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Tax Reform Requires Plan Sponsors to Update 401(k) Plan Special Tax Notices

Section 402(f) of the Internal Revenue Code (the "Code") requires plan sponsors to give written explanations of tax implications to recipients of qualified retirement plan distributions eligible for rollover treatment, often termed a “special tax notice.” The Internal Revenue Service (IRS) periodically has issued model special tax notices that meet the requirements of Code Section 402(f) as well as updates to those models to reflect changes in the law. As of yet, the IRS has not issued updates to the model notice to reflect changes in the law enacted into the Tax Cuts and Jobs Act (“TCJA”) signed into law December 22, 2017, and effective January 1, 2018.

When the IRS issued its model special tax notice updated for the Pension Protection Act of 2006 (PPA), it stated in Notice 2009-68 that if “the law governing the tax treatment of distributions or other provisions described in a safe-harbor explanation in this notice is amended after September 28, 2009, the safe-harbor explanation will not satisfy §402(f) to the extent that the safe-harbor explanation no longer accurately describes the relevant law.” As a result, plan administrators have since been on their own to update the special tax notice to ensure it remains accurate in between IRS updates. The IRS last updated the model special tax notices in Notice 2014-74 to incorporate changes in the law since 2009.

As we reported previously here, the TCJA extended the period for rolling over plan loan offsets. Plan loan offsets occur with many 401(k) plans that allow participants to take loans from their account balances because they contain an acceleration provision requiring all outstanding loan balances to be repaid at termination of employment. If not repaid, the loan balance will be defaulted, offset against the participant’s account balance, and deemed a taxable distribution includable in the participant’s income. The plan is also required to withhold income tax, usually at a flat 20-percent rate, which is deducted from the participant’s account as well, and the withheld amount is also includable in the participant’s income for that tax year. The remaining account balance can be distributed to the participant and rolled over to an individual retirement account (IRA) or other qualified plan within 60 days (or directly rolled over in a trust-to-trust transfer).

Before TCJA took effect, participants who had outstanding loan balances defaulted and offset at termination had 60 days to come up with other funds equal to the outstanding loan balance, plus any amount of tax withholding, and roll those funds into an IRA or other qualified plan willing to accept them. If the defaulted amount was not rolled over within 60 days (or a waiver of the 60-day requirement was not obtained from the IRS), the offset amount plus any tax withholding amount would be includable in the participant’s income for the tax year of the distribution. The amount also could be subject to the 10-percent early withdrawal penalty in Code Section 72(t) if the participant had not yet reached age 59

1/2 or met any other exception to the penalty.

TCJA modified the rollover distribution rules for participants who have experienced a 401(k) loan balance default and offset due to acceleration of the loan at termination of employment. Participants now have until the participant's tax-filing deadline (usually April 15 of the following year, or October 15 if extended) to come up with the funds equal to the offset plus tax withholding and make the rollover. In several places in the 2009 IRS model 402(f) special tax notice as modified by Notice 2014-74, references are made to the 60-day rollover requirement and consequences that flow from failing to make a rollover within that time. Because TCJA creates an exception to these consequences, the model special tax notice "no longer accurately describes the relevant law" and needs to be updated to avoid any inaccuracies or correct any statements that have now become misleading due to the new legislation.

Many plan administrators rely on their service providers to prepare and provide the special tax notice when processing distributions to participants. But under Code Section 402(f), the plan administrator is ultimately responsible for making the required special tax notice disclosure to the participant, and could face a potential breach of fiduciary duty suit under the Employee Retirement Income Security Act of 1974 (ERISA) to the extent a participant relied on any inaccurate or misleading statements. Consequently, plan administrators should update their special tax notices or check with their service providers to ensure that the appropriate updates have been made.

The above is excerpted from an article prepared for publication in the July 2018 issue of BLR's newsletter, "The 401(k) Handbook."