Client Alert

April 2020

Update – COVID-19 Hardship Distributions from Qualified Retirement Plans

As temporary furloughs and layoffs become more prevalent during the COVID-19 pandemic, employees and employers are looking at the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") economic relief provisions to help with financial struggles. One such relief provision that was discussed in an earlier client alert is the COVID-19 hardship distribution, which allows employees to withdraw up to $100,000 on a tax-favored basis from an eligible retirement account for expenses and losses resulting from COVID-19.

COVID-19 Hardship Distribution

Under the Internal Revenue Service (IRS) guidance, employers are permitted to add a new safe harbor hardship category to allow employees who are participating in certain company retirement plans to take a hardship withdrawal to cover such expenses. To be eligible for a COVID-19 hardship distribution, the taxpayer must self-certify that they have suffered a COVID-19 related hardship, which includes:

1. A COVID-19 diagnosis for themselves, their spouse, or dependent; or

2. Financial consequences as a result of COVID-19, such as a reduction in income due to a quarantine, a furlough, a layoff, reduced hours, or an inability to work because of the lack of child care.

The 10% early withdrawal excise tax is waived for distributions up to $100,000 taken before age 59½ for those affected by the COVID-19 pandemic. Qualifying distributions must be made on or after January 1, 2020 and before December 31, 2020. Taxpayers taking such distributions have the option to pay the income taxes ratably on the distribution across three years (i.e., 2020, 2021 and 2022) or to repay the distribution to the plan. If repaid within such three-year period, starting on the day after a distribution, the plan participant would avoid some or all of the income tax

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liability. Such repayments will be treated as a trustee to trustee transfer, as though the repayment was made within 60 days of the distribution under the normal hardship distribution rules. Accordingly, even though the income taxes may have been paid to the IRS during the three-year period, if the amount distributed is repaid to the plan in the third year, the plan participant could recoup income taxes paid by filing amended income tax returns to report less taxable income and erase the income tax. Doing so would essentially make this distribution a three-year, interest-free loan.

Buyer Beware: Potential Hurdles with Implementing the Relief Program

For many individuals, the COVID-19 hardship distribution seems promising. However, the CARES Act lacks clarity on the precise mechanics of the program, especially as the terms for each retirement plan may vary; plan administrators lack critical guidance from the IRS on how to implement the program; and the income tax consequences among individuals could be vastly different. As a result, both individuals and plan administrators could face numerous challenges with the implementation of the program.

First, under the basic "hardship distribution" rules for retirement plans, an individual must demonstrate to the plan administrator that an immediate and heavy financial need exists, which makes the distribution necessary, such as eligible medical costs, funeral costs or funds needed to prevent an eviction from a primary residence. The COVID-19 hardship distribution rules relax these requirements and more importantly waive the early withdrawal 10% excise tax. However, to qualify, the COVID-19 hardship requirements must be met. As such, this distribution may be limited to a smaller group of plan participants. Those who do not qualify for the COVID-19 rules may still meet the basic rules and could be subject to the usual hardship requirements and the terms and conditions of their retirement plans.

Second, the timeframe for distributions under this program is rigid; it applies only to distributions taken on or after January 1, 2020 and *before* December 31, 2020.

Third, the total *amount* that can be withdrawn from an eligible retirement plan for a COVID-19 hardship distribution is capped at $100,000. However, the CARES Act is silent on the *number* of distributions that can be taken. This ambiguity could result in individuals seeking to take multiple distributions at various points in time within the allowed timeframe, equaling $100,000 in the aggregate. Each distribution could be subject to a different three-year window for repayment. As a result, care and planning must be scrupulous to meet the deadline on each such distribution.

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Finally, as noted above, those who plan to repay some or all of the distribution in the third year will be incurring income tax liabilities for the first two years. After repaying the distribution, amended income tax returns may be needed to recover the taxes paid in the first two years. The mechanics of this process could become quite cumbersome. In particular, those who are cash-strapped might find this option difficult to manage, as the payment of income taxes would reduce the total relief they receive from a distribution.

Conclusion

The COVID-19 hardship distribution under the CARES Act may benefit individuals seeking relief from pandemic-related hardships. However, the provision lacks clarity in many respects that could yield unexpected (and perhaps unfavorable) results for some. Accordingly, careful planning and evaluation of one's particular financial circumstances and risks must be made before taking a COVID-19 hardship distribution.

Olshan lawyers from multiple practice groups are working together with clients to address COVID-19-related matters, including the CARES Act stimulus programs (i.e., the Paycheck Protection Program and EDIL) and other corporate matters, including contractual analysis and financing, tax, restructuring, employee benefits and employment practices, insurance coverage and litigation. Click here to access additional materials addressing issues raised by COVID-19.

Please contact the Olshan attorney with whom you regularly work or the attorney listed below if you would like to discuss this client alert or have questions about its content.

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