Today's Webinar will begin shortly

Please register today for our next Trucker Huss Webinar:
"ERISA Litigation Update: 401(k) and 403(b) Excessive Fee Lawsuits"

Date: July 23, 2019 – 10:00 AM PDT / 1:00 PM EST

Description: Clarissa Kang, Joseph Faucher and Dylan Rudolph of the Trucker Huss litigation group will discuss recent developments in excessive fee lawsuits filed against sponsors of 401(k) and 403(b) plans across the country, plaintiffs' evolving theories of liability, and lessons learned for plan committees overseeing these types of plans.

401(k) Hot Topics

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Agenda

- Hardship Withdrawal Changes for 2019
- Student Loan “Matching” Contributions to 401(k) Plans
- “Back Door” Roth 401(k) Contributions

HARDSHIP WITHDRAWAL CHANGES

Hardship Distribution Option

- Available only to profit sharing and 401(k) plans (i.e. NOT pension plans).
- 403(b) plans may also permit hardship distributions with some modifications regarding the permitted sources.
- Allows in-service distribution to employee based on "immediate and heavy financial need."
- Optional Provision – qualification rules do not mandate hardship distributions.
- Document must reflect employer's choice.

Hardships: Pro and Con

- Con
  - Tough to administer
  - Frequent cause of plan errors
  - Can be source of frustration if you have to deny request
  - If you spend it today, it isn't there when you retire
- Pro
  - Lets participants get $$ if they really need it
    - Otherwise they may quit to get distribution
  - Good "karma"
  - Even more important in tough times
  - May encourage deferrals
    - Workers more likely to defer if they can get it if they need it

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)**
  - Attainment of age 59½
  - Plan termination
  - Qualified reservist distributions
  - HEART Act distributions (but only if receiving military differential pay)

Distribution Restrictions

- 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 glitch in the law’s language.
- This change is effective for the 2019 plan year and will be discussed in greater detail later in the program.

Hardship Distributions

- Two requirements:
  1. The distribution must be on account of an immediate and heavy financial need ("needs" test).
  2. The distribution must be necessary to satisfy that need ("necessity" or "resources" test).
- No "hardship" exception to the 10% additional income tax per IRC §72(t).

Plan Document Choice

- Two alternative approaches:
  - Objective plan provisions.
    - Facts and circumstances.
    - Can NOT use in prototype.
  - Safe harbor.
    - Must use in prototype.

NEED TEST

Safe Harbor Financial Need

- The current regulations deem a distribution to be on account of an immediate and heavy financial need if it is for one of six reasons:
  1. Costs directly related to purchase of the participant's principal residence (not mortgage payments!).
  2. Amount necessary to avoid eviction from or foreclosure on participant's principal residence.
  3. Expenses for casualty loss to participant's principal residence (disregard 10% AGI floor).

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Three Events for Broader Group

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.
6. Funeral expenses for deceased parent, spouse, child, dependent or primary beneficiary.

Facts and Circumstances Financial Need

- The regulations allow a facts circumstances approach to the needs test but provides very little guidance.
  - "… the need to the pay the funeral expenses of a family member would constitute an immediate and heavy financial need."
  - "A distribution made to an employee for the purchase of a boat or television would generally not…."
- Due to the lack of guidance, few plans use this approach.

NECESSITY/RESOURCES TEST

Facts and Circumstances Necessity/Resources Test

- A participant may not receive a hardship distribution if there are other resources reasonably available which could be used to satisfy the heavy and immediate financial need.
- Examples from the regulations of other resources include liquidation of assets, loans from commercial sources, insurance reimbursement, etc.
- The distribution amount may be grossed up for income taxes and penalties reasonably anticipated to result from the distribution.

Facts and Circumstances Necessity/Resources Test

- The employer may 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.
- Again, very little guidance in the 401(k) regs on the facts and circumstances approach so little used (and its going away).

Safe Harbor Necessity

- Under current regulations, a distribution is deemed necessary to satisfy the hardship financial need if three requirements are satisfied:
  1. The distribution does not exceed the amount required to satisfy the need.
     - The amount required can be "grossed-up" for federal, state, or local income taxes or penalties anticipated to result from the hardship distribution.
     - Not clear whether the amount required can be "grossed up" for any plan imposed fees applicable to the distribution.

Safe Harbor Necessity

2. The employee has obtained all non-hardship distributions and all nontaxable loans available from the employer's plans.
3. The employee must then 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

Hardship Rule Changes

- Changes made by the Bipartisan Budget Act of 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.

Proposed 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 does not have to be in a federally declared disaster area (this was an unintended consequence of TCJA 2017).

Proposed Regulations

- Added a new item to the list of safe harbor reasons to have an immediate and heavy financial need – **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).

Proposed Regulations

- 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).

Proposed 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.

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Proposed Regulations

- Effective for the 2019 plan year, the proposed regulations would 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 (but why would you?).
- Employee must still receive all available non-hardship distributions before receiving a hardship distribution.
- Effective for the 2019 plan year, the proposal eliminates the facts and circumstances methodology for the "other resources" test and now there is ONE general standard (see next slide).

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Proposed 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).

Proposed 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 59½, or severance from employment.
  - Elective deferrals may also be paid on account of hardship
  - QNECs and QMACs that <u>are not</u> in 403(b)(7) custodial accounts are <u>eligible</u> for a hardship distribution.

Proposed 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 made 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.

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Proposed Regulations

- Reliance
  - The proposed regulations did not include a traditional "reliance statement," i.e., a statement that taxpayers can 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.

Hardship Rule Changes

- Individually designed plan amendment deadline –
  - The end of second calendar year that begins after the issuance of the Required Amendments list that includes the regulation as finalized.
  - Assuming the proposed regulation is finalized this year and the list is published before year end, the deadline will be 12/31/2021.

Hardship Rule Changes

- Pre-Approved plan interim amendment deadline –
  - 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.

Hardship Rule Changes

- Pre-Approved plan interim amendment deadline –
  - 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

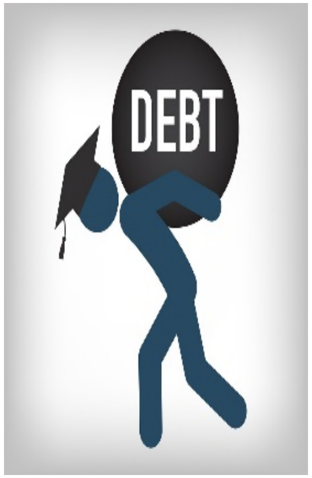
- Given the transitional rules, an argument can be made that a plan does not have a disqualifying provision until January 1, 2020, which is the latest date on which it will no longer be permissible to require a 6-month suspension upon receiving a hardship distribution and the new certification of resources will be required.
- Under this argument, the deadline for interim amendments would be the due date of the employer's tax return for the tax year which includes January 1, 2020 (the effective date of the disqualifying provision).

Hardship Rule Changes

- The preamble to the proposed regulation provides that the discretionary/optional changes will be treated as integrally related to the disqualifying provisions.
- "Therefore all amendments that relate to the final regulations will have the same amendment deadline. This deadline will also apply to an amendment reflecting the extension of the relief under Announcement 2017-15 to victims of Hurricanes Florence and Michael, as provided in this preamble."
- In the absence of clarification from the IRS, it appears that the prudent approach is to adopt an interim amendment by the due date of the 2019 tax return.

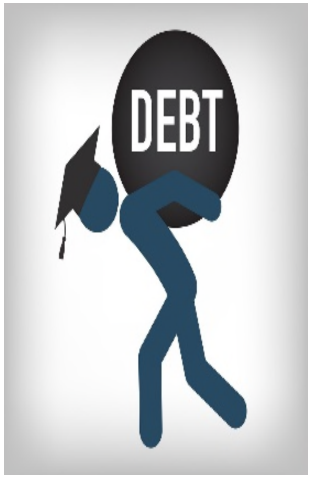
STUDENT LOANS AND 401(K)S

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 will begin in 2020.

Student Loans and 401(k) Plans

- PLR – 2018-33012 (Abbott Laboratories requested).
- Private letter rulings are issued to a specific taxpayer who is the only taxpayer who can "rely" on the guidance.
- It is possible the IRS may address a similar fact pattern in a full blown revenue ruling which could be relied upon 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.
- Under the rule no benefit, inside or outside of the plan, may be contingent on an employee making (or not making) elective deferrals, other than matching contributions.

Student Loans and 401(k) Plans

- Under the Abbott program, 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 **nonelective contribution** of 5% and no actual matching contribution but must be employed at year end.
- If employees do not sign up for student loan "matching" contributions, they remain eligible for the traditional match.
- If they sign up but don't actually make student loan payments, they get a "true-up" matching contribution at year end if still employed.

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 non-elective contributions that are tested under the general non-discrimination test of IRC §401(a)(4).
- 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 student loan payments?
- 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

- On May 13, 2019, Senator Ron Wyden introduced the Retirement Parity for Student Loans Act of 2019 (RPSLA).
- Under the RPLSA, 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

- The 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

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 401k plan.
- The 2019 limit is $19,000 plus a potential catch-up contribution limit of $6,000.
- Similarly, Roth IRA contributions are limited to $6,000 with a $1,000 catch-up limit.
- In 2019, if a taxpayer's modified adjusted gross income is greater than $137,000 (single) or $203,000 (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.

Back Door Roth

- This first step in the process is to contribute the maximum elective Roth contributions, $19,000 or $26,000, to the 401(k) plan.
- Assuming no other employer contribution, step two is to then make after–tax employee voluntary contributions up to the participant's 415 limit (lesser of 100% of compensation or $56,000 for 2019).
- Then, at a future date, the plan participant elects to make an in-plan Roth conversion of the after-tax voluntary employee contributions and is taxed only on the accrued earnings.
- The converted amount can then be invested and future earnings can be distributed tax free if the other qualifying conditions for Roth treatment are satisfied.

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 $19,000 as a Roth contribution to the plan. The employer makes a 3% matching contribution equal to $7,500.
- Sue also elects to make $29,500 in after-tax employee voluntary contributions up to her maximum 415 limit of $56,000.
- After contributing the after-tax contribution, Sue elects to make an in-plan Roth conversion of the funds.
- The earnings that accrue thereafter 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:
  - Must permit Roth contributions;
  - Must permit after-tax employee voluntary contributions; and
  - Must permit in-plan Roth conversions.
- ACP testing.
- Potential 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.

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 as compared to the non-highly compensated employees.
- What can be over looked 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
  - $29,500 in after-tax employee voluntary contributions.
- Sue's actual contribution percentage is 14.8% ($37,000/$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

- 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 election and it must be consistent 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 are considered to be HCEs by virtue 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.

Step Transaction – Congress

- Since back door Roth contributions are a series of related transactions, the IRS could view it as a single transaction and view the contribution as exceeding the IRC §402(g) limit.
- Lengthening the time between when the after-tax contribution is made and when it is converted into a Roth account would help insulate against the doctrine being applicable.
- There is also concern that Congress may someday prohibit this loophole but that would be a prospective worry.

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 than 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 ?

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