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The TAX Issue

Retirement Funds:
Accessing the Nest Egg in a Coronavirus Era

by J. Virginia Peiser

It was easy – setting up that retirement account. Just complete some identifying information, check a few boxes and provide a check. Or perhaps withholdings simply began from salary. Either way, a process started to provide a nest egg for retirement. Now, with the economy in shambles, many folks are looking to their nest eggs for assistance with their current needs.

There are various types of retirement plans, such as accounts opened by an individual, including an Individual Retirement Arrangement (IRA), a SIMPLE IRA or a SEP, and plans established by an employer, including a 401(k) plan, a 403(b) plan or a 457 plan. Contributions to these retirement plans are deductible from income for tax purposes, but each type of plan has different contribution rules.

Distributions from Retirement Plans

All plan types have restrictions on withdrawals designed to maintain assets in the nest egg over the long term – at least until a person reaches retirement age. When distributions are withdrawn from most retirement plans, the distributions are included as taxable income in the year of the withdrawal.[1]

Traditionally, distributions from any of these plans before the plan owner attains age 59½ have been penalized with:

1. An excise tax of 10%[2] (25% for certain distributions from SIMPLE IRAs[3]) of the amount distributed, paid together with the income tax on the distribution; and

2. Tax withholding by certain plans of 20% of any amount distributed.[4]

Each type of plan however, permits distributions prior to age 59 ½ for various hardship circumstances without penalty, although the distributions will still be subject to income tax. The current coronavirus epidemic presents hardships for taxpayers who may want to access funds in their retirement nest egg, but many of them will not qualify under the current limited hardship distribution rules.

The 2020 Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"), signed into law on March 27, 2020[5], and amplified by recent IRS Notices 2020-50 and 2020-51[6], recognized the need of many taxpayers to access their nest eggs due to the current economic environment. Qualified individuals can receive favorable tax treatment for distributions from their retirement plans during 2020[7] that are coronavirus-related distributions (CRD). Most important, a CRD avoids the 10% (or 25%) excise tax and income tax withholding.[8] In addition, the CRD can be included in the individual's income ratably over a three-year period, beginning with the year of the CRD, instead of entirely in the year of the distribution, although the participant may elect to pay tax on the full CRD in the year of distribution.[9] If an individual taking a CRD recontributes part or all of the distribution to the same retirement plan or another retirement plan in the three-year period following the distribution, the distribution will not be subject to income tax.[10]

Qualified Individuals

An individual qualified to take a CRD is a person who, or whose spouse, dependent or member of the household:

1. Is diagnosed with coronavirus.[11]
2. Experiences adverse financial consequences due to coronavirus with:
   (i) quarantine, furlough or lay off, or a reduction in work hours;
   (ii) inability to work due to lack of childcare; or
   (iii) closure or reduced hours of a business owned or operated by that person.
3. Has a reduction in pay or self-employment income or had a job offer rescinded or start date for a job delayed due to coronavirus.[12]

A CRD is not limited to amounts withdrawn from a retirement plan solely to meet a need arising from coronavirus, and the amount of the CRD does not have to correspond to the extent of the adverse financial consequences experienced by the individual.[13] A plan sponsor may rely on a participant's self-certification of qualification to take a CRD, unless the plan sponsor has actual knowledge to the contrary.[14]

Limitation on Withdrawals and Reporting

The maximum CRD that can be withdrawn from all retirement plans is $100,000.[15] If more than $100,000 is withdrawn, the first $100,000 can be a CRD taxed over three years, while the amount in excess of $100,000 is subject to the 10% (or 25%) excise tax and fully taxed in the year of distribution, unless another exception from tax applies.[16]

A CRD is reported to the participant on Form 1099-R, Distributions from Pensions, IRAs, etc., using early distribution codes to report exceptions.[17] The participant reports the CRD on (yet-to-be created) Form 8915-E, Qualified 2020 Disaster Retirement Plan Distributions and Repayments, filed with the 2020 income tax return and for the following two years.[18]

Recontribution of CRDs

Once a CRD is taken, it can be recontributed to the retirement plan or another retirement plan of the individual at any time within the three-year period following the distribution, and the taxable amount of the CRD will be reduced by the amount of the recontribution.[19] New form 8915-E will also be used to report a recontribution. If the CRD is repaid in a year after the year in which it was included in taxable income, an amended return may be filed to claim a refund for the tax year in which tax on the CRD was paid.[20]

Retirement Plan Loans

Certain retirement plans, such as profit-sharing plans, permit participants to take loans from their retirement plans. Loans have been limited to 50% of the vested plan balance with a maximum of $50,000[21], and must generally be repaid within 5 years.[22] The CARES Act has increased the permitted plan loan amount for qualified individuals made on or after March 27, 2020, and prior to September 23, 2020, to the lesser of $100,000 or 100% of the participant's vested account balance.[23]

In addition, pay-ments for plan loans outstanding on March 27, 2020, to qualified individuals have been suspended for 2020. Payments due between March 27, 2020, and December 31, 2020, are delayed for a period of up to one year, when the loan will be adjusted to reflect the delay and the accrued interest during that period.[24]

Required Minimum Distributions

Beginning in the year a taxpayer turns 72 (formerly age 70½), required minimum distributions (RMDs) must be taken each year based upon an IRS table derived from life expectancies.[25] Under the CARES Act, all RMDs have been suspended for 2020.[26] Any RMD taken in 2020 under earlier rules, including RMDs for 2019 that were deferred to 2020, may be recontributed to the retirement plan without penalty. All repayments of RMDs taken earlier in 2020 must be made by August 31, 2020, even if that date is more than 60 days after the distribution.[27] A person is not required to be qualified for a CRD to defer RMDs during 2020.

Conclusion

Although retirement plans have permitted limited hardship distributions in the past, the limitations do not address the challenges faced by many in this coronavirus era. The recent CARES Act provides direct assistance to taxpayers adversely affected by coronavirus in accessing their nest eggs.

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1 Distributions from Roth IRAs are not taxed upon withdrawal.

2 Internal Revenue Code (hereinafter "IRC") §72(t).

3 IRC §72(t)(6).

4 IRC §3405(c)(1).

5 Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136, 134 Stat. 281 (2020) (hereinafter "CARES Act"), §2202.

6 IRS Treasury Notice 2020-50 (hereinafter "Notice 2020-50"); IRS Treasury Notice 2020-51 (hereinafter "Notice 2020-51").

7 CARES Act §2202(a)(4)(A)(i); Notice 2020-50 §1.C.

8 CARES Act §2202(a)(1).

9 CARES Act §2202(a)(5)(A); Notice 2020-50 §4.A.

10 CARES Act §2202(a)(3); Notice 2020-50 §4.B.

11 The term "coronavirus" includes the virus SARS-CoV-2 and coronavirus disease 2019 (i.e., COVID-19) as diagnosed by a test approved by the Centers for Disease Control and Prevention (including a test authorized under the federal Food, Drug, and Cosmetic Act).

12 CARES Act §2202(a)(4)(A)(ii); Notice 2020-50 §1.B.

13 Notice 2020-50 §1.C.

14 CARES Act §2202(a)(4)(B); Notice 2020-50 §2.E.

15 CARES Act, §2202(a)(2); Notice 2020-50 §1.C.

16 Notice 2020-50 §4.A.

17 Notice 2020-50 §3.A.

18 Notice 2020-50 §4.

19 CARES Act §2202(a)(3)(A); Notice 2020-50 §4.C.

20 Notice 2020-50 §4.D.

21 IRC §72(p)(2)(A).

22 IRC §72(p)(2)(B).

23 CARES Act §2202(b)(1); Notice 2020-50 §5.A.

24 CARES Act §2202(b)(2); Notice 2020-50 §5.B.

25 IRC §401(a)(9); Notice 2020-51 §II.

26 CARES Act §2203(a); Notice 2020-51 §II.

27 CARES Act §2203; Notice 2020-51 §III.C.