Client Alert

March 2020

401(k) Strategies During the COVID-19 Pandemic

In a very short period of time the COVID-19 pandemic has transformed nearly every aspect of our lives. Federal and state officials are responding to the crisis through a variety of law proposals that have impacted general employment practices, health and welfare benefit plans as well as qualified retirement plans.

COVID-19 has adversely affected the economy, many businesses have been temporarily closed and many employees have been furloughed and/or have had their hours reduced. Understandably, many Americans may be facing cash flow problems and may look to retirement plans as a means to make ends meet.

Hardship Distributions

Employees who have separated from service can receive distributions from their employer's retirement plans, but it is slightly more complicated for employees who are still working.

An employee who is still employed may want to access their 401(k) plans through in-service distributions. For plans that permit it, an employee may take an in-service "hardship distribution" upon a showing of an "immediate and heavy financial need," and such distribution must be "necessary to satisfy the financial need." The requirements to take an in-service distribution are very detailed, including, for instance, the requirement that the employee must have taken all other available distributions from the plan before receiving a hardship distribution (i.e.: plan loan).

For ease of administration, the Internal Revenue Service ("IRS") created several safe harbors for what constitutes a hardship distribution. Reduced hours and/or a furlough do not fall within the safe harbor provisions, and thus, by themselves would generally not qualify as a hardship distribution.

Two safe harbor provisions most relevant to the COVID-19 crisis are (1) a distribution that is used to pay for medical expenses, and (2) a distribution that is necessary to prevent the employee from being evicted or foreclosing

attorneys

Stephen L. Ferszt
sferszt@olshanlaw.com
212.451.2229

Marc N. Aspis
maspis@olshanlaw.com
212.451.2378

practice

Employee Benefits

on the mortgage of a principal residence. Additionally, a third safe harbor would be available should the Federal Emergency Management Agency ("FEMA") declare a region (or, conceivably, the entire country) to be a "disaster," which would enable the employee to receive a hardship distribution.

Hardship distributions are generally subject to a 10% excise tax on early distributions. However, proposed legislation in the Senate (the "CARES Act"), if adopted in its current form, would eliminate such tax for the remainder of 2020 if the distribution is a "coronavirus-related distribution," namely a distribution to an individual if the individual (or the individual's spouse or dependent) has tested positive for COVID-19 or if the individual experienced "adverse financial consequences" as a result of some of the negative impacts of the COVID-19 crisis. These include instances where such person experiences such consequences as a result of being quarantined, being furloughed or laid off, or being unable to work due to a lack of child care.

For those plans that permit it (or amending a plan to permit it), an employee may be able to receive a distribution from the portion of their account balance that consists of employer contributions. Other than being subject to vesting rules, these types of distributions are generally not subject to the restrictive rules that govern in-service distributions of elective contributions.

Finally, for service providers subject to plans governed by Internal Revenue Code ("Code") Section 409A, a service provider may be eligible to receive an in-service distribution in the case of an "unforeseeable emergency," namely a severe financial hardship of the participant resulting from an illness or other event beyond the participant's control that cannot be satisfied by other financial means, such as insurance or liquidation of other assets. Meeting the specific requirements of an "unforeseeable emergency," while generally uncommon, might be easier due to the current situation.

<u>Plan Loans</u>

In addition and as a prerequisite to in-service distributions, certain employees, especially those who are working reduced hours or subject to a furlough, may take a plan loan, provided that their plan allows for plan loans. While plan provisions governing loans vary widely in scope, plan loans must meet specific requirements to avoid being treated as a prohibited transaction (and subject to the draconian rules thereunder). Additionally, a plan loan must conform to the following provisions:

(1) the loan is evidenced by a legally enforceable agreement;

attorneys

Stephen L. Ferszt
sferszt@olshanlaw.com
212.451.2229

Marc N. Aspis
maspis@olshanlaw.com
212.451.2378

practice

Employee Benefits

(2) the loan cannot exceed the lesser of $50,000 or 50% of the participant's vested benefits; the CARES Act, if adopted in current form would increase the cap to the lesser of $100,000 or 100% of the participant's vested benefits for loans made in the next six months;

(3) the loan generally must be repaid within five years; the CARES Act, if adopted in current form, would extend this period under certain circumstances;

(4) the loan has substantially level amortization with payments that are no less frequent than quarterly; and

(5) as a result of the SECURE Act, the loan cannot be made via credit cards.

The plan may also permit a terminated employee to repay a plan loan from severance payments.

<u>Plan Issues – Sponsors/Employers</u>

An employer facing serious cash flow concerns may consider terminating its 401(k) plan. However, terminating a 401(k) plan may have significant drawbacks, such as the inability to cover the same employees under a new plan for 12 months following the plan termination and the requirement of full vesting of all participant account balances. A more desirable option might be to suspend or reduce contributions.

If employer contributions are discretionary nonelective or matching contributions, eliminating or reducing such contributions is accomplished by a simple plan amendment. Notice of the changes to the participants is important.

For safe-harbor 401(k) plans, a safe harbor contribution may generally not be reduced or suspended midyear. However, there are two exceptions available. The first exception applies where the employer is operating under an economic loss (eligible employees must receive a supplemental notice). The second exception applies where the employer specifies in its required annual notice that it may reduce or suspend safe harbor contributions during the plan year, and such suspension or reduction will not start until at least 30 days after eligible employees receive a supplemental notice of such reduction or suspension. Under these exceptions, employees are required to have a reasonable opportunity after receipt of the supplemental notice to change their elective contribution rates. Additionally, the plan must be amended to require non-discrimination testing. We note that the SECURE Act eliminated the notice requirement for nonelective safe harbor contributions. Thus,

attorneys

Stephen L. Ferszt
sferszt@olshanlaw.com
212.451.2229

Marc N. Aspis
maspis@olshanlaw.com
212.451.2378

practice

Employee Benefits

additional IRS guidance is needed for a mid-year suspension or reduction of nonelective safe harbor contributions.

To reduce or suspend non-safe harbor matching contributions, the employer must amend the plan and must make the matching contributions for the part of the plan year before the amendment's effective date.

Employers are advised to seek assistance from counsel and their plans' Third Party Administrators (TPAs), if any, for compliance assistance. For example, the above requirements are important because an employer's failure to timely remit a safe harbor contribution or matching contribution may cause the plan to lose its tax-qualified status. Moreover, the plan's fiduciaries may be found to have engaged in a prohibited transaction.

Conclusion

The economic impacts of COVID-19 are wide-ranging. The legislative landscape is changing quickly as measures are implemented to try to minimize economic disruption. Employees and employers need to take special care when navigating retirement plan issues as a result of COVID-19. For employers seeking to amend plans, the amendments should be made as quickly as possible. As the economic and legislative impacts are constantly shifting, we remain available to help guide you.

Please contact the Olshan attorney with whom you regularly work or one of the attorneys listed below if you would like to discuss further or if you have questions.

attorneys

Stephen L. Ferszt
sferszt@olshanlaw.com
212.451.2229

Marc N. Aspis
maspis@olshanlaw.com
212.451.2378

practice

Employee Benefits

This publication is issued by Olshan Frome Wolosky LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising.

Copyright © 2020 Olshan Frome Wolosky LLP. All Rights Reserved.