**RECENT LEGISLATIVE AND REGULATORY CHANGES
TO RETIREMENT PLANS**

By

Pamela D. Perdue
Pamela D. Perdue, P.C.
St. Louis, Missouri
pperdue@pdp.law

I. Introduction

Both the Tax Cuts and Jobs Act of 2017 and the Bipartisan Budget Act of 2018 make significant changes to qualified retirement plans. These legislative changes affect primarily plan distributions.

In addition to these legislative changes, the Internal Revenue Service ("IRS") has also adopted regulations and other guidance that impact the taxation of distributions from retirement plans.

The changes are discussed in this Outline.

II. Hardship Distributions

A. Amounts Eligible for Hardship Withdrawal—Current Law

1. Restrictions on Distributions of Elective Deferrals

Participant contributions to a Section 401(k) Plan, whether made on a pre-tax or a Roth after-tax basis, along with their attributable earnings, may not be distributed earlier than the earliest of: (i) the participant's severance from employment, death, or disability; (ii) the termination of the plan without the establishment of another "alternative defined contribution plan"; (iii) the attainment of age 59 ½ in the case of a profit sharing or stock bonus plan, or (iv) in the case of a profit sharing or stock bonus plan, on account of a hardship. In addition, a Section 401(k) or 403(b) plan may also be drafted to allow distributions of elective deferrals to those called up to active duty in the reserves or National Guard for at least 179 days. [IRC Section 401(k)(2)(B)(i)]

2. Hardship Withdrawals Excluding Earnings

Where a profit sharing or stock bonus plan permits distribution due to hardship, the distribution is generally limited to the participant's elective deferrals excluding earnings, unless those earnings are grandfathered.

In order to be grandfathered, earnings would have to have been credited to the employee's account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989. [Treas. Reg. Section 1.401(k)-1(d)(3)(ii)(B)] Special rules apply for purposes of determining grandfathered amounts under a collectively bargained plan. [Treas. Reg. Section 1.401(k)-1(d)(3)(ii)(B)]

3. Changes to the Amounts Eligible for Hardship Distributions

Effective for plan years beginning after December 31, 2018, the Budget Act amends the Code to provide that the amounts eligible to be withdrawn upon a hardship is extended to include QNECs, QMACs and earnings from all such contribution sources including pre-1989 earnings on elective contributions. [Bipartisan Budget Act, Section 41114; IRC Section 401(k)(14)(A)]

B. Changes to Requirements to constitute a Hardship Withdrawal

1. Basic Requirements—Current Law

In order to constitute a hardship withdrawal:

(1) the distribution must be made on account of an immediate and heavy financial need of the employee, and

(2) subject to the right to have the amount grossed up for taxes, the amount to be withdrawn must be no more than the amount necessary to satisfy the financial need.

[Treas. Reg. Section 1.401(k)-1(d)(3)(i)]

It should also be noted that each of these two requirements have optional safe harbor methods plans can use to satisfy the requirement.

2. Immediate and Heavy Financial Need

Whether an employee has an immediate and heavy financial need is generally to be determined based upon all of the relevant facts and circumstances. The vast majority of plans choose to satisfy this "immediate and heavy financial need" requirement by use of the safe harbor.

Under the safe harbor, a distribution is deemed to be on account of an immediate and heavy financial need of the employee, i.e., the "deemed immediate and heavy financial need" standard, if the distribution is for:

(1) expenses for (or necessary to obtain) medical care that would be deductible under Section 213(d) (determined without regard to whether the expenses exceed the threshold percentage of adjusted gross income to be deductible);

(2) costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(3) payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in Section 152, and, for taxable years beginning on or after January 1, 2005, without regard to Section 152(b)(1), (b)(2) and (d)(1)(B));

(4) payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;

(5) payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents (as defined in Section 152, and, for taxable years beginning on or after January 1, 2005, without regard to Section 152(d)(1)(B)); or

(6) expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under Section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income)

[Treas. Reg. Section 1.401(k)-1(d)(3)(iii)(B)]

Note that in some of the "deemed standards", the need of the employee can in some instances also include the needs of the employee's spouse or dependents.

3. Necessary to Satisfy the Need

A distribution is not considered necessary to satisfy an immediate and heavy financial need if the employee has other resources available to meet the need, including assets of the employee's spouse and in some instances those of any minor children. [Treas. Reg. Section §1.401(k)-1(d)(3)(iv)(B)]

To satisfy this second requirement, a plan can either rely upon a written representation of the participant or a safe harbor.

Where a plan relies upon a participant's written representation, the employee must represent that the amount requested does not exceed the amount of the need and that there are no other resources available.

In the alternative, a plan can rely upon a safe harbor under which, a distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if:

(1) the employee has obtained all other currently available distributions and loans

under the plan and under all other plans maintained by the employer, other than hardship distributions; and

(2) the employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least six months after receipt of the hardship distribution. [Treas. Reg. Section §1.401(k)-1(d)(3)(iv)(E)]

4. Changes to the Hardship Rules

1. Deemed Immediate and Heavy Safe Harbor Standard

The Tax Cuts and Jobs Act of 2017 ("Tax Act") amended the casualty loss provisions of Section 165.

As amended, for tax years 2018-2025, a personal casualty deduction for damage or loss to an individual's home will only be available with respect to losses attributable to a Federally declared disaster. [IRC Section 165(h)(5)(A)]

2. Safe Harbor for the Necessary to Satisfy the Need Standard

i. Removing the 6-Month Suspension Rule

The Budget Act directs the Treasury to modify its regulations to delete the six-month suspension requirement. The regulation is to be amended not later than one year after the date of enactment of the Budget Act and the revised regulations are to apply to plan years beginning after December 31, 2018. [Bipartisan Budget Act of 2018, Section 41113]

3. Participant Not Required To Borrow First

Whether the plan relies upon a participant's written representations that the financial need can not be relieved by readily available resources or uses the safe harbor, the participant is required to obtain any nontaxable (at the time of the loan) loans, under all plans maintained by the employer before a hardship withdrawal can be allowed. [Treas. Reg. Section 1.401(k)-1(d)(3)(iv)(C)(4), Treas. Reg. Section 1.401(k)-1(d)(3)(iv)(E)(1)]

The Budget Act removes this requirement effective for plan years beginning after December 31, 2018. [Bipartisan Budget Act of 2018, Section 41114(a); IRC Section 401(k)(14)(B)]

Note, however, that the employee will still have to have obtain all other currently available distributions, other than hardship distributions, under the plan and from all other plans maintained by the employer before being eligible to obtain a hardship distribution.

However, the removal of the six month suspension rule following a hardship withdrawal as well as the removal of the requirement to first obtain a loan will likely be viewed as a mandatory amendment in the case of plans using that safe harbor rule.

Finally, all of the changes may require changes to plan procedures including such things as hardship distribution request forms.

III. Participant Loans

Under the Tax Cuts and Jobs Act of 2017, this 60 day period for replacing funds lost as a result of a loan offset and rolling over in the event of a loan offset due to plan or employee termination is extended to the due date, including extensions, for filing the participant's tax return for the taxable year in which the loan offset occurs.[IRC Section 402(c)(3)(C)] This change applies to plan loan offset amounts which are treated as distributed in taxable years beginning after December 31, 2017.

Note that this change does not impact other situations of loan defaults. Rather, it applies only where a participant terminates employment with a loan outstanding of where the plan terminates with a participant with a loan outstanding. If a participant who remains employed defaults on an existing plan loan and the plan does not terminate, no special rule would apply nor would there be any extended rollover period.

IV. Changes to IRA Recharacterization Rules

As amended by the Tax Act, the rules allowing a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA will no longer apply to a conversion contribution to a Roth IRA.[IRC Section 408A(d)(6)(B)(iii)] This means that, effective for taxable years beginning after December 31, 2017, recharacterization can no longer be used to unwind a Roth conversion.

However, the Conference Report clarifies that recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA. An individual may also still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, however, this provision would then preclude the individual from later unwinding the conversion through a recharacterization. [See Joint Committee on Taxation Explanation of Tax Cuts and Jobs Act of 2017, Section E]

The IRS has clarified that this change is to be interpreted such that a Roth IRA conversion made in 2017 may still be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. However, a Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized.

V. Relief For IRS Levies Later Reversed

If a taxpayer's plan assets are subject to a wrongfully-imposed Federal levy that is subsequently released, it may well be beyond the 60-day indirect rollover period available for indirect rollovers to be able to roll the returned funds over and avoid taxation.

The Budget Act seeks to provide relief in such cases by giving the taxpayer until the due date (not including extensions) for filing the return for the taxable year in which such property or money is returned to contribute such amounts into an eligible retirement plan. [IRC Section 6343(f)]

This provision applies for taxable years beginning after December 31, 2017.

VI. Regulatory Changes

A. Changes to the One Rollover Per Year Rule for IRAs

1. Background

There are two ways to rollover funds from one IRA to another:

(1) a direct rollover, i.e., a trustee-to-trustee transfer, where funds are transferred by the trustee or custodian of the distributing IRA directly to the trustee or custodian of the receiving IRA with the IRA owner never touching the funds, and

(2) an indirect or 60-day rollover where there is a distribution from an IRA to the IRA owner who then must redeposit all or part of the funds into an IRA not later than the 60^{th} day after the day on which the owner receives the distribution if income inclusion is to be avoided. [Section 408(d)(3)(A)(i)].

People will often use the indirect rollover option where there is a short term need for access to the funds. For example, where a taxpayer is building a home and needs funds to pay contractors before an actual loan is finalized or to pay medical expenses until insurance can be settled.

2. Restriction on 60-Day Rollovers

However, Section 408(d)(3)(B) restricts the use of the 60-day rollover option to one in any 1-year period. The 1-year period begins on the date the individual receives the IRA distribution rather than on the date it is rolled into an IRA.

IRS Historical Interpretation of One-Rollover-Per-Year Rule

Historically, the IRS has always interpreted the one-rollover-per year restriction as applying on an IRA- by-IRA basis. This interpretation was reflected in its proposed regulations. [Previously

Prop. Treas. Reg. Section 1.408-4(b)(4)(ii); 46 FR36198, (07/14/1981)] Essentially, the historical interpretation was the one-rollover-per-year rule restricted both the distributing and the receiving IRA.

For example, in the 2014 version of Publication 590, Individual Retirement Arrangements (IRAs), the one rollover rule is explained as follows:

"Waiting period between rollovers. Generally, if you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover.

> Example. You have two traditional (meaning non-Roth) IRAs, specifically, IRA-1 and IRA-2. You make a tax-free rollover of a distribution from IRA-1 into a newly-established also traditional IRA (IRA-3). You cannot, within 1 year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA.
>
> However, the rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because you have not, within the last year, rolled over, tax free, any distribution from IRA-2 or made a tax-free rollover into IRA-2."
>
> [Publication 590, Individual Retirement Arrangements (IRA), 2014]

The idea that the restriction applies to the IRAs involved in the rollover, whether as a distributing or as a receiving IRA, but not to any other IRAs of the taxpayer uninvolved has been the IRS' interpretation since the statute was first enacted until 2014.

Tax Court's Interpretation of One-Rollover-Per-Year Rule

However, the Tax Court in Bobrow v. Commissioner, T.C. Memo. 2014-21, completely upended the IRS' historical interpretation and held instead that the limitation applies on an aggregate basis.

Specifically, the Tax Court found that by its terms, the one-year limitation of Section 408(d)(3)(B) is not specific to any single IRA maintained by an individual but instead applies to *all* IRAs maintained by a taxpayer. The Court goes on to state that plain language of Section 408(d)(3)(B) limits the frequency with which a *taxpayer* may elect to make a nontaxable rollover contribution and is not tied to the number of IRAs. Rather, the court states, Section 408(d)(3)(B) speaks in general terms. That is, an individual may not receive a nontaxable rollover from an individual retirement account or individual retirement annuity if that individual has already received a tax-free rollover within the past year from an individual retirement account or an individual retirement annuity.

In other words, a taxpayer who maintains multiple IRAs may not make a rollover contribution from each IRA within one year. The Tax Court also found support for its interpretation in the legislative history where Congress imposed the restriction as a way to ensure that taxpayers did not take advantage to repeatedly shift nontaxable income in and out of retirement accounts. [citing e.g., H.R. Rept. 93-779, at 139 (1974), 1974-3 C.B. 382]

IRS Adopts Tax Court Interpretation Of One-Rollover-Per Year Restriction

In Announcement 2014-15, 2014-16 IRB, 03/20/2014, the IRS announced that it will follow the Tax Court's more restrictive interpretation.

This means that an individual receiving an IRA distribution on or after January 1, 2015, cannot roll over in an indirect rollover (meaning a 60-day rollover) any portion of the distribution into an IRA if the individual has received a distribution from <u>any</u> IRA in the preceding 1-year period that was rolled over into an IRA.

Transition Relief for 2014 Distributions

However, as a transition rule for distributions in 2015, a distribution occurring in 2014 that was rolled over is disregarded for purposes of determining whether a 2015 distribution can be rolled over in a 60-day roll over, provided that the 2015 distribution is from a different IRA that neither made nor received the 2014 distribution. This is intended to provide a fresh start in 2015. [Announcement 2014-32, 2014-48 IRB 907, 11/10/2014]

In other words, the <u>*Bobrow*</u> aggregation rule, which takes into account all indirect rollovers among an individual's IRAs, will apply to distributions from different IRAs only if each of the distributions occurs after 2014. That is, under the transition relief, IRA distributions rolled over to another (or the same) IRA in 2014 will not prevent a 2015 distribution from being rolled in an indirect rollover to an IRA provided the 2015 distribution is from a different IRA than the ones involved in the 2014 rollover.

Thus, the 2014 transition relief effectively allows an individual to disregard, for purposes of applying the restriction in 2015, 2014 indirect rollovers provided that the rollovers in 2014 involved different IRAs from any IRA involved in an indirect rollover in 2015.

> <u>Example</u>: Lee has three traditional IRAs; IRA-1, IRA-2, and IRA-3. On May 15, 2014, Lee took a distribution from IRA-1 and rolled it over into IRA-2 on the same day.
>
> Lee cannot roll over a distribution from IRA-1 or IRA-2 within the 1-year period of the May 15, 2014, distribution.
>
> Lee could roll over a distribution from IRA-3 within the 1-year period.

Remember, this transition rule applies *only* to 2014 distributions and *only* if different IRAs are involved.

How The New Interpretation works Starting in 2015

The new interpretation means that an individual receiving an IRA distribution on or after January 1, 2015, cannot roll over in an indirect rollover, (i.e., in a 60-day rollover) any portion of the distribution into an IRA if the individual has received a distribution from any IRA in the preceding 1-year period that was rolled over into an IRA.

This is the case starting in 2015 without regard to the number of IRAs held by the individual.

Note, however, that the restriction still applies only with respect to indirect rollovers. Trustee-to-trustee transfers between IRAs are not limited and rollovers from traditional IRAs to Roth IRAs (conversions) are not limited.

> <u>Example</u>: Lee has three traditional IRAs; IRA-1, IRA-2, and IRA-3. Lee did not take any distributions from his IRAs in 2014.
>
> On January 1, 2015, Lee took a distribution from IRA-1 and rolled it over (in an indirect rollover) into IRA-2 on the same day.
>
> For 2015, Lee cannot roll over any other 2015 IRA distribution, including a rollover distribution involving IRA-3.
>
> This restriction would not apply, however, should Lee elect to implement a conversion of one of his/her traditional IRAs into a Roth IRA.

3. Timing the Rollover

When electing to move funds via an indirect rollover, the individual must make a rollover contribution to the new account by the 60^{th} day after the day the individual received the distribution. [IRC Section 402(c)(3)(A)]

The IRS may waive the 60-day requirement where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster or other events beyond the reasonable control of the individual. [IRC Section 402(c)(3)(B)]

Note, however, that when a waiver is granted, it applies only to the principal amount and not to any subsequent earnings. That is, the rules regarding the amount that can be rolled over within the 60-day period also apply to the amount that can be deposited due to a waiver.

Example: Lee decides to move his IRA consisting of $45,000 from one financial institution to another. Lee completes the necessary paperwork to have the amount rolled into an IRA held by the new financial institution as custodian.

Six months later when the account is valued at $52,000, Lee discovers that the financial institution has mistakenly deposited the amount into a brokerage account rather than into an IRA.

Lee applies for and is granted a hardship waiver granting him a new 60-day period to roll the funds into an IRA. However, the waiver is available only with the respect to the original $45,000.

4. Types of Arrangements Affected by the One-Rollover-Per Year Restriction

The limit will apply by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit.

A 60-day rollover between an individual's Roth IRAs will preclude a separate rollover within the 1-year period between the individual's traditional IRAs and vice versa. [Announcement 2014-32, 2014-48 IRB 907, 11/10/2014]

5. Plans and Arrangements Not Subject to the One-Rollover-Per Year Restriction

The one rollover per year limit does not apply to:

- trustee-to-trustee transfers between IRAs;
- rollovers from traditional to Roth IRAs ("conversions");
- IRA to qualified plan rollovers;
- qualified plan to IRA rollovers;
- qualified plan to qualified plan rollovers

[Announcement 2014-32, 2014-48 IRB 907, 11/10/2014]

The restriction does not impact or affect the ability of an IRA owner to do a trustee-to-trustee transfer from one IRA trustee or custodian directly to another, because such a transfer is not a rollover and, therefore, is not subject to the one-rollover-per-year limitation of Section 408(d)(3)(B). [See Rev. Rul. 78-406, 1978-2 C.B. 157]

VII. Self-Certification of Indirect Rollovers

A. Background

There are two ways to effectuate a rollover; a direct rollover or a 60-day indirect rollover. In a direct rollover, the funds go directly from one tax-deferred vehicle to the other. In an indirect rollover, the distributee has possession of the funds between the time of distribution and re-contribution. In such case, the amount distributed will be excluded from income only if it is transferred to an eligible retirement plan no later than the 60th day following the day of receipt. [IRC Sections 402(c)(3) & 408(d)(3)]

A distributee who does not elect a direct rollover of an eligible rollover distribution will be subject to withholding from the distributing plan with respect to the amount not directly rolled over. Specifically, in such case, the distributing plan is required to withhold 20% of the payment for federal income taxes (up to the amount of cash and property received other than employer stock). This means that, in order to roll over the entire payment in a 60-day rollover, the participant must use other funds to make up for the 20% withheld.

The Secretary may waive the 60-day rollover requirement “where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.” [IRC Sections 402(c)(3)(B); 408(d)(3)(I)] The requirements for making a rollover may be postponed in the event of service in a combat zone, or in case of a Presidentially-declared disaster, or a terroristic or military action. [IRC Sections 7508; 7508A] In addition, Revenue Procedure 2003-16 provides for automatic approval of a waiver in certain circumstances in which a rollover is not timely made due to an error on the part of a financial institution.

To accommodate request for relief from the 60-day requirement in other circumstances, the IRS established a private letter ruling procedure where taxpayers could request a waiver of the 60 day requirement. [Rev. Proc. 2003-16, 2003-1 C.B. 359, 01/08/2003]

However, the IRS may have been unprepared for the number of request. In response, the IRS has now instituted a self-certification process. [Rev. Proc. 2016-47, 2016-37 IRB, 08/24/2016]

Under the self-certification program, an eligible taxpayer may make a written certification to a plan administrator or an IRA trustee that a contribution satisfies the conditions for self-certification. Taxpayers may make the certification by using the model letter in the appendix of the revenue procedure on a word-for-word basis or by using a letter that is substantially similar in all material respects. A copy of the certification is required to be kept in the taxpayer's files and be available if requested on audit.

In order to qualify for this process, the following three requirements must be satisfied:

(1) No prior denial by the IRS. The IRS must not have previously denied a waiver

request with respect to a rollover of all or part of the distribution to which the contribution relates.

(2) Reason for missing 60-day deadline. The taxpayer must have missed the 60-day deadline because of the taxpayer's inability to complete a rollover due to one or more of the following reasons:

(a) an error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates;

(b) the distribution, having been made in the form of a check, was misplaced and never cashed;

(c) the distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan;

(d) the taxpayer's principal residence was severely damaged;

(e) a member of the taxpayer's family died;

(f) the taxpayer or a member of the taxpayer's family was seriously ill;

(g) the taxpayer was incarcerated;

(h) restrictions were imposed by a foreign country;

(i) a postal error occurred;

(j) the distribution was made on account of a levy under Code Section 6331, and the proceeds of the levy have been returned to the taxpayer; or

(k) the party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

(3) Contribution as soon as practicable; 30-day safe harbor. The contribution must be made to the plan or IRA as soon as practicable after the reason or reasons listed in the preceding paragraph no longer prevent the taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the taxpayer from making the contribution.

The IRS intends to modify Form 5498 to require that an IRA trustee report that the contribution was accepted after the 60-day deadline.

A plan administrator or IRA trustee is allowed to rely upon the self-certification for purposes of accepting and reporting the rollover. However, they may not rely upon the self-certification for other purposes or if the plan administrator or IRA trustee has actual knowledge that is contrary to the self-certification.

In the case of an audit, the IRS may determine that the taxpayer did not qualify for the waiver and may impose additions to income and penalties.