Advanced Issues in Distributions

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Hardship Documentation: History

- 2004 final regulations preamble:

- Some commentators asked for specific guidance on the documentation and verification requirements for a hardship distribution. The final regulations do not address this issue. However, taxpayers are reminded that section 6001 requires that they keep the records necessary to demonstrate compliance with the qualification requirements of section 401 and the rules of section 401(k) and 401(m).

- Translation: We won't tell you what records to keep but you'd better keep them.

Final 403(b) Regulations Preamble

- Prohibit plan from delegating to participants the task of plan administration, such as hardship determination
  - Employees lack expertise
  - They don't understand the importance
  - They have a conflict of interest
- Speaking about 403(b) plan procedures:
- For example, the procedures must be reasonably designed to determine … whether the hardship withdrawal rules are satisfied, and whether a plan loan constitutes a deemed distribution under section 72(p). By contrast, procedures that rely on an employee certification, such as … whether the participant has other outstanding loans, would generally not be adequate to meet this standard, because such a certification is not disinterested, and also because of the lack of employer oversight in the certification process to ensure accuracy.

IRS Addressed Documentation in Employee Plans Newsletter

Employee Plans News

Issue No. 2015-4, April 1, 2015

Plan sponsors
Keep documentation for hardship distributions and plan loans

- Focused on the need for the **Plan Sponsor** to obtain and keep records documenting proper issuance of hardship distributions and loans
  - TPA and participants are not ultimately responsible
  - Raised concerns regarding electronic self-certification by participants
    - Participant records may not be available on audit

Hardship Distribution Documentation per IRS

» The plan sponsor must obtain and keep hardship distribution records. Failure to have these records available for examination is a qualification failure that should be corrected using the Employee Plans Compliance Resolution System (EPCRS).

» The plan sponsor should retain these records in paper or electronic format:

1. Documentation of the hardship request, review and approval

2. Financial information and documentation that substantiates the employee's immediate and heavy financial need

3. Documentation to support that the hardship distribution was properly made in accordance with the applicable plan provisions and the Internal Revenue Code

4. Proof of the actual distribution made and related Forms 1099-R

Participant Records: Self-Certification

- It's not sufficient for plan participants to keep their own records of hardship distributions. Participants may leave employment or fail to keep copies of hardship documentation, making their records inaccessible in an IRS audit.

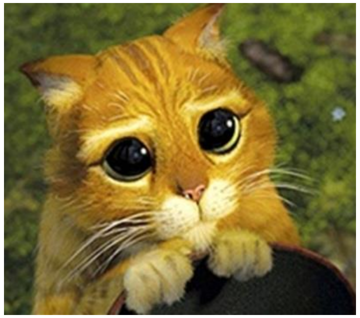
- Also, electronic self-certification is not sufficient documentation of the nature of a participant's hardship. IRS audits show that some TPAs allow participants to electronically self-certify that they satisfy the criteria to receive a hardship distribution. While self-certification is permitted to show that a distribution was the sole way to alleviate a hardship, self-certification is not allowed to show the nature of a hardship. (See Treasury Regulation Sections 1.401(k)-1(d)(3)(iv)(C) and (D)). You must request and retain additional documentation to show the nature of the hardship.

Loans Too!

- The IRS highlighted similar issues with regard to participant loans
  - Inadequate records maintained by the plan sponsor
  - Participants allowed to self-certify that loan proceeds were being used to pay for primary residence
    - Loans > five years improperly permitted (deemed distribution when issued)

Hardships: Common Questions

- *Can a plan issue a hardship distribution so that:*
  - *Q1: A participant may travel to the funeral of a parent?*
  - *Q2: A participant may repair a crack/leak in the foundation of his principal residence?*
  - *Q3: A participant may repair water damage to principal residence from a flood (river/creek)?*
  - *Q4: A participant can pay past due mortgage balance after receiving a late notice?*
  - *Q5: A participant can pre-pay his daughter's four-year college tuition (to take advantage of discount)?*



Case Study: Suspension of Deferrals

- *Basic facts: Fred receives a hardship distribution from the Astaire 401(k) Plan on March 15, 2015.*
- *Q1: In early 2016, it is discovered that Fred's 401(k) deferrals were never suspended.*
- *Q2: In early 2016, it is discovered that Fred's deferrals into the Kelly 401(k) Plan (part of controlled group) were not suspended*
- *Q3: Fred receives a hardship distribution and ceases 401(k) deferrals, but continues to contribute to the Astaire Nonqualified Deferred Compensation Plan.*
- Q4: *Astaire does suspend Fred's deferrals but doesn't restart them at the end of the six months*

Case Study: Hardships and Loans

- Q1: Mary wants to get a hardship distribution of $40,000 so she can make a down payment on a house ($25,000 for the down payment and $15,000 for taxes on the $40,000). The plan notes that she can borrow the $25,000 instead. However, the bank won't give her a first mortgage if she borrows the down payment

- Q2: Assume the same facts except:

  - Mary wants the distribution to pay her daughter's tuition

  - Mary says she doesn't want to take a loan because she doesn't have money to repay it

Regulations on Counterproductive Actions

- (D) Employee need not take counterproductive actions. For purposes of [the necessity regulations], a need cannot reasonably be relieved by one of the actions described in paragraph (d)(3)(iv)(C) [such as taking a loan] if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

QDRO: Brown versus Continental Airlines

» Facts:

- Pilots got a divorce ostensibly to get lump sum distributions that were payable to the alternate payee ex-wife but not the still-employed pilot
- After receipt of distribution, parties remarried
- Continental sued to reclaim the distributions by saying that the divorces were a sham
- Pilots filed motion to dismiss
- District court found for pilots; Continental appealed

Brown versus Continental Airlines

» Fifth circuit said:

  – Code and ERISA do not authorize the plan administrator to adjudicate whether the divorce is a “sham” – only to review court order for the necessary QDRO elements

  – QDRO must be taken “at its face”

  – Pilots win

» What could the airline have done in plan drafting?

No New Benefit Forms

- QDRO generally can’t order type or form of benefit not allowed under plan.
  - Example: PS plan’s only distribution option is lump sum. QDRO can’t order installment payments.
  - Example: Defined benefit plan only provides benefits after NRA or severance of employment. No special plan provisions for QDRO. QDRO can’t order immediate distribution for alternate payee of young participant.
  - Example: Plan provides annual valuation on last day of plan year. DRO orders payment of 50 percent of balance valued as of June 4, 2019. DRO is not QDRO.
  - Payments to alternate payee can’t violate 401(a)(9) minimum distribution rules.

Youngest Age Exception

- Regardless of plan terms, QDRO can order payment to alternate payee begin at earliest retirement age, as if participant retired
- Earliest retirement age – earlier of:
  - Date participant entitled to distribution, or
  - Later of:
    - Participant's attains age 50, or
    - Earliest date participant could receive benefits after separation from service

Earliest Age Example – Age 50

- DB plan allows distributions on death, separation, or attainment of age 65.
- QDRO orders distribution to Pam's ex-husband as soon as plan allows.
- Pam (35 when QDRO issued) continues work until 70.
- Earliest retirement age is 50 (later of 50 or earliest Pam could get money after separation).

Earliest Age Example – Actual Date

» Same facts except Pam separates from service at age 40.

» Plan can distribute QDRO as soon as Pam is actually entitled to benefits

Earliest Age – NRA

- Same facts except plan provides no distribution until death or age 65. Separation of service while living is not distributable event.

- Earliest retirement age is 65 (unless Pam dies first).

- Many plans contain provision allowing immediate payment of QDRO to alternate payee, regardless of earliest retirement age.

Case Study: Lost Participants: Ongoing Plan

» Easy Go Scooters has a lot of employee turnover

» Easy Go 401(k) plan has mandatory cash-out of vested balances below $1,000; for larger accounts the plan cannot distribute without participant consent earlier than age 65 (normal retirement age)

  – Plan has daily valuation and allows distribution as soon as practical after severance

a) Jack severs employment a $1,400 account balance ($800 vested)

  i. What actions should the plan take when Jack severs?

  ii. What happens if notices to Jack come back undeliverable? What steps should they take to look for Jack? If they can't find Jack, what should they do with his money?

b) Assume the same facts except Jack (age 48) is fully vested

Mandatory Search Steps: FAB 2014-1

» “Some search steps involve so little cost and such high potential for success that a fiduciary should always take them before abandoning efforts to find a missing participant, regardless of the size of the participant’s account balance. The failure to take such steps would violate the fiduciary obligations of prudence and loyalty, as set forth in section 404(a) of ERISA.

» “However, other more expensive approaches may be required when the account balance is large enough to justify an additional plan expense and other efforts have failed.”

Required Steps

» Do all the following before abandoning search:

- 1. Use certified mail
- 2. Check related plan and employer records
- 3. Check with plan designated beneficiary
- 4. Use free electronic search tools

Free Electronic Search Tools

- Plan fiduciaries must make reasonable use of Internet search tools that do not charge a fee to search for a missing participant or beneficiary. Such online services include
  - Internet search engines
  - Public-record databases such as those for:
    - Licenses
    - Mortgages
    - Real-estate taxes
  - Obituaries
  - Social media
- Consider using whitepages.com; yellowpages.com/whitepages

Additional Search Tools

- If a plan administrator follows the required search steps, but does not find the missing participant or beneficiary, the duties of prudence and loyalty require the fiduciary to consider if additional search steps are appropriate. A plan fiduciary should consider the size of a participant's account balance and the cost of further search efforts in deciding if any additional search steps are appropriate. As a result, the specific additional steps that a plan fiduciary takes to locate a missing participant may vary depending on the facts and circumstances. Possible additional search steps include the use of
  - Internet search tools
  - Commercial locator services
  - Credit reporting agencies
  - Information brokers
  - Investigation databases
  - Analogous services that may involve charges

IRS Forfeiture Provision

- Applies to entire account balance
- Applies only if benefit is payable
- Applies if plan is unable to find participant or beneficiary
- Condition: if participant/beneficiary comes forward to claim benefit, plan must reinstate it
- Can also forfeit to comply with state escheat laws
  - DOL ruled that state law cannot compel escheat

Plan Distribution Changes: Anti-Cutback Rule

- Limits ability to remove distribution options with regard to existing accrued benefit
  - Example: remove in-service distribution at 59½
- Limits ability to change timing of distribution
  - Example: change from distribute ASAP after severance to distribute in year following year of severance

Benefits, Rights, and Features with Anti-Cutback

- BRF testing generally required when a benefit (such as a distribution option) is available to some participants and not others

- Exception: if plan removes (or changes) distribution option, but provides that existing balances retain the old option, does not require BRF testing

  - But that forces plan to keep two buckets

Make It Easy – Perhaps

- Employer decides to handle the change by saying:
  - Old participants continue to have the old distribution option for their entire account balance
  - New participants have just the new option
- No exception to BRF testing applies
  - Over time this could become discriminatory

Two Approaches to Protected Benefits

	Current Participants	New Participants
Before Amendment	A – Protected Benefits	–
After Amendment	B – Not Protected	C – Not Protected

	Horizonal	Vertical
Protected Benefits	A	A and B
New Rules	B and C	C
Buckets needed	Two buckets for current participant	One bucket each
Document	Does automatically	Requires special language
BRF Testing	No BRF issue	Test for BRF

Anti-Cutback and BRF Testing: Case 1

- Plan allows in-service distribution at age 59½
- Employer decides to eliminate in-service distribution effective January 1, 2015
  - Protected benefit
- Employer decides on horizontal amendment
  - Old money retains 59½ distribution
  - New money (including for current participants) doesn't have in-service distribution
- No BRF issue

Anti-Cutback and BRF Testing: Case 2

- Plan allows in-service distribution at age 59½
- Employer decides to eliminate in-service distribution effective January 1, 2015
  - Protected benefit
- Employer decides on vertical amendment
  - Old participants retain 59½ distribution
  - New participants don't have in-service distributions
- BRF testing

Test January 1, 2016

» Effectively available: shouldn't be a concern in a situation like this

» Currently available:

	Old	New
HCE	5	0
NHCE	18	2
Coverage	90% Pass	

Test January 1, 2026

- Effectively available: shouldn't be a concern in a situation like this
- Currently available:
- Concentration ratio: 83.33% (20/24)
- Safe-harbor percentage: 32.75%
- Unsafe-harbor percentage 22.75%

	Old	New
HCE	4	0
NHCE	5	15
Coverage	25% ???	

Anti-Cutback and BRF Testing: Case 3

- Plan allows in-service distribution at age 59½
- Employer wants to eliminate in-service distribution effective January 1, 2015
  - Protected benefit
- Employer doesn’t want to have two buckets
- Employer doesn’t want to do BRF test every year forever after
- Employer decides it’s easier to leave in-service distribution in place

After-tax distributions

Two Types of Plan Funds

Pretax

- Regular deferrals
- Employer contributions
  - Profit sharing
  - Match
  - Forfeitures
- Earnings

After-tax

- After-tax employee contributions
- Roth
  - Deferrals
  - Rollovers from other Roth plans
  - In-plan Roth rollovers
- Repaid deemed distributions

Taxation of Pretax Amounts

- Distribution of pretax amounts are **taxable**
- Exception: Rollover to conventional IRA or other plan
- Taxable amounts distributed before 59½ may be subject to **ten percent premature distribution penalty**
  - Exception: Roth conversion
- **Twenty percent withholding** applies to eligible rollover distributions of pretax amounts that are not rolled over

Taxation of After-Tax Amounts

» Not taxed

» No withholding

» Not subject to premature distribution penalty

Plan Distribution from Mixed Account

- Mixed account: has both pretax and after-tax funds
- Distribution includes pro-rata share of both types
- Example:
  - Pat Participant (50) wants $4,000 from after-tax account
  - Basis
  - Earnings
  - Withholding
  - Penalty

After-tax contribution account	
Basis	$8,000
Earnings	$2,000
Total	$10,000

Separate Contract Theory

- If plan separately accounts for after-tax accounts, then distribution from that account is treated separately from the balance of the plan
- Example:
- Assume Pat also has $90,000 in pretax account.
- Since plan separately accounts for after-tax contributions:
  - Pat can ask for distribution from after-tax account
  - Plan ignores pretax account in determining taxation
- Otherwise:
  - Basis is $8,000 out of $100,000
    - $3,680 (92% X $4,000) is taxable

Separate Contract Theory

- If plan separately accounts for after-tax accounts, then distribution from that account is treated separately from the balance of the plan for purposes of computing balance and basis

1. Employee contribution account
2. Designated Roth account
   - Deferrals
   - Rollovers
   - In-plan Roth rollovers
3. Everything else
   - Deferrals
   - Employer contributions
   - Forfeitures

Significance of Separate Contract

- Figure basis and taxable portion separately for each separate account.
- Jack takes $30,000 distribution
- If from employee contributions 20 percent ($6,000 taxable)
- Otherwise 80 percent ($24,000) taxable

	Employee contributions	Everything else
Basis	$40,000	$20,000
Pretax	$10,000	$80,000
Total	$50,000	$100,000

Rollover Rules

- Rollovers are not taxable
  - Exception: conversion of pretax to Roth
- Few limits on pretax rollovers
- Limit on after-tax rollover: can't roll after-tax funds except:
  - Direct or 60-day rollover to IRA
  - Direct rollover to plan that will separately account for the after-tax funds, including basis
- 60-day rollover from mixed account:
  - Pretax funds rolled first

Rollover Examples: Direct Rollover

- Pat directs plan to roll $3,000 directly to Roth IRA
  - Basis
  - Earnings
  - Withholding
  - Penalty tax

Designated Roth account	
Basis	$8,000
Earnings	$2,000
Total	$10,000

Rollover Examples: 60-Day Rollover

» Plan distributes Pat's entire Roth account to her
  - Not qualified distribution
  - Withholding

Designated Roth account	
Basis	$8,000
Earnings	$2,000
Total	$10,000

» Example 1: Pat rolls over $3,000 to Roth IRA
  - Earnings rolled
  - Basis rolled
  - What's left

» Example 2: Pat wants to do 60-day rollover to new employer's plan
  - Maximum rollover

Notice 2014-54: Coming Together

- "All disbursements of benefits from the plan to the recipient that are scheduled to be made at the same time (disregarding differences due to reasonable delays to facilitate plan administration) are treated as a single distribution without regard to whether the recipient has directed that the disbursements be made to a single destination or multiple destinations."
  - Applies for purposes of allocating between pretax and after-tax
  - Applies to participants, beneficiaries, and alternate payees
  - Example: Pat says rollover $5,000 to IRA and distribute $5,000 to me. Treat as one distribution

Direct Rollovers > Pretax

- “If the pretax amount with respect to the aggregated disbursements that are treated as a single distribution is less than the amount of the distribution that is directly rolled over to one or more eligible retirement plans, the entire pretax amount is assigned to the amount of the distribution that is directly rolled over.”

- Pat takes $5,000 distribution and asks plan to roll $5,000 to IRA
  - Earnings rolled
  - Basis rolled
  - What was distributed?

After-tax contribution account	
Basis	$8,000
Earnings	$2,000
Total	$10,000

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All Rollovers ≥ Pretax Amounts ≥ Direct Rollovers

- In other words, there are 60-day rollovers
  - There may or may not be direct rollovers
  - Total rolled over exceeds pretax
- Entire amount of direct rollovers are pretax
- Remaining pretax assigned to 60-day rollovers
- Amounts not rolled over are tax free

Recipient Selection

» Rule 1: If:

– Direct rollovers > pretax

– More than one direct rollover

» Then: recipient can allocate pretax between rollover accounts as recipient wishes

» "Inform the plan administrator of the allocation prior to the time of the direct rollovers"

» Rule 2: If:

– Pretax > direct rollovers

– More than one 60-day rollover

» Then: recipient can allocate pretax between 60-day rollovers accounts as recipient wishes

» Logically, it is up to the recipient to inform the custodians/trustees of the rollover accounts

» Remember, 60-day rollover to plan must be entirely pretax

Pretax > All Rollovers

- All rollovers are pretax
- Balance included in recipient’s income
  - Subject to 20 percent withholding
  - Subject to ten percent penalty tax

1099-R Reporting

- Even though distributions to multiple sources may be treated as a single distribution, may need multiple 1099-R forms
- 1099-R forms should reflect these allocations
  - But 1099-R forms do not consider 60-day rollovers

Pretax > Direct Rollover

- Val (50) separates and requests $100,000 (total) distribution
- Pretax?
- Direct rollover to new plan $70,000
  - Earnings?
  - Basis?
- Paid to Val $30,000
  - Earnings?
  - Withholding?
  - Penalty?

Total account (not Roth)	
Basis (20%)	$50,000
Earnings (80%)	$200,000
Total	$250,000

Direct Rollovers > Pretax

- Val (50) separates and requests $100,000 distribution
- Pretax is 80% = $80,000
- Direct rollover to plan $50,000
- Direct rollover to IRA $32,000
  - Where does $2,000 basis go?
- Cash to Val $18,000
  - All after-tax

Total account (not Roth)	
Basis (20%)	$50,000
Earnings (80%)	$200,000
Total	$250,000

60-Day Rollover

- Val (50) separates and requests $100,000 distribution
- Pretax is 80% = $80,000
- Direct rollover to plan $50,000
  - All pretax
- Cash to Val $50,000
  - $20,000 after-tax
  - $6,000 withholding
- 60-day rollover to IRA $20,000
  - All pretax
  - Val taxed on $10,000

Total account (not Roth)	
Basis (20%)	$50,000
Earnings (80%)	$200,000
Total	$250,000

- 2 1099-R forms
  - 1 for direct rollover (Code G)
  - 1 for $50,000 cash (Code 1)
    - $30,000 taxable

Choose the Rollover

- Val (50) separates and requests $100,000 distribution
- Pretax is 80% = $80,000
- Direct rollover to plan $80,000
- Direct rollover to Roth IRA $20,000
  - Val can allocate the entire basis to the Roth IRA
  - Must let administrator know before rollover

Total account (not Roth)	
Basis (20%)	$50,000
Earnings (80%)	$200,000
Total	$250,000

- 1 1099-R form
  - $100,000 distribution
  - $0 taxable
  - $20,000 basis
  - Code G

Questions?