Alert

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COZEN O'CONNOR

The CARES Act Provides New Distribution and Loan Options for Individual Account Retirement Plans

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Employers that offer their employees individual account retirement plans such as 401(k) and 403(b) plans should know that participants affected by the coronavirus have new options to access funds in their retirement plan accounts. Under the CARES Act, which was signed into law by President Trump on March 27, 2020, participants affected by the coronavirus can take a penalty-free distribution or loan of up to $100,000 from their retirement plan account. Coronavirus distributions and loans are only available through December 31, 2020.

Who Qualifies?

Coronavirus distributions are only available to a participant who: (i) is personally diagnosed or whose spouse/dependent is diagnosed with the coronavirus; or (ii) experiences adverse financial consequences as a result of being unable to work because of the coronavirus (specific reasons for inability to work include being quarantined, furlough/layoff, and lack of child care). Plans may rely on a participant's self-certification of eligibility.

Will a Coronavirus Distribution be Taxable?

It depends on whether the coronavirus distribution is repaid by the participant. If the coronavirus distribution is repaid, the participant will not be taxed on the distribution. In order to avoid incurring income tax on the coronavirus distribution, the participant must repay the coronavirus distribution over a three-year period (the three-year repayment period begins on the day after the distribution is received by the participant). Repayments can be made on a pre-tax basis and can be made to the retirement plan that made the coronavirus distributions or another tax-qualified retirement plan in which the individual participates or is a beneficiary. Pre-tax repayments of a coronavirus distribution will not count toward the annual limit on pre-tax contributions to an individual account retirement plan (the 2020 annual limit on contributions is $19,500, plus $6,500 in catch-up contributions for participants over age 50).

If a coronavirus distribution is not repaid by the participant, the participant will be required to pay income tax on the distribution (although the 10 percent early distribution penalty is waived). However, the amount of income can be reported ratably by the participant over a three-year period starting with 2020. (For example, if the participant takes a $30,000 coronavirus hardship distribution, the participant can report and pay taxes on $10,000 income for each of the 2020, 2021 and 2022 tax years instead of reporting the full $30,000 as taxable income for the 2020 tax year.)

The Internal Revenue Service (IRS) has not yet issued guidance on how participants should elect to make repayments, whether partial repayments are permissible, or how participants should report repayments to plans and to the IRS.

Does the Plan Decide Whether a Coronavirus Distribution is Repaid?

No. A participant who receives a coronavirus distribution decides whether to repay the distribution. The plan sponsor has no obligation to record the coronavirus distribution as a loan or track repayments.

Are Plan Sponsors Required to Allow Coronavirus Distributions?

No. Coronavirus distributions are permissive, not mandatory, terms for qualified retirement plans. Plan sponsors can decline to offer coronavirus distributions under their individual account retirement plan. If plan sponsors want to offer coronavirus distributions under their retirement plan, the plan document will need to be amended, and any amendment will have to be consistent with the way the plan was actually operated prior to the amendment.

If a Plan Sponsor Wants to Offer Coronavirus Distributions, When Must the Plan Document be Amended?

Although the plan sponsor can immediately allow coronavirus distributions, the plan document must be amended (on a retroactive basis) to provide for coronavirus distributions, as long as that amendment is adopted no later than the last day of the first plan year beginning on or after January 1, 2022. For retirement plans with a calendar plan year, this means that plan sponsors have until December 31, 2022, to adopt a plan amendment on a retroactive basis.

Does the CARES Act Affect Plan Loans?

Yes. The CARES Act impacts retirement plans that allow loans in at least two different ways. First, the CARES Act allows plans to increase the limit on plan loans to $100,000 (typically plan loans are capped at $50,000). However, this increased loan limit is only available to participants affected by the coronavirus. Second, the CARES Act delays the repayment dates for outstanding plan loans where there are repayments due between March 27, 2020 (the enactment date of the CARES Act) and December 31, 2020. Under existing law, retirement plan loans generally must be repaid within five years. However, under the CARES Act, any loan repayment that comes due between March 27, 2020 and December 31, 2020, can be delayed one year (with all subsequent repayments due under the loan adjusted for the one-year delay). This payment date extension only applies to participants affected by the coronavirus.

Based on the plain language of the CARES Act, it appears that these changes in the loan rules apply to all individual account retirement plans, regardless of whether the plan allows coronavirus distributions. Furthermore, it is unclear whether the one-year delay of loan repayments that come due March 27, 2020 – December 31, 2020, is a permissive or mandatory term for retirement plans. The IRS needs to issue guidance to clarify these provisions of the CARES Act.

Other Than Coronavirus Distributions and Loans, Does the CARES Act Affect Individual Account Retirement Plans in Other Way?

Yes. The CARES Act will affect the administration of individual account retirement plans in other key ways.

For example, in the future, participants may want to repay coronavirus distributions received from other retirement plans (and IRAs) into a different retirement plan. These repayments are to be treated as rollovers, so any retirement plan that accepts rollovers can potentially be faced with accepting a coronavirus distribution repayment in the next three years (even though the retirement plan receiving the repayment did not offer coronavirus distributions during 2020).

Additionally, the CARES Act also allows individual account retirement plans to suspend required minimum distributions payable in 2020. This provision is permissive, not mandatory, and plan sponsors will need to amend their plan document no later than the last day of the first plan year beginning on or after January 1, 2022, to take advantage of these relaxed required minimum distribution rules. For most plan sponsors with calendar plan years, this means the plan document may need to be amended no later than December 31, 2022.