401(k) Hot Topics

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AGENDA

• Hardship Withdrawal Changes for 2019
• Federal Disaster Relief in the 2020 Budget Act
• Student Loan “Matching” Contributions to 401(k) Plans
• “Back Door” Roth 401(k) Contributions

HARDSHIP DISTRIBUTIONS
Hardship Distribution Option

- A hardship distribution is a type of in-service distribution and therefore can only be made from a profit sharing or 401(k) plan (i.e. NOT pension plans).
- 403(b) plans may also permit hardship distributions with some modifications regarding the permitted sources.
- Optional provision – qualification rules do not mandate that a plan offer hardship distributions. (Not a protected benefit under the anti-cutback rules.)
- Plan document must objectively describe the conditions under which a hardship distribution will be made.

Hardships: Pro and Con

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<thead>
<tr>
<th>Con</th>
<th>Pro</th>
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<tbody>
<tr>
<td>Tough to administer</td>
<td>Lets participants get $5 if they really need it</td>
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<tr>
<td>Frequent cause of plan errors</td>
<td>Otherwise they may quit their job just to get a distribution</td>
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<td>Can be source of employee frustration if you have to deny request</td>
<td>Good “karma” and doesn’t cost anything</td>
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<td>If you spend it today, it isn’t there when you retire (leakage)</td>
<td>Earn more important in tough times</td>
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Old Distribution Restrictions

- Under prior law, distributions from “restricted” 401(k) plan accounts (deferrals, QNECs, QMACs, safe harbor contributions) could occur only on account of:
  - Severance from employment
  - Death
  - Disability
  - Hardship (limited to the principal amount of elective deferrals, no earnings, no QNECs, no QMACs)
  - Attainment of age 59½
  - Plan termination
  - Qualified reservist distributions
  - HEART Act distributions (but only if receiving military differential pay)
New Rules

• Under the Bipartisan Budget Act of 2018, all restricted accounts may now be paid out on account of hardship.
• Special rules apply for 403(b) plans because of a glitch in the law’s language.
• This change is effective for the plan years beginning after 2018.

Hardship Distributions

• Two requirements:
  1. The distribution must be on account of an immediate and heavy financial need (the "needs" test); and
  2. The participant must not have other resources available to satisfy the immediate and heavy financial need (the "necessity" or "resources" test).
• There is no "hardship" exception to the 10% additional income tax for distributions before age 59 ½ per IRC §72(t).

Plan Document Choice

• Under the new regulations:
  • The needs test may be satisfied through either a safe harbor approach or a facts and circumstances approach;
  • The resources test, however, will no longer have a facts and circumstances option and instead will consist of a single safe harbor standard.
• As a practical matter, few plans used the facts and circumstances approach anyway.
NEEDS TEST

Safe Harbor Financial Need
The prior regulations deem a distribution to be on account of an immediate and heavy financial need if it is for 1 of 6 reasons:
1. Costs directly related to purchase of the participant's principal residence (not mortgage payments);
2. Amounts necessary to avoid eviction from or foreclosure on the participant's principal residence;
3. Expenses for a casualty loss to participant's principal residence (disregard 10% AGI floor);
4. Medical expenses of the employee, spouse, dependent or primary beneficiary (disregard 7.5% AGI floor);
5. College tuition, room and board and related expenses for employee, spouse, children, dependents or primary beneficiary; and
6. Funeral expenses for deceased parent, spouse, child, dependent or primary beneficiary.

Safe Harbor Financial Need
Reasons (cont'd.):
4. Medical expenses of the employee, spouse, dependent or primary beneficiary (disregard 7.5% AGI floor);
5. College tuition, room and board and related expenses for employee, spouse, children, dependents or primary beneficiary; and
6. Funeral expenses for deceased parent, spouse, child, dependent or primary beneficiary.
Facts and Circumstances Financial Need

- The 401(k) regulations provide little guidance on the facts and circumstances approach other than to say the determination should be based on all the relevant facts and circumstances and provides two examples:
  - "Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need."
  - "A distribution to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need."
- The regs also provide, "A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee."
- In the absence of an IRS determination letter, few plan sponsors want to take a chance with an expanded list of non-safe harbor financial needs.

NECESSITY - RESOURCES TEST

- A distribution is not necessary to the extent it exceeds the amount of the need or may be satisfied from other resources reasonably available to the participant.
- The "need" amount may be "grossed up" to include income taxes and penalties reasonably anticipated to result from the distribution.
- For the facts and circumstances approach, the employer can generally rely on the participant's written representation that the hardship can not be relieved with funds from other sources unless the employer has actual knowledge to the contrary. This approach is no longer available.
- Once again, very little guidance was provided in the 401(k) regs on the facts and circumstances approach to the necessity test and few plans used it.
Old Safe Harbor Necessity Test

- Under prior regulations, a distribution was deemed necessary to satisfy the hardship financial need (i.e., satisfied the safe harbor) if three requirements were satisfied:
  1. The distribution does not exceed the amount required to satisfy the need. (The amount of the distribution can be “grossed-up” for federal, state, or local income taxes or penalties anticipated to result from the hardship distribution.)
  2. The employee has obtained all non-hardship distributions and all nontaxable loans available from the employer’s plans.
  3. The employee must be suspended from making any deferrals to any plan of deferred compensation (qualified and nonqualified), including 401(k) and stock purchase plans, but not health or welfare benefit plans. The period of suspension must be for at least 6 months after the hardship distribution.

HARDSHIP RULE CHANGES

- Changes made by the Bipartisan Budget Act of 2018 (BBA 2018):
  - No requirement to take loans before hardship;
  - No need to suspend deferrals for six months;
  - Sources now available – deferral earnings, QNECs, QMACs and Safe Harbor 401(k);
- Effective for plan years beginning after December 31, 2018.
Regulations

• On November 14, 2018, the IRS published proposed 401(k) regulations to take into account the changes made by the BBA of 2018.
• The proposed regulations were finalized on September 23, 2019, and generally apply to distributions made on or after January 1, 2020.
• Optional transitional rules permit the regulations to be applied in the 2019 plan year (or January 1, 2018, in the case of revised list of safe harbor needs).

Final Regulations

• Added “primary beneficiary” as an individual who could qualify for medical, educational or funeral expenses. This was a law change from PPA '06.
• Clarified that the home casualty loss safe harbor need does not have to be in a federally declared disaster area (this was an unintended consequence of TCJA 2017).

• Added a new item to the list of safe harbor immediate and heavy financial needs, i.e., expenses or losses incurred by the employee as a result of a FEMA declared federal disaster, provided the employee lives or has a principal place of employment within the disaster area.
• This was the type of relief the IRS has previously provided on an episodic basis for federal disasters (e.g., floods, hurricanes, and wildfires).
• Suspension of elective deferrals or after-tax contributions will no longer be allowed for any reason.
• This was previously part of the "other resources" safe harbor test.
• This change is generally effective as of the beginning of the 2019 plan year. However, there are optional transition rules (next slide).

Final Regulations

• Optional transition rules:
  • A suspension that started in the last 6 months of the 2018 plan year may be lifted as of the first day of the 2019 plan year.
  • A six-month suspension may continue to be applied for hardship distributions made before January 1, 2020.

• Needless to say, operational decisions have already been made with regard to the transitional rules.
• The point to remember is that how the plan is operated will have to be reflected in a plan amendment.

Final Regulations

• Effective for the 2019 plan year, the final regulations do away with the requirement that the employee take all available, non-taxable, loans from the plan before receiving a hardship distribution.
• This change is optional and a plan can still require that a loan be taken first (by why would you?).
• Employee must still receive all available non-hardship distributions before receiving a hardship distribution.
• Effective for the 2019 plan year, the final regulations eliminate the facts and circumstances methodology for the "necessity/resources" test and now there is ONE general standard (see next slide).
Final Regulations

- General standard:
  - Hardship may not exceed amount of the need, increased for anticipated taxes and penalties.
  - Participant must first obtain all other available distributions under the employer’s plans (but remember not loans).
  - For distributions made after December 31, 2019, employee must represent that he or she has insufficient cash or liquid assets to satisfy the financial need.
  - Plan administrator may rely on this representation unless there is actual knowledge to the contrary.

Hardship Rule Changes

- Sources for hardship expanded:
  - Elective deferrals PLUS earnings.
  - QNECs, QMACS, safe harbor contributions – all of these plus earnings.
  - Note that this is optional and plans may still limit the available sources for a hardship distribution (for example, only from the elective deferral account with accrued earnings).

Final Regulations

- §403(b) arrangements:
  - Income allocable to elective deferrals is still not eligible for hardship – this needs a technical correction in the law.
  - 403(b) custodial account plans are limited by IRC §403(b)(7)(A)(ii) so that a distribution may only be paid at death, disability, age 59 ½, or severance from employment or in the case of elective deferrals, on account of hardship.
  - QNECs and QMACs that are not in 403(b)(7) custodial accounts are eligible for a hardship distribution.
Final Regulations

• The employee representation standard applies to distributions made on or after January 1, 2020.
• The updated list of safe harbor reasons may be relied upon and can be retroactively effective as early as January 1, 2018.
• This may help with confusion that occurred due to the need to be in a federally declared disaster area in order to take a casualty loss deduction under TCJA.

Final Regulations

• Reliance -
  • The proposed regulations did not include a traditional “reliance statement,” i.e., a statement that taxpayers could rely on the proposed regulations until final regulations are issued.
  • However, the “Operational Compliance List” on the IRS Employee Plans website now provides that taxpayers may rely on the proposed regulations until the date of publication of the final regulations in the Federal Register.

IDP Amendment Deadline

• Individually designed 401(k) plan amendment deadline -
  • The end of second calendar year that begins after the issuance of the Required Amendments list that includes the regulation .
  • The final regulation is the 2019 list, therefore the deadline will be December 31, 2021.
  • 403(b) plans deadline is December 31, 2021 per Rev. Proc. 2019-39.
Pre-Approved Plan Amendment Deadline

- Pre-Approved 401(k) plan interim amendment deadline normally:
  - Disqualifying Provisions – the later of:
    • the end of the plan year in which the disqualifying provision took effect, or
    • the due date of the employer tax return for the tax year which includes the effective date of the disqualifying provision.

Pre-Approved Plan Amendment Deadline

- Pre-Approved 401(k) plan interim amendment deadline normally:
  - Integrally Related Provisions – the later of:
    • the end of the plan year in which the plan was operated in accordance with the change, or
    • the due date of the employer tax return for the tax year which includes the date on which the plan was first operated in accordance with the change.

Hardship Rule Changes

- The preamble to the final regulation provides that all discretionary/optional changes will be treated as integrally related to the disqualifying provisions and the amendment deadline is extended to the same time as the required amendment.
- "Under this extension, for an employer using a pre-approved plan, the interim amendment deadline for the required amendment to the hardship distribution provisions of the plan will also be the deadline for all amendments integrally related to the hardship distribution provisions."
- Remember, the plan amendment must be consistent with how the plan was operated.
Hardship Rule Changes

- But what if the 401(k) plan sponsor chose to make all changes for the final regulation effective at the beginning of the 2019 plan year (which many plans did)?
- There was concern that an example in the preamble indicated that the IRS intended to distinguish plans that chose to make the changes effective earlier than January 1, 2020.
- Rev. Proc. 2020-09 cleared up the confusion by providing a December 31, 2021 deadline for pre-approved plan interim amendments for both the required and integrally related changes under the final regulations.

Federal Disaster Distributions

- A disaster relief provision, which was not originally part of SECURE, was added as Division Q under the 2020 budget bill.
- It will apply with respect to major disasters, as declared by the President under federal law, during the period beginning January 1, 2018, and ending February 29, 2020.
Federal Disaster Relief
• Under this provision, "qualified disaster distributions" of up to $100,000 are:
  • Exempt from the premature distribution penalty tax under IRC section 72(t);
  • They may be rolled back into a qualified plan or IRA for up to 3 years after the distribution;
  • They may be included in income ratably over the 3-year period beginning in the year of the distribution.
• In addition, the participant loan limit is increased for these individuals from $50,000 to $100,000 for loans made during the 180-day period beginning on December 20, 2019.

Federal Disaster Relief
• A "qualified disaster distribution" is a distribution made to an individual who suffered an economic loss and whose principal residence is located in a qualified disaster zone during the period of the disaster (as specified by the Federal Emergency Management Agency (FEMA)).
• To the extent a California wildfire disaster qualified under earlier relief provided by the Bipartisan Budget Act of 2018, the 2019 bill specifically denies a double benefit under both laws.

STUDENT LOANS AND 401(k) PLANS
Student Loans and 401(k) Plans

- Financial advisors talk about the battle for an employee’s benefit budget.
  - Retirement
  - Health care and HSAs
  - Saving for child’s college
  - Repayment of student loans
- These obligations impact the ability to save for retirement.
  - Not good for plans
  - Not good for participant

Student Loans and 401(k) Plans

- Why consider a contribution to the plan for those that are currently repaying student loans:
  - Help attract and retain employees (college grads)
  - A tax deferred benefit
  - Deductible by employer
  - No FICA or FUTA tax on non-elective contributions
- USA Today Money Section headline on May 31, 2019 - "Americans look for student-debt lifeline – Workers increasingly drawn to firms offering payback help."
- Travelers Insurance Company recently announced a 401(k) student loan “matching” program to begin in 2020.

Student Loans and 401(k) Plans

- Private letter rulings are issued to a specific taxpayer who is the only taxpayer who can “rely” on the guidance. PLR – 2018-33012 was issued to Abbott Laboratories in May of 2018.
  - It is possible the IRS may address a similar fact pattern in a full blown revenue ruling which could then be relied on by all taxpayers. The only specific issue on which the IRS opined is that the Abbott Laboratories student loan matching program did not violate the “contingent benefit rule.”
- The “contingent benefit rule” provides that no benefit, inside or outside of the plan, may be contingent on an employee making elective deferrals other than matching contributions.
Student Loans and 401(k) Plans

- Employees who are making student loan repayments receive a special contribution into their 401(k) plan.
- Contributions -
  - Traditional match - plan provides a 5% of compensation matching contribution if a participant defers at least 2% (per payroll).
  - New feature - if employee makes a student loan repayment of at least 2% (not a deferral into the 401(k)), they would receive a non-elective contribution of 5% and no actual matching contribution.
- If employees do not sign up for student loan “matching” contributions, they remain eligible for the traditional match.

Student Loans and 401(k) Plans

- Student loan “matching” contributions are not matching contributions under the (401(k) and (m) regulations because they are not made with respect to elective deferrals or after-tax voluntary contributions.
- The “matching” contributions are actually employer treated the same as employer non-elective contributions that are tested under the general non-discrimination test of IRC §401(a)(4).
- Discrimination testing could be problematic if HCEs are the ones benefiting under the program.

Look Before You Leap

- Potential detrimental impact on ADP/ACP testing.
  - If student loan matching contributions are made predominately for NHCEs then the overall ACP average will be lower since these contributions are not considered in the ACP test.
  - Similarly, the student loan repayments are not considered in the ADP test making it harder to pass if the program is predominately benefiting NHCEs.
- If the “matching” contribution is the only non-elective contribution, then coverage testing could be a problem if HCEs are receiving the “match.”
Look Before You Leap

- What allocation formula will be used for the student loan matching contributions?
  - Most prototype plans allow for the individual allocation groups but this can be unwieldy for a large plan.
  - If the allocation formula is going to be changed, then care must be taken not to violate the anti-cutback rules, i.e., no change if a participant has earned the right to an allocation under the current formula.
- How to substantiate that student loan payments were actually made?
  - Ruling is specifically limited to the holding that the arrangement doesn't violate the contingent benefit rule and nothing else (and only the taxpayer who requested the PLR may rely on it).

Proposed Legislation

- Identical provisions are included in the Retirement Security and Savings Act of 2019 (RSSA) jointly sponsored by Senators Rob Portman (R-OH) and Ben Cardin (D-MD).
- Under the RPSLA, if certain requirements are satisfied, matching contributions made with respect to student loan repayments:
  - Are tested under the ACP test; and
  - A student loan payment can be treated as an elective deferral for purposes of a safe harbor 401(k) plan.
- The student loan repayment is not, however, considered in the ADP test.

Proposed Legislation

- To qualify for this treatment, student loan matching contributions must be made available to all employees who are eligible to make salary reduction contributions.
- The rate of matching contributions must be the same for both student loans and for salary reduction contributions. For example:
  - If a 401(k) plan provides a 100% matching contribution on elective deferrals up to 5% of compensation; then
  - A 100% matching contribution must be made for student loan repayments up to 5% of compensation.
Proposed Legislation
• This treatment will only apply to repayments of student loan debt that was incurred by an employee for higher education expenses.
• In addition, the employee must certify to the amount of student loan repayments that were made during the plan year.

Proposed Legislation
• If a participant makes both salary reduction contributions and student loan repayments -
  • The student loan repayments are only taken into account to the extent that the workers has not made the maximum annual contribution under IRC section 402(g).
  • For example, a 35 year old employee who contributes $15,000 in elective deferrals and pays $5,000 in student loan payments may only have $4,000 of student loan repayments considered for a plan match.

Proposed Legislation
• RPSLA is not likely to be considered in this session of Congress because of the upcoming election cycle.
• Dealing with the student loan problem remains a priority for both Republicans and Democrats.
• Although Senator Wyden’s bill is co-sponsored by four other Democrats, Senators Rob Portman (R-OH) and Ben Cardin (D-MD) have included identical provisions in their latest iteration of proposed retirement legislation.
Back Door Roth

• Roth contributions are typically made as after-tax elective deferral contributions to a 401(k) plan or IRA.
• Generally, if a Roth contribution account is maintained for 5 years, earnings on the account are not taxed when distributed.
• Roth contributions have traditionally been recommended for individuals who believe their current marginal income tax rate is lower than it will be when the amounts are withdrawn.
• Roth has also been recommended as a way to diversify the tax treatment of retirement income sources to provide retirees with tax flexibility.

Back Door Roth

• Roth contributions are subject to the normal 402(g) limits when contributed to a 401(k) plan.
• The 2020 limit is $19,500 plus a potential catch-up contribution limit of $6,500.
• Similarly, Roth IRA contributions are limited to $6,000 with a $1,000 catch-up limit.
• In 2020, if a taxpayer’s modified adjusted gross income is greater than $139,000 (single) or $206,000 (married filing jointly), then he/she is not eligible to contribute to a Roth IRA.
• There is no adjusted gross income limit for making Roth contributions to a 401(k) plan.
Back Door Roth

- A back door 401(k) Roth is a way to make Roth contributions in excess of the 402(g) limit.
- A similar strategy can be used with a back door Roth IRA as a work around the AGI limit.
- We will focus on using the strategy in the context of a 401(k) plan.

Example - How Does It Work

- Sue is 45 and a participant in the ABC company 401(k) plan. In 2019, Sue earns $250,000 and contributes $19,500 as a Roth contribution to the plan. The employer makes a 3% matching contribution equal to $7,500.
- Sue also elects to make $30,000 in after-tax employee voluntary contributions up to her maximum 415 limit of $57,000.
- At a later date, Sue elects to make an in-plan Roth conversion of the funds.
- The earnings that accrue after the conversion will ultimately be paid out on a tax free basis (or they could be rolled over to a Roth IRA and be paid out favorably at a later date).
Four Potential Concerns

- Plan provisions.
- ACP testing.
- Violation of the “step transaction doctrine.”
- Will Congress close this “loophole.”

Plan Provisions

- The ability to make after-tax Roth contributions is not available in every 401(k) plan (although many plans now offer this option).
- Similarly, the ability to make an in-plan Roth conversion is not always a plan option.
- After-tax employee voluntary contributions were, at one time, very popular but with the advent of ACP testing, very few plans offer this option today. A plan would need to add this option if not already there.

ACP Testing

- IRC section 401(m) is most often thought of as a test that compares the average rate of matching contributions for the highly-compensated employees to the average rate for the non-highly compensated employees.
- What can be overlooked is that after-tax employee voluntary contributions are also included in the respective averages when running the ACP test.
- Since the back door Roth strategy tends to appeal to higher paid employees, it could cause havoc with the ACP test.
ACP Testing

- For example, Sue, at Acme Paint Company, received:
  - $7,500 of matching contributions; and
  - $30,000 in after-tax employee voluntary contributions.
- Sue’s actual contribution percentage is 15% ($37,500/$250,000).
- If Sue is an HCE, her individual ACP, when added to the HCE average, may cause the test to fail since the plan matching rate is 3% (which will likely be what most NHCEs have as their individual ACP ratio).

ACP Testing Safe Harbor Plan

- If the plan is a safe harbor plan, the after-tax contributions are still subject to ACP testing.
- In other words, there is no way to make a safe harbor contribution to avoid the ACP test on after-tax employee voluntary contributions.
- If after-tax employee voluntary contributions are made to a safe harbor plan, then the ACP test can be run by:
  - Considering only the after-tax employee voluntary contributions; or
  - Considering both the matching and after-tax employee voluntary contributions.

ACP Testing

- Because of the ACP testing issue, the back door strategy will only work if there are sufficient NHCEs receiving matching contributions and/or making after-tax employee voluntary contributions to pass the test.
- The most likely plan sponsors who can offer this option will be large companies where the average employee is highly paid.
- This is because the top paid group election for determining HCEs can result in significant number of higher paid individuals being classified as NHCEs given the right demographics.
- The plan document needs to address the top paid group election and it must be made consistently with respect to all plans of the employer.
ACP Testing

• For example, consider a high tech company with 10,000 employees. Under the top paid group election, only the 2,000 highest paid employees would be in the top-paid group and could be classified as HCEs because of their compensation.
• If the employees just below that threshold are interested in employing the back door Roth strategy, they would be unencumbered by the ACP test since they are NHCEs (assuming they don’t fall into any other HCE category).
• In fact, their participation will raise the ACP average for the NHCE group making it potentially possible for HCEs in the top 20% to contribute some amount of after-tax employee voluntary contributions if desired.

Conclusion

• Back door Roth 401(k) contributions will only work for employers with the right demographics.
• There is also the question of whether it makes sense for a high income individual to make Roth contributions in their prime working years when his or her marginal tax rate is likely higher then it will be in retirement.
• To diversify the tax treatment of retirement distributions, a participant may want to consider having retirement savings invested in both pre-tax and after-tax Roth accounts.

Questions