EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

IRS AND DEPARTMENT OF LABOR RELEASE NEW RETIREMENT PLAN GUIDANCE

At the beginning of the year, the employee benefits community anticipated that the Setting Every Community Up for Retirement Enhancement Act (the "SECURE Act") and other retirement plan provisions in the accompanying federal budget legislation enacted at the end of 2019 would be the focus of regulatory efforts from the Internal Revenue Service ("IRS") and Department of Labor ("DOL") in early 2020. Instead, the agencies had to turn their resources to addressing the special needs created by the COVID-19 pandemic and associated legislation. The summer and now September have seen the SECURE Act and other regulatory initiatives come back to the foreground. This newsletter provides an overview of some of the more significant pieces of guidance relevant to retirement plans.

IRS SECURE Act Guidance

In Notice 2020-68 (available at https://www.irs.gov/pub/irs-drop/n-20-68.pdf), the IRS issued preliminary guidance on several different provisions of the SECURE Act and its accompanying legislation.

Notice 2020-68's provisions addressing qualified birth/adoption distributions from qualified defined contribution retirement plans and IRAs are likely to be of the greatest interest to plan sponsors and recordkeepers. Under the SECURE Act, up to $5,000 can be withdrawn from a qualified defined contribution plan, 403(b) plan, governmental 457(b) plan or IRA without being subject to the 10% early withdrawal penalty tax, if the withdrawal is made within a year of the birth of a child or the qualifying adoption of a child (other than the child of a spouse) who is under age 18 or is physically or mentally incapable of self-support. The withdrawn amount is taxable, but subsequently can be recontributed to the paying plan or to an IRA, and is exempt from the normal direct rollover notice and withholding rules. Among other details, Notice 2020-68:

- Confirms that the $5,000 amount is available to both parents (i.e., if X and Y have a child, each can take $5,000 from his or her respective plan accounts/IRAs, for a combined total of $10,000).
- Confirms that the $5,000 limit applies on a per-child basis (i.e., if X and Y have twins, each can take $10,000, for a combined total of $20,000).
- States that plans are NOT required to offer qualified birth/adoption distributions, but that if a plan does so, it must permit the recipient to recontribute the distributed amount if the recipient is entitled to make a rollover contribution to the plan at the time of recontribution.
- Allows a participant whose plan does NOT allow qualified birth/adoption distributions but who qualifies for an in-service distribution on other grounds to claim the tax benefits for the distribution, and to recontribute the distribution to an IRA.

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Notice 2020-68 does not address whether any deadlines apply to recontribution. The statute does not impose any, and plan sponsors have been reluctant to add this feature with an open-ended recontribution right. The IRS has indicated it intends to issue regulations addressing recontributions and associated timing requirements.

In addition to discussing qualified birth/adoption distributions, Notice 2020-68 discusses:

- Tax credits for qualifying employers (generally, employers with no more than 100 employees who received at least $5,000 of compensation in the prior year) who establish eligible automatic contribution arrangements.
- Post-age-70½ contributions to IRAs.
- Special vesting service rules for long-term part-time employees who become eligible to participate in a 401(k) plan under the SECURE Act's rule for employees who work at least 500 hours of service in three consecutive years, with the IRS indicating that service prior to January 1, 2021 *does* count for vesting purposes even though that service is disregarded for purposes of determining whether the employee has met the 500 hours in three years participation threshold.
- IRA and qualified defined contribution plan opportunities associated with "difficulty of care" foster care payments.
- The new ability under the Bipartisan American Miners Act (the "Miners Act") for pension plans and governmental 457(b) plans to offer in-service distributions as early as age 59½, a provision that the Notice confirms to be optional.
- The timing of plan amendments for both required and optional provisions of the SECURE Act and the in-service withdrawal provisions of the Miners Act, which in most cases will be due by the end of the first plan year that begins on or after January 1, 2022 (governmental and collectively bargained plans may have more time).

IRS Loan Rollover Guidance

The Tax Cuts and Jobs Act of 2017 allowed a participant who defaulted on a plan loan due to severance from employment or plan termination to roll the defaulted amount over by the deadline (including extensions) for the participant's tax return for the year the loan amount was deducted from the participant's account balance, rather than requiring the rollover to be completed within the usual 60 days. The IRS has now issued proposed regulations (new Section 1.402(c)-3 of the Treasury Regulations) explaining how to administer loan offset rollovers generally and this extended rollover deadline in particular. Most notably, the IRS stated that the default must occur within 12 months of the severance from employment to be considered attributable to that termination. The IRS also clarified that a participant who files a timely tax return without seeking an extension and prior to completing a loan rollover can subsequently make the rollover and file an amended return by the extended deadline.

IRS Special Tax Notice Updates

The IRS has issued an updated "special tax notice," required to be distributed for all rollover-eligible distributions under Section 402(f) of the Internal Revenue Code. The new notice accommodates the SECURE Act's increase of the age for mandatory commencement of distributions from 70½ to 72, the availability of SECURE Act qualified birth/adoption distributions and the associated exemption from the 10% penalty tax, and the special tax and rollover rules applicable to various statutes associated with natural disasters and the COVID pandemic, such as the coronavirus-related distributions available under the CARES Act. Plan administrators should update their plans' distribution forms to include the new version of the notice.

Department of Labor Lifetime Income Illustrations

The SECURE Act required the DOL to provide preapproved assumptions and disclosures for defined contribution plans to use in providing participants with lifetime income illustrations. The illustrations must provide the amount of monthly income the participant's balance will generate if paid in the form of (i) a single-life annuity or (ii) a qualified joint and survivor annuity. Beginning 12 months after the regulations containing the preapproved assumptions and disclosures are published, defined contribution plans must include these illustrations with at least one benefit statement per year. Plan fiduciaries are protected against liability if actual participant income differs from the illustrations provided using the pre-approved assumptions and disclaimers.

The DOL has issued an interim final rule containing the requisite assumptions and model disclosure language, and anticipates that the rule will be published in the Federal Register this month, thus starting the 12-month clock on the rule's effective date. The DOL clarified during an American Benefits Council webinar that a September publication of the rule means that for participant-directed plans required to issue quarterly statements, the first illustration will be due with the second-quarter statement for 2022 (to be published within the first 45 days of the third quarter of 2022). That is the last statement that will fall within the one-year period after the effective date, meaning that it is the last chance to provide the illustration "annually" for the first year after the deadline.

The DOL will accept comments on the interim final rule for 60 days after the rule's publication, and anticipates issuing a superseding regulation in 2021, sufficiently in advance of the deadline to allow recordkeepers to update their system programming.

During the American Benefits Council webinar, the DOL also confirmed that the illustrations must be provided as part of the benefit statement. However, there are no specific layout or formatting requirements, and it remains permissible to provide additional illustrations not based on the pre-approved assumptions and to refer participants to online calculators and other tools.

Department of Labor "ESG" Investing and Shareholder Engagement Rules

The DOL has issued two sets of proposed regulations expressing concern about benefit plans investing assets and exercising shareholder voting rights based on "environmental, social and/or governance"

(“ESG”) concerns rather than investing and voting solely in accordance with the economic interests of the plan. The DOL has also contacted individual plans to inquire about their practices in this regard.

Previous guidance had allowed ESG factors to be used as “tie-breakers” (i.e., with two equally good investments to choose from, a fiduciary could choose the ESG-favorable one). The DOL had also allowed inclusion of prudently selected ESG investment funds on a defined contribution plan investment menu along with a diversified array of other options from which participants could choose, although the DOL had stated that an ESG-focused investment should not be used as the default investment option in a participant-directed plan.

Additionally, the DOL had conceded that ESG factors could be considered in an economic analysis to the extent that a given ESG factor was also a bona fide economic factor. For example, a fiduciary might forego an investment in a business facing a high risk of environmental clean-up liability, or with a history of management corruption, out of legitimate economic concern. While statistics indicate that very few plans use investment vehicles with a specific ESG mandate, more and more investment professionals have highlighted the extent to which the business impact of environmental risks and consumer demands for sustainability and green energy, consumer perceptions of social responsibility, the quality of corporate governance and similar factors are taken into account in their economic analyses.

The DOL’s new proposed regulations on investment selection would require plans pursuing ESG investment strategies, or using investment vehicles that do so, to engage in (and document) specific analyses intended to ensure the primacy of economic considerations. Furthermore, the preamble to the proposed regulations strikes a strongly negative tone about ESG investing and the probability that an ESG strategy could satisfy ERISA’s fiduciary prudence requirements. In contrast, the overwhelming majority of the 1,000+ comments submitted in response to the proposed regulation, including those submitted by almost all financial sector commentators, rejected the DOL’s negative outlook on ESG investing. The regulation has not yet taken effect, so its specific documentation requirements do not yet apply. However, plan fiduciaries should be sure their existing portfolios and investment policies are consistent with the long-standing requirement that the plan’s economic best interests not be sacrificed to other factors, and should pay special attention to documenting the economic rationale for any ESG-themed investments.

Shortly after issuing the investment rule, the DOL also issued proposed regulations relating to proxy voting. The new regulations are intended to take effect 30 days after publication of the final regulation in the Federal Register, and allow for a 30-day comment period. However, the preamble to the regulation already says that the previous proxy voting guidance in Interpretive Bulletin 2016-01 “no longer represents the view” of the DOL regarding proxy voting. While both the old and the new guidance agree that prudent exercise of proxy voting rights is part of a fiduciary’s duty, the proposed regulations weight the scale heavily in favor of a decision that the exercise of voting rights is not cost-effective. While Interpretive Bulletin 2016-01 had said that “in some special cases” the cost of voting proxies might “involve out of the ordinary costs” that would require a cost/benefit analysis regarding whether to vote at all, the DOL not only expressly states in the preamble to the new regulations that there is no presumption in favor of voting, it asserts that, “a plan fiduciary must not vote any proxy unless the fiduciary prudently determines that the matter being voted upon would have an economic impact on the plan after considering those factors described in [the regulation] and taking into account the costs involved" and adds that "In the Department's view, fiduciaries must be prepared to articulate the anticipated economic benefit of proxy-vote decisions in the event they decide to vote." However, the new regulations would allow plans to develop general policies to limit the need to engage in a potentially cost-intensive analysis of whether a given vote would be cost-effective each time a vote occurs.

In many cases, of course, fiduciaries of plans holding investments that include proxy voting rights delegate the voting responsibilities to investment managers and/or proxy voting advisors. While plan fiduciaries have always been subject to a duty to monitor those to whom they delegate responsibilities, the new regulations also add details regarding fiduciaries' obligations to monitor proxy voting decisions specifically, again emphasizing the need for economically based voting decisions.

Many plans invest in mutual funds, which seldom generate proxy voting opportunities, and which are not themselves subject to ERISA with respect to management of the fund's assets. Participant-directed plans often pass voting rights through to participants, whose voting rights are not addressed by the proposed regulations and who should generally be insulated from fiduciary obligations by Section 404(c) of ERISA. Accordingly, the proposed regulations will be largely irrelevant to many plan fiduciaries. However, fiduciaries who are responsible for proxy voting or for selecting investment managers (including collective investment trust managers) should consider whether any changes are needed to existing proxy voting policies and documentation protocols in order to ensure accommodation of both prudent investment practices and regulatory expectations. They also should monitor the progress of the proposed regulations to be prepared for potentially enhanced obligations if the regulations are finalized.

The SEC recently issued rules governing proxy voting practices for registered investment advisers. However, while the DOL acknowledged that the SEC's new rules addressed "some" of the DOL's concerns, plan fiduciaries should not just assume that a manager that is in compliance with SEC guidelines is also in compliance with ERISA.

Department of Labor Guidance Regarding Private Equity in Defined Contribution Plans

In an Information Letter dated June 3, 2020, the DOL discussed the considerations pertinent to including private equity opportunities as part of a mixed-asset investment account or vehicle offered to participants in a defined contribution plan. The letter confirmed that fiduciaries can opt to include private equity holdings within a managed "white label" custom fund or collective investment trust that holds a variety of asset classes in furtherance of a target date, target risk or "balanced" fund, but noted the complexities and potential risks inherent in including these assets on a defined contribution platform. The DOL emphasized that the letter addressed only the inclusion of a private equity component within a multi-asset-class fund, not individual participants making standalone private investments.

Ultimately, the letter confirms that inclusion of private equity assets within a multi-asset-class fund is not *per se* imprudent, and that there are valid reasons why a fiduciary might decide to use private equity assets within a fund of this sort. However, the Department cautioned that, "Private equity investments…present additional considerations to participant-directed individual account plans that are different than those involved in defined benefit plans. In making such a selection for an individual account plan, the fiduciary must engage in an objective, thorough, and analytical process that compares the asset allocation fund with appropriate alternative funds that do not include a private equity component, anticipated opportunities for investment diversification and enhanced investment returns, as well as the complexities associated with the private equity component."

For More Information

If you have any questions regarding this LEGALcurrents, please contact any member of the Employee Benefits and Executive Compensation group at 585.232.6500, 716.853.1616, or visit www.hselaw.com.