax the language of the plan document. In other words, if the plan says the loan is income, it's income, notwithstanding CARES.

Nonetheless, the Notice provides substantial guidance about reporting CRDs and about the dichotomy created by the employer-vs-employee potential. Perhaps future guidance is forthcoming in relation to loans; but don't bet on it. The KETRA guidance (Notice 2005-92) dealing with a similar suspension provision after Hurricane Katrina included identical language, and the IRS never softened the position.

Assuming the Plan Permits the Delay, How Is Repayment Handled?

The Notice provides a safe harbor method for repayment that is essentially identical to the Hurricane Katrina loan guidance. Under this safe harbor:

- All payments are suspended for any period after March 27, 2020, through December 31, 2020.
- Beginning with the first payment date occurring in 2021, the loan, plus any accrued interest, is reamortized. The period for the reamortization will run from January 1, 2021, through the date that is one year after the original loan repayment date.

<u>Example</u>: Kevin borrows $20,000 from the plan on April 1, 2020, to be repaid in level monthly installments through payroll deduction over five years (last payment is due March 31, 2025). The monthly installment is $368.33. Kevin makes payments for three months (through June 30, 2020), before becoming a QI. At that point, payments are suspended through December 31, 2020. On January 1, 2021, the loan value is determined, including interest on the unpaid balance from July 1 through December 31, 2020. The reamortization of that amount runs from January 1, 2021, through March 31, 2026 (one full year after the original repayment date). The revised amortized payment is $343.27.

Alternate Handling

The Notice confirms that "there may be additional reasonable, if more complex, ways to administer section 2202(b) of the CARES Act." The Notice then uses the example of permitting the suspension for a full year, and then reamortizing at that time. However, it appears under this section of the Notice that repayments will begin anew in January of 2021 at the original repayment amount ($368.33 in the above example), with the reamortization then to occur on April 1, 2021 (the one-year anniversary of the date of suspension), as to the remaining loan after both the suspension and the early 2021 repayments.

This section implies that repayments must begin again in January of 2021. Therefore, anyone who believed that the language of CARES simply provided for no loan payments for a year, beginning with the date of suspension (which includes Ilene, by the way) is simply disappointed (and, truth be told, wrong). (Insert Derrin's chortling here.)

<u>Additional Bits and Pieces</u>

The Notice provides a few more nitpicky details:

- None of the following is a CRD: corrective distributions or refunds of deferrals to comply with §§415, 402(g), or the ADP test; corrective distributions to comply with the ACP test; deemed loan distributions; dividends on employer securities under §404(k); PS-58 costs (or their equivalent); prohibited allocations treated as deemed distributions under §409(p); permissible withdrawals from an EACA under §414(w); and distributions of premiums for accident and health insurance under Treas. Reg. §1.402(a)-1(e)(1)(i).
- There is no requirement that the amount of a CRD or a loan be related in any fashion to the QI's need for funds or adverse financial consequences of the pandemic. This means there is no need to question the appropriateness of the amount requested, or to request proof of a connection between such amount and the actual financial adversity.
- Beneficiaries of death benefits, other than spouses, cannot repay a CRD.
- A hardship distribution that was made to a QI is a CRD and can be recontributed, notwithstanding the normal classification of a hardship distribution as ineligible for rollover.
- While a CRD is a distributable event for 401(k), 403(b), and governmental 457(b) plans, it does not change distribution rules for money purchase pension and defined benefit plans. Thus, pension plans cannot make in-service CRDs before age 59½. If a plan is subject to the QJSA rules, the normal waiver and consent rules apply to CRDs.
- There is language in Treas. Reg. §1.401(a)(31)-1, Q&A 19 that provides that, if a plan accepts an invalid rollover contribution, the rollover will be treated as valid if: (1) the plan administrator reasonably concluded it was valid when it was received; and (2) upon determining that the amount was an invalid rollover, the plan administrator distributes the invalid amount, plus earnings, to the employee. The Notice provides that this same treatment will apply to an invalid recontribution of a CRD. Whether the plan administrator reasonably concluded that the recontribution was valid may be based on the receipt of the participant's COVID certification, unless the administrator had contrary actual knowledge.
- Plans may be amended to accept recontribution of CRDs even if they don't accept other rollovers, and no change in the plan's terms or procedures is required.
- If the QI dies during the three-year period over which the income is being spread, any balance that has not been declared becomes income in the year of death.
- A participant who is taking substantially equal payments (and thereby eluding the 10 percent early distribution penalty) will not be considered to disturb that payment structure because a CRD is taken.
- A QI in a nonqualified deferred compensation plan may cancel his or her deferral election without violating Code §409A; it is considered to be made due to an unforeseen emergency.
- Most plans do not need to adopt CARES Act amendments before the last day of the 2022 plan year. This is the same deadline that applies to SECURE Act amendments.

More to Come?

The Notice does not answer any of the lingering questions about the defined contribution required minimum distribution ("RMD") holiday in CARES. That may be the subject of further guidance. In the meantime, the principles of Notice 2009-82, the WRERA RMD holiday, likely apply.

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