LEGAL UPDATE

Withdrawals and Loans from Defined Contribution Retirement Plans

Marcia S. Wagner, Esq.

In reaction to the current volatility in the economy due to the coronavirus pandemic, we have been receiving a large number of questions from defined contribution plan sponsors regarding ways participants can access money in their accounts. While recognizing such leakage may cause future headaches for participants in their retirement, many individuals do not have the resources to weather this storm and have no other option but to access their retirement accounts.

In-Service Withdrawals

Many defined contribution plans permit in-service withdrawals. Such withdrawals generally can be provided without

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restriction from rollover accounts, upon attainment of age 59-1/2 and in the event of a financial hardship. Although salary deferral contributions and safe harbor contributions cannot be distributed unless or until a participant attains age 59-1/2, becomes disabled or terminates employment, plans with profit-sharing features can provide in-service withdrawals under other situations. For example, participants may be able to withdraw vested profit sharing amounts if they have been plan participants for at least five years or if the contributions have been in the plan for at least two years.

With respect to hardship withdrawals, not every state has been declared a national emergency for which hardship withdrawals are available under the IRS's "safe harbor" deemed reasons, and even then an individual has to live and/or work in an affected area for which FEMA will provide individual assistance. In addition, participants could separately satisfy one or more of the deemed hardship situations in the plan – for medical care and expenses, to prevent foreclosure, to pay tuition, etc. Hardship withdrawals are generally subject to ordinary income taxes and a 10 percent early distribution penalty tax if taken before the participant attains age 59-1/2.

Plan sponsors also may make coronavirus-related distributions available. Coronavirus-related distributions are available at any time during calendar 2020 by an individual (i) who is diagnosed with COVID-19 by a CDC-approved test, (ii) whose spouse or dependent is diagnosed with COVID-19 by a CDC-approved test, (iii) who "experiences adverse financial consequences as a result of being quarantined, being furloughed or laid off, or having work hours reduced due to" COVID-19, (iv) who is unable to work due to COVID-19 child care issues, (v) who has closed or reduced hours in a business owned or operated by the individual, due to COVID-19, or (vi) who has experienced other factors as determined by the Secretary of the Treasury. The administrator of the plan may rely on the individual's certification that the individual qualifies for a coronavirus-related distribution under these categories.

The 10 percent early distribution penalty tax will not apply to such distributions up to $100,000. The amount distributed may be re-contributed to that plan or another plan within three years after the date the distribution is received, and if the individual does not re-contribute the distribution within that time period, taxes on the distribution may be spread over a 3-year period. Federal income tax withholding is not required on a coronavirus-related distribution, and a direct rollover need not be offered.

Participants whose employment is terminated usually can take a distribution of their entire vested account balance from a defined contribution plan. Also, if a partial plan termination occurs, terminated participants will have to be made fully vested in their accounts. A partial plan termination may occur if one or a series of employer-initiated employment terminations (permanent layoffs and reductions in force) affects 20 percent or more of the workforce; we explain the mechanics of partial plan terminations in our article "Partial Plan Terminations of Qualified Plans" (*The ASPPA Journal*, Winter 2010).

Loans

Many defined contribution plans permit participants to borrow against their vested plan accounts. Participants might not recognize negative implications of taking a loan from a plan, which includes: initial issuance and annual fees, missing out on growth through tax-deferred earnings, selling investments at bottom of market, making repayments from after-tax amounts, and the potential taxes and penalties resulting from default or if repayments are missed.

However, a participant with an outstanding plan loan who is placed on an unpaid leave of absence may forego making loan payments during the leave of absence without triggering taxation of the loan, provided the following requirements are met:

1. The unpaid leave of absence does not exceed one year.
2. The loan must still be repaid by the end of the original term of the loan. Thus, the participant may make up the missed loan repayments upon returning to work, resume the original repayments with a lump sum payment of the missed repayments at the end of the term, or increase the amount of each repayment for the remainder of the repayment period upon returning to work.

Subject to the plan's loan policy (as it may be amended), participants also may continue to make repayments from their personal accounts, provided the trustee will accept direct checks or electronic transfers. If participants are already making repayments from their personal accounts, the plan administrator can confirm whether the plan's loan policy permits suspension of repayments, and notify affected participants accordingly.

Also, note that participants who are laid off/terminated generally have until the end of the calendar quarter following the calendar quarter in which repayments are missed to cure the missed repayments. Otherwise, the participant will be taxed on the balance of the loan. However, employers may permit terminated employees to continue to make loan repayments, either from severance pay or from their personal accounts, but the plan's loan policy must provide for the ability to make such repayments.

Plan sponsors may amend their plan documents or loan policies to provide added flexibility within limits, including, in addition to the repayment options noted above, allowing participants to take more loans than are currently offered or additional money types that might otherwise be restricted.

Plan sponsors also may modify their plan documents or loan policies to reflect changes made by the CARES Act. Legal limitations on loans from qualified plans have been relaxed. For example, the limit on loans is increased from 50 percent of a participant's vested account balance up to $50,000, to 100 percent of the participant's vested account balance up to $100,000 for loans to "qualified individuals" made during the 180-day period from the date of enactment. A "qualified individual" is one who could meet the same coronavirus-related tests discussed above for coronavirus-related distributions.

The CARES Act also allows the plan to delay the due date for any repayment by a qualified individual of a participant loan that would occur from the date of enactment through December 31, 2020, for up to one year. Later repayments for such loans are adjusted to reflect the delayed due date and any interest accruing during such delay. The delay period is ignored in determining the 5-year maximum period for such loan. *[Editor's note: Allowing increased loan amounts, deferred payment yet not increasing the 5-year term can spell disaster.]*

The long-term prospects for the economy are uncertain, but the immediate short-term impact of the current degradation in economic growth has been significant. Employers may take steps to allow participants to access amounts in their defined contribution plan accounts. The Wagner Law Group can provide whatever assistance is needed to review and revise plan documents, draft amendments, and prepare employee communications for employers wishing to expand the availability of in-service withdrawals or loans.

Marcia S. Wagner *is the Managing Director of The Wagner Law Group. She can be reached at 617-357-5200 or* Marcia@WagnerLawGroup.com.