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Memorandum

CARES Act Impact on Qualified Retirement Plans and Other Considerations for Defined Contribution Plans

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The coronavirus disease 2019 ("COVID-19") continues to put significant pressure on employers to navigate various employee issues, including with respect to retirement plans. In the provisions of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") that cover qualified retirement plans, Congress has provided additional tools to plan sponsors and relief to both plan sponsors and participants, including penalty-free distributions, plan loan relief, a temporary waiver of required minimum distributions for defined contribution plans, and temporary funding relief for single-employer defined benefit plans. Each of the foregoing is discussed in this memorandum. This memorandum also addresses selected issues related to defined contribution plans that employers and plan fiduciaries may face as a result of the COVID-19 crisis.

CARES Act Relief

DEFINED CONTRIBUTION PLANS

The Internal Revenue Code has a number of rules governing distributions from defined contribution plans to participants, imposing strict limitations on distributions to active employees and requiring minimum distributions to certain participants. For employee elective contributions in 401(k) plans, such plans may allow in-service distributions to be made to an employee who has reached age 59 ½ or due to financial hardship. Participants may also be allowed to take out loans from the defined contributions plans in which they participate, including 401(k) plans, subject to limits.

In addition, the Internal Revenue Code requires that participants start receiving distributions from certain retirement accounts generally no later than April 1 after the calendar year in which they reach age 70 ½ (age 72 for participants who reach age 70 ½ on or after January 1, 2020) or, if later, after they terminate employment with the plan sponsor. The amount of money that must be withdrawn each year is called a required minimum distribution ("RMD").

The CARES Act eases some of these rules by (i) permitting plan sponsors to offer optional financial relief to retirement plan participants who are "qualified individuals" through both in-service "coronavirus-related distributions" and plan loan relief, and (ii) temporarily waiving RMDs for all participants. A "qualified individual" is someone who:

- has been diagnosed with the virus SARS-CoV-2 or with COVID-19 by a test approved by the Centers for Disease Control and Prevention ("CDC"),
- has a spouse or dependent who has been diagnosed with the virus SARS-CoV-2 or with COVID-19 by a CDC-approved test,
- has experienced adverse financial consequences from being quarantined, furloughed, laid off, or having reduced work hours due to the virus SARS-CoV-2 or COVID-19,
- has experienced adverse financial consequences from being unable to work because of lack of child care due to the virus SARS-CoV-2 or COVID-19,
- has experienced adverse financial consequences from closing or reducing hours of a business owned or operated by the individual, or
- has experienced adverse financial consequences due to other factors determined by the Secretary of Treasury.

The plan administrator may rely on a participant's self-certification that the participant meets one or more of the factors in the definition of "qualified individual" above.

Penalty-Free Coronavirus-Related Distributions

The CARES Act provides for expanded distribution options and favorable tax treatment for "coronavirus-related distributions" from eligible retirement plans, including employer-sponsored 401(k), profit sharing and 403(b) plans, and individual retirement accounts ("IRAs"). Coronavirus-related distributions are limited to $100,000 and must be made to a qualified individual before December 31, 2020.

A coronavirus-related distribution is taxable to the participant, but is subject to more favorable tax treatment than would typically apply to retirement plan distributions, as follows:

- The 10% penalty tax on distributions made before age 59 ½ does not apply to a coronavirus-related distribution.
- A coronavirus-related distribution is taxed ratably over three years unless the participant elects to include the full distribution in the participant's income in 2020.
- Participants can repay all or part of a coronavirus-related distribution within three years by recontributing the amount to a qualified retirement plan that accepts rollovers or an IRA. If a participant timely repays a coronavirus-related distribution, the participant will not owe federal income tax on the distribution.
- Eligible rollover distributions are subject to a reduced 10% withholding rate rather than the typical 20% rate (unless the participant elects no withholding).

Plan Loan Relief

The CARES Act also allows employers to increase the limit on retirement plan loans made to qualified individuals to up to $100,000 (or, if less, 100% of the participant's vested account balance). Typically, the limit is $50,000 (or, if less, 50% of the participant's vested account balance). The higher loan limit applies to loans made to qualified individuals between March 27, 2020, and September 22, 2020.

The CARES Act further allows employers to suspend loan repayments (on existing and new plan loans) due after March 27, 2020, and before December 31, 2020, for up to one year for qualified individuals. The maximum five-year loan term may be extended for the length of the suspension period. Loans will continue to accrue interest during the suspension period and future payments will be adjusted to reflect the delayed payments and accrued interest.

Temporary Waiver of Required Minimum Distributions

In order to limit the impact on participants of investment losses in plan accounts, the CARES Act provides a temporary waiver of RMDs in 2020 for certain defined contribution plans, including 401(k), profit sharing and 403(b) plans, and IRAs. As a result, participants who would otherwise be required to liquidate plan account investments in order to take a RMD can avoid doing so, thereby giving them an opportunity to potentially recover investment losses caused by a temporary market downturn (*e.g.*, as a result of the COVID-19 crisis). Employers should consult with their recordkeepers/third-party administrators and other service providers about administering this change. To the extent that an RMD has already been made in 2020 that would qualify for this temporary waiver, the distribution can be rolled back into a qualified retirement plan or IRA to avoid taxation in 2020, as long as the rollover is completed within 60 days from the date of the RMD (the Internal Revenue Service has extended the 60-day deadline to July 15, 2020, if the deadline would have fallen between April 1, 2020, and July 15, 2020).

DEFINED BENEFIT PLANS

For single-employer defined benefit plans, the CARES Act provides relief to plan sponsors through certain extensions, so that funding requirements can be better managed in light of other cash flow considerations. Minimum funding contributions, including quarterly contributions, that are otherwise due anytime during 2020 can be delayed until January 1, 2021. The delayed payment must be adjusted for interest accrued between the original due date and the payment date, determined based on the plan's effective interest rate.

Employers can also choose to use the 2019 adjusted funding target attainment percentage ("AFTAP") for 2020. For defined benefit plans, actuaries are required to calculate the AFTAP as a measure of the plan's funding status. If the AFTAP falls below certain percentages, the Internal Revenue Code imposes funding-based benefit restrictions on the plan, such as limiting lump-sum payments or restricting future benefit accruals. Using the 2019 AFTAP for 2020 will minimize the significant market impact of COVID-19, which could otherwise cause a plan's AFTAP to fall and trigger certain benefit restrictions.

IMPLEMENTING CHANGES

Employers can adopt and begin implementing the CARES Act changes immediately. A written plan amendment will be required, but employers may adopt the amendment at any time prior to the end of the plan year starting on or after January 1, 2022 (December 31, 2022, for calendar year plans) and the amendment will apply retroactively.

As noted above, however, the CARES Act does not require employers to amend their retirement plans to provide for the distribution and loan relief described above. It merely provides more flexibility if employers want to provide it. Even if an employer does not amend its plans to allow coronavirus-related distributions, qualified individuals may still benefit from the more favorable tax treatment available for such distributions, such as the relief from the 10% penalty tax on early distributions. For example, a terminated participant who is a qualified individual may treat a distribution as a coronavirus-related distribution (to the extent the distribution meets the requirements) on the individual's federal income tax return and not be subject to the 10% penalty tax on such distribution.

Before making changes, employers should consider their current plan design and confirm with the plan's service providers that the changes can be administered. Existing plan features such as hardship withdrawals and plan loans may be alternative avenues for employee assistance if the employer elects not to implement the CARES Act flexibility or for employees who do not meet the definition of "qualified individuals." It should also be noted that many plan service providers are moving at an accelerated pace to implement changes and are giving employers a very short period of time to make decisions. In some instances, service providers are making changes unless an employer "opts out."

Employers should consult with legal counsel before making any decisions and stay alert for regulatory guidance, including from the Internal Revenue Service, which may impact how these features are administered.

Other Considerations

REDUCING EMPLOYER CONTRIBUTIONS

Employers adversely affected by COVID-19 may wish to suspend or reduce employer contributions (such as matching or nonelective contributions) to their defined contribution plans, such as 401(k) plans, profit sharing plans, and 403(b) plans. For plans that are not safe harbor plans, employers may have significant flexibility to suspend or reduce employer contributions.

If the plan provides for discretionary contributions, employers are not required to make any contributions and can decide at any time to suspend or reduce future contributions. If the plan provides for fixed matching or nonelective contributions, the plan can be amended to suspend or reduce contributions prospectively, so long as the participants have not met the requirements for receiving the contributions. For example, if a plan provides that a matching contribution will be made for participants who have 1,000 hours of service during a plan year, the matching contribution for the plan year cannot be suspended or reduced for participants who have met the service requirement. Employers should review their plan documents and participant communications and consult with legal counsel to confirm whether participants' benefits have accrued.

For safe harbor plans, contributions can be suspended or reduced during a plan year only if the employer is operating at an economic loss[1] for the plan year (which may be the case due to the COVID-19 crisis) or if the plan's safe harbor notice stated that the employer could reduce or suspend employer contributions during the plan year. Employers must provide at least 30 days' notice describing the reduction or suspension before it becomes effective. The plan will need to be amended and will also need to meet nondiscrimination testing requirements for the plan year.

Employers that are considering reducing or suspending employer contributions to retirement plans should consult with legal counsel to ensure that any changes are made in compliance with the Internal Revenue Code, the Employee Retirement Income Security Act, and the plan's terms.

PARTIAL PLAN TERMINATIONS

If an employer is planning on laying off a large portion of its employees, the employer should consider whether a partial plan termination would occur. Whether a partial plan termination has occurred is a facts and circumstances determination, although Internal Revenue Service guidance presumes that a plan has partially terminated if the turnover rate of plan participants is 20% in a plan year. When a partial plan termination occurs, affected employees become 100% vested in all employer contributions. Affected employees generally include employees who left employment for any reason during the plan year of the partial plan termination and who still have an account balance in the employer's retirement plan.

FIDUCIARY CONSIDERATIONS

The COVID-19 crisis also presents issues for employers and their retirement plan committees with fiduciary responsibility for plan administration and investment decisions. Retirement plan committees should continue to monitor plan investments and should consider whether the recent market volatility warrants scheduling additional meetings to facilitate review and committee decision making. Committee decisions should be formally documented to demonstrate procedural prudence, and the plan's investment policy statement should be reviewed to confirm that it is being followed. Committees should work with their investment advisors to determine whether to make changes to the plan's investment lineup or investment policy statement. Committees may also consider revisiting decisions that were made prior to the onset of the COVID-19 crisis but that have not been implemented to determine whether those decisions continue to be appropriate.

Employers should continue to monitor plan service providers carefully to assess whether they are responding to participant requests and are able to meet increased demands for services (*e.g.*, increased call volume, participant-

[1] Although the term "economic loss" is not defined in the tax regulations, practitioners generally agree that it means that expenses exceed income in the financial statements for the employer and members of its controlled group.

directed investment changes, or requests for distributions). Employers should also understand whether service providers are changing plan administrative processes in response to the COVID-19 crisis, including in response to the CARES Act.

Additionally, employers and their retirement plan committees should monitor participant decision-making during this time, including whether participants are changing deferral elections or investment elections, or requesting loans and/or distributions. This information will help employers decide if additional participant communication is needed (*e.g.*, additional education on investment options) and to help make plan design and administrative decisions going forward.

Employers and retirement plan committees should pay particular attention to employer stock investment options in retirement plans. Employer stock funds have long been a target for litigation claims against plan fiduciaries for breach of fiduciary duty asserting that employer stock funds were not an appropriate investment option for the plan. Each employer's situation is unique and warrants an individualized determination with respect to its employer stock investment option. Therefore, it is important for plan fiduciaries to carefully assess the employer stock fund (along with all other plan investment options) on a regular basis. Disclosures and participant communications about the employer stock fund should be reviewed and special communications that educate participants about the benefits of diversification may be appropriate. Employers and plan fiduciaries may also consider taking other actions to mitigate risk, including restricting or imposing limits on contributions to the employer stock fund, or engaging an independent fiduciary to assume fiduciary responsibility for managing the employer stock fund.

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