TAX AND BUDGET BILLS INCLUDE TAX QUALIFIED RETIREMENT PLAN PROVISIONS

Date: 22 February 2018

U.S. Tax and Employee Benefits Alert

By: Michael A. Hart

The tax bill enacted late last year (Public Law No. 115-97) and the budget bill enacted earlier this month (the Bipartisan Budget Act of 2018) included a handful of changes to the rules applicable to tax-qualified retirement plan distributions. Generally, the changes are intended to provide more flexibility for retirement plan distributions. Most are immediately effective but some will not become effective until next year.

PLAN LOAN OFFSETS

The tax bill extends the rollover deadline for "plan loan offsets." Plan loan offsets are otherwise taxable distributions that result from certain loan payment defaults (usually defaults resulting from nonpayment of a loan that accelerates at termination of employment). These distributions are eligible for tax-free rollover to another retirement plan. Under prior law, the deadline for rolling over a plan loan offset distribution was the same as any other eligible rollover distribution 60 days after the date of the distribution. The tax bill extends the deadline for rolling over a plan loan offset distribution to the due date of the participant's federal income tax return (including extensions) for the year in which the plan loan offset distribution is treated as occurring. The tax bill effectively gives the participant additional time to repay a loan and avoid a taxable distribution.

This provision of the tax bill is effective for plan loan offsets treated as distributed in tax years beginning after December 31, 2017. It applies only to plan loan offsets that occur solely by reason of plan termination or the failure of a participant to meet the repayment terms of the loan because of the participant's severance from employment. It does not apply to "deemed distributions" that occur with respect to loan defaults prior to the date on which the participant is otherwise eligible to receive a distribution. Nor does it apply to deemed distributions attributable to the failure of a loan to be properly structured as a tax-free loan in the first place.

HURRICANE AND WILDFIRE DISASTER RELIEF

Under the tax bill, a current or former employee whose principal residence was in the Hurricanes Harvey, Irma, or Maria disaster areas and who sustained economic loss (including property damage, home displacement, or job loss) can receive distributions of up to $100,000 from their retirement plans (including tax-qualified retirement plans, 403(b) plans, and individual retirement accounts) that take advantage of a number of special tax rules:

- The distributions can be included in income ratably over three years.
- If otherwise eligible for rollover, the distributions can be repaid tax-free to a retirement plan at any time up to three years from the date of distribution.

©2005-2024 K&L Gates LLP. All Rights Reserved.

- The distributions are not subject to the 10 percent excise tax that may otherwise be applicable to distributions made prior to age 59 1/2 and are not subject to mandatory 20 percent withholding.
- The distributions can be permitted by the plan even if they are not otherwise permitted by the Internal Revenue Code. For example, employees can take these distributions even if they are still employed, under age 59 1/2 and would not otherwise satisfy the requirements for a hardship distribution.

These provisions apply to distributions made before January 1, 2019, and after August 22, 2017, for Hurricane Harvey, after September 3, 2017, for Hurricane Irma, and after September 15, 2017, for Hurricane Maria. To be eligible, the current or former employee's principal residence must have been located in the applicable disaster area on August 23, 2017 (Harvey), September 4, 2017 (Irma), or September 16, 2017 (Maria).

The budget bill contains similar relief for distributions to a current or former employee whose principal residence at any time from October 8, 2017, to December 31, 2017, was in the California wildfire disaster area. The California wildfire disaster area distribution provisions apply to distributions made on or after October 28, 2017, and before January 1, 2019. In addition, the budget bill includes two provisions designed to give participants affected by the California wildfires more access to plan loans:

- It temporarily increases the maximum amount that may be withdrawn as a loan to 100 percent of the employee's vested account balance up to $100,000. This provision applies to loans between February 9, 2018, and December 31, 2018.
- It postpones the due date for any loan repayment otherwise due between October 8, 2017 and December 31, 2018, for one year if the loan was outstanding on or after October 8, 2017. The postponed payment must be adjusted for additional interest and the extended loan repayment is disregarded for purposes of the five-year limit on general purpose loans.

HARDSHIP WITHDRAWAL CHANGES

The budget bill includes several provisions that facilitate hardship withdrawals from 401(k) and 403(b) plans, all of which become effective for plan years beginning after December 31, 2018:

- Elimination of Six-Month Contribution Suspension. Under current Internal Revenue Service regulations, a 401(k) or 403(b) plan participant is permitted to take a hardship distribution only if the distribution is necessary to satisfy an immediate and heavy financial need. The regulations include a "safe harbor" under which a distribution will automatically be treated as necessary to satisfy an immediate and heavy financial need of the participant if, among other things, the participant's right to contribute to the plan is suspended for at least six months. The budget bill directs the Internal Revenue Service to modify the regulation to delete the six-month contribution prohibition from the safe harbor.
- Expansion of Hardship Withdrawal Sources. The budget bill expands the sources of contributions from which 401(k) hardship withdrawals may be taken to include earnings on elective deferral contributions and so-called "qualified nonelective contributions" and "qualified matching contributions," which are contributions that plan sponsors can make to remedy a plan's failure to pass nondiscrimination testing. The bill also makes clear that hardship withdrawals may be taken from profit sharing plans.

©2005-2024 K&L Gates LLP. All Rights Reserved.

- Elimination of Requirement to Take Loans. The budget bill eliminates the requirement that a participant take all available loans under the plan as a condition to receiving a hardship distribution.

RECONTRIBUTION OF RETURNED INTERNAL REVENUE SERVICE LEVY AMOUNTS

Under the budget bill, if an amount was distributed from a retirement plan (including a tax-qualified retirement plan, a 403(b) plan or an individual retirement account) pursuant to an Internal Revenue Service levy and the Internal Revenue Service returns the levy to the participant, the participant may recontribute the amount returned by the Internal Revenue Service (plus any interest returned to the participant) to the plan. The contribution must be made no later than the due date (not including extensions) for the participant's federal income tax return for the year the levied amount was returned to the participant. To the extent recontributed, any taxes paid on the distribution are refundable (unless the distribution was made from a non-Roth account and recontributed to a Roth account, which would effectively be treated as taxable Roth conversion). This provision is effective for levy amounts returned by the Internal Revenue Service in tax years beginning after December 31, 2017.

WHAT DO PLAN SPONSORS NEED TO DO?

None of the tax-qualified retirement plan provisions in the tax and budget bills require retirement plan sponsors to make any changes to their retirement plan designs. That said, many plan sponsors will want to consider accepting repayments of qualified plan loan offset distributions, disaster-related distributions and returned Internal Revenue Service levy distributions, and allowing plan participants to take advantage of the looser hardship withdrawal rules and the California wildfire disaster loan provisions. Plan sponsors may implement any of these changes operationally immediately or, in the case of the changes to the hardship withdrawal rules, beginning in 2019. The deadlines for adopting amendments reflecting any operational changes may vary and plan sponsors should consult with their advisors regarding those deadlines.

Two provisions of the tax and budget bills require plan sponsors to adjust plan administration:

- The one-year extension for loan repayments by individuals affected by the California wildfire disaster is mandatory. Plans that permit loans will need to permit adjustments to loan repayment schedules for these individuals.

- Because the tax and budget bills exempt disaster-related distributions from the 10 percent early distribution excise tax and 20 percent mandatory withholding, it appears that plan sponsors will need to adjust their reporting of disaster-related distributions and withholding for those distributions. For example, the Internal Revenue Service has recently suggested that Form 1099-R for a distribution to a participant who qualifies for hurricane relief under the tax bill should be marked with Code 2 in Box 7 to signify that the distribution is exempt from the 10 percent early distribution excise tax. Presumably, the Internal Revenue Service would expect similar reporting to a participant who is eligible for California wildfire relief under the budget bill. It is not clear how a plan would determine a participant's eligibility for disaster-related distribution tax-relief. Presumably, it may rely on the representation of the participant assuming the plan is not otherwise aware of facts that would disqualify the participant from relief.

©2005-2024 K&L Gates LLP. All Rights Reserved.

KEY CONTACTS

MICHAEL A. HART
PARTNER

PITTSBURGH
+1.412.355.6211
MICHAEL.HART@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2024 K&L Gates LLP. All Rights Reserved.