Daily Tax Report ®

INSIGHT: Qualified Plans Under the CARES Act—What Employers Need to Know

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April 24, 2020, 9:00 AM

Coronavirus relief legislation authorized distributions and loans from retirement plans without penalties or withholding requirements to assist employees and plan participants suffering economic consequences from the Covid-19 pandemic. Lauren Parker and Joshua Sutin of Chamberlain Hrdlicka explain the provisions and employer considerations.

The Coronavirus Aid Relief and Economic Stability Act (CARES Act (Public Law 116-136)) implements several changes to qualified retirement plans which are geared to assist employees and plan participants who suffer economic consequences related to Covid-19 and the stay-at-home orders issued throughout the majority of the U.S. which should be carefully considered.

Plan recordkeepers and document providers are beginning to amend their pre-approved and volume submitter plan documents to implement the CARES Act changes and generally giving employers the option to opt out of most of the amendments. Employers should carefully review communications from their plan document providers as employers have a duty to understand the law and opt out of or revise any amendments to which an employer may object.

CARES Act Distributions

The CARES Act implements new “coronavirus-related distributions” (CARES distributions) from retirement plans including 401(k), 403(b), 457(b), and employee stock ownership plans (ESOPs), as well as individual retirement accounts (IRAs). These distributions are not subject to the 10% early withdrawal penalty that would otherwise apply to early distributions from these types of qualified retirement plans nor are they subject to withholding requirements that are generally imposed on distributions.

CARES distributions may be made between Jan. 1, 2020, and Dec. 31, 2020, to individuals who are diagnosed with SARS-CoV-2 or Covid-19, individuals whose spouse or dependent is diagnosed with the virus or disease, or any individual who experiences adverse financial consequences resulting from quarantine, furlough, being laid off, a reduction in work hours, or being unable to work because of a lack of child care. Importantly for employers, a plan administrator may rely on the employee's certification that the employee meets one of these conditions for eligibility for CARES distributions.

CARES distributions are limited to the lesser of $100,000 or 100% of the participant's account balance. The CARES Act allows distributions to be repaid, without interest, within the 3-year period starting the day after the participant receives the CARES distribution. Repayment may be made either to the qualified retirement plan or IRA from which distributions were made or to a new 401k, other qualified retirement plan or IRA. If the distribution is repaid within the 3-year period, it is treated, for income tax purposes, as if the repayment was a direct trustee to trustee transfer made within 60 days of the distribution.

If not repaid, the CARES distributions are subject to income tax. For income tax purposes, the distributions can be reported by the participant ratably over a 3-year period instead of in a single lump sum which could result in a lower income tax rate applying to the distributions.

Unlike plan loans, the CARES distributions are not due as a result of a termination of employment. This is a great benefit for employees who have already lost their jobs, have been laid off or furloughed, and especially for those who remain employed, but who are at risk of losing their jobs in the coming weeks and months.

Plan sponsors and administrators should be particularly diligent regarding recordkeeping for CARES Act distributions and repayments and related reporting to the IRS.

Employee Stock Ownership Plans

Employers sponsoring ESOPs should carefully consider whether to amend their plans to implement CARES distributions as plan participants requesting such distributions would likely exercise their put options requiring employers to buy participants' shares well in advance of any expected repurchase liability. The ability of participants to repay these distributions could further complicate the administration of an ESOP as it would have to be determined whether the repayments could be used to add employer stock to a participants account, and, if so, at what price or whether the repayments would be held in a separate account and used for other investments besides employer stock. Employers that sponsor both a 401(k) plan and an ESOP should consider amending only their 401(k) plans to accommodate CARES distributions.

It is important to note that the loans available to small employers under the Paycheck Protection Program (PPP) of the CARES Act may be used for payment of retirement benefits. Therefore, an employer could use a portion of the funds it receives from a loan to make its annual contribution to its ESOP or to repurchase shares distributed to participants. However, if an employer does so and is subsequently unable to meet the employee compensation and retention metrics required by the PPP, it may be disqualified from the eventual forgiveness of all or a portion of the loan.

Plan Loans

Most 401(k), 403(b), and 457(b) plans allow plan participants to take loans from their plan accounts. Generally, the loans are limited to the lesser 50% of a participant's account or $50,000 and most plans only allow for one loan to be outstanding at any given time. Unless a loan was used to purchase a principal residence, it must be repaid over five years at an interest rate specified by the plan document. If a participant fails to make a scheduled repayment, the remaining outstanding balance is treated as a distribution from the plan, is included in the participant's income for the given year for tax purposes and may be subject to a 10% early withdrawal penalty.

The CARES Act makes a few significant changes to the loans available from a 401(k), 403(b), or 457(b) plan, but only for a limited time period. Beginning on March 27, 2020, plan loan limitations are increased to the lesser of $100,000 or 100% of a participant's vested plan account balance.

Repayments of existing loans or new loans under the CARES Act are suspended for the remainder of 2020. The usual five-year period to repay plan loans will not include 2020 which effectively gives participants six years to repay their loans. However, interest will continue to accrue on outstanding loans throughout the period that repayments are suspended.

It is important to note that the CARES Act does not implement changes to the number of loans a participant may have outstanding at one time. Very often, plans limit participants to only one outstanding loan at any time. Plan sponsors and administrators should carefully review their plan terms and loan policies to ensure the participants do not take loans that are not allowed by a plan and to determine if a plan needs to be amended to allow participants to have more than one loan outstanding at a given time.

Additionally, even when loans and repayments are handled by a third-party administrator or outside vendor, employers and plan sponsors should institute policies and controls to monitor loan repayment schedules to confirm that repayments are appropriately suspended in 2020 and restarted in 2021.

Hardship Distributions

Hardship distributions continue to be an option for employees and plan participants dealing with the economic impact of Covid-19. However, the CARES Act does not change the distribution scheme for hardships, which means that hardship distributions, if allowed under a plan, may be subject to an early withdrawal penalty, are subject to income tax, may not be repaid, and the distributions may not exceed the amount of the demonstrated hardship.

Employers and plan sponsors are unlikely to see an increase in hardship distribution requests unless they decline to implement the CARES distributions or the increases in plan loans.

Required Minimum Distributions

The CARES Act suspends required minimum distributions (RMDs) from qualified plans and IRAs for the year 2020 including required beginning distributions that should have been taken by April 1, 2020. Qualified retirement plans must be amended for this change, and employers will not be able to opt of such an amendment. Employers with pre-approved or volume submitter plans will likely be notified by their recordkeepers that their plans are being amended to account for this suspension. Those with individually designed plan documents, ESOPs in particular, should amend their plans to ensure that plan participants are not required to take required minimum distributions in 2020. While the amendments do not have to be adopted until Jan. 1, 2022, or Jan. 1, 2024, in the case of governmental plans, all plans must be operated in compliance with this suspension of RMDs regardless of when a plan is amended.

Document providers and recordkeepers are acting quickly to implement these changes so that participants can access the various forms of financial relief that may be available to them. Employers sponsoring qualified retirement plans should carefully evaluate which optional plan changes they would like to implement and consult with their vendors and ERISA counsel in making those decisions. Employers should also monitor communications to participants to be sure participants are well informed of the choices that are available to them.

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