With Year-End Deadline Looming IRS Issues Much Anticipated Hardship Guidance

PUBLISHED: November 16, 2018

Plan sponsors and recordkeepers have been eagerly anticipating IRS guidance on changes to the hardship distribution rules made by the Bipartisan Budget Act of 2018 (the "Act"), which are effective for plan years beginning on or after January 1, 2019. These changes impact 401(k) plans that offer hardship withdrawals, which provide active participants the ability to receive their elective deferrals prior to reaching age 59-1/2. They also impact 403(b) plans, although those are subject to some different rules. Because current regulations under 401(k) regarding hardship withdrawals are now inconsistent with the statutory requirements under the Act, the IRS recently issued proposed regulations to conform the regulations to the new rules and to incorporate prior changes and guidance. 83 Fed. Reg. 56763 (Nov. 14, 2018).

The proposed regulations generally address: 1) the required elimination of the post-withdrawal suspension of elective deferrals, 2) the optional elimination of the requirement for participants to take plan loans first, 3) the ability to include additional plan account sources in hardship distributions, 4) changes in the ability to qualify for a hardship distribution in the case of casualty losses and losses associated with federal disaster areas, and 5) changes in the administrative process required to document that a participant has demonstrated the requisite financial need.

Although the Act's hardship withdrawal provisions are effective January 1, 2019 for calendar year plans, the proposed regulations do not mandate any operational changes for 2018-2019. Beginning January 1, 2020, following the likely issuance of the final regulations, however, certain changes will be required. Below is a review of the current hardship rules, a look at the changes in the proposed regulations and a list of action steps.

Current Rules – 401(k) Plans

A hardship distribution permits active participants to receive a distribution of their elective deferrals in-service, prior to reaching 59-1/2, for an immediate and heavy financial need and the distribution is necessary to meet that need, determined based on all relevant facts and circumstances. However, a number of rules apply to hardship distributions, including the following:

- **Immediate and Heavy Financial Need.** The regulations provide a safe harbor where the following expenses automatically (i.e., are "deemed" to) satisfy the requirement to be on account of an immediate and heavy financial need: (1) unreimbursed medical expenses of the participant or primary beneficiary, (2) purchase of principal residence, (3) post-secondary school tuition, fees, room and board for 12 months for an employee, spouse, child or primary beneficiary, (4) to avoid eviction or foreclosure, (5) to repair damage to a principal residence as a "casualty loss" under Code section 165, or (6) funeral expenses.
- **Necessary to Satisfy a Financial Need.**
  - o ***Facts and Circumstances.*** A distribution is not treated as necessary to satisfy an immediate and heavy financial need to the extent the need may be satisfied by alternative means, based on the relevant facts and circumstances. The regulations provide that, for purposes of satisfying the requirement that the financial need cannot be satisfied by alternative means, an employer may rely on the participant's representation that the need cannot be relieved through reimbursements or other compensation, liquidation of other assets, stopping plan contributions, other available plan distributions, or by borrowing from commercial sources like a bank (absent actual knowledge to the contrary).
  - o ***Deemed Necessary.*** Alternatively, the regulations provide a safe harbor requirement that the distribution is deemed necessary to satisfy an immediate and heavy financial need, if the participant (1) has obtained all other currently available distributions (including distribution of ESOP dividends, but not hardship distributions) and non-taxable (at the time of the loan) loans, under the plan and all other plans maintained by the employer, and (2) 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 6 months after receipt of the hardship distribution.
- **Available Hardship Sources.** Hardship distributions are not available from the following sources under a 401(k) plan: (A) qualified nonelective contributions (QNECs), (B) qualified matching contributions (QMACs), (C) safe harbor plan contributions, and (D) post-12/31/1988 earnings, including earnings on pre-tax contributions.

Proposed Regulations

The proposed regulations make a number of changes to the hardship distribution provisions, following the recent legislative changes.

- **Elimination of 6-Month Suspension (Optional for 2019 Plan Year, Mandatory Beginning 1/1/2020).** The proposed regulations permit (but do not require) plan sponsors to eliminate the 6-month suspension period on employee contributions (401(k), 403(b), after-tax, Roth) beginning for hardships distributions in plan years beginning after December 31, 2018. However, for hardship distribution made on or after January 1, 2020, no suspension is permitted for any plan.

Notably, the elimination of the 6-month suspension can (but is not required to) apply as of the first day of the first plan year beginning after December 31, 2018, even if the distribution was made in the prior plan year.

- **Elimination of Plan Loans First Requirement (Optional Beginning With 2019 Plan Year).** The proposed regulations provide that, effective for hardship distributions in plan years beginning after December 31, 2018, plan sponsors can elect to retain or eliminate the requirement that plan loans must be taken first, prior to receiving a hardship distribution.

- **Expansion of Accounts Eligible For Hardship Distributions.** The proposed regulations permit (but do not require) a plan sponsor to make available plan accounts holding elective deferrals, QNECs, QMACs, and traditional safe harbor contributions, and all earnings thereon. The proposed regulations are consistent with the Act's expansion of available amounts.

  Comment on 403(b) Plan Differences: There are special rules for 403(b) plans. First, income attributable to section 403(b) elective deferrals continues to be ineligible for a hardship distribution because the Act did not amend that restriction on distributing such income under Code section 403(b)(11). Second, QNECs and QMACs in a 403(b) plan that are in a 403(b)(7) custodial account continue to be ineligible for hardship distributions. However, QNECs and QMACs in a non-custodial 403(b) annuity plan (e.g., under 403(b)(1) or 403(b)(9)) are eligible for hardship distribution.

- **Casualty Loss Expenses Not Tied To a Disaster (Optional for 2018, Required for 2019 Plan Year).** As noted above, the 401(k) plan regulations permit a hardship withdrawal generally for a "casualty loss" as defined under Code section 165 (without regard to certain limitations). As such, when the Code section 165 casualty loss provision was changed following the Tax Cuts and Jobs Act of 2017 to require that the loss be incurred due to a federally declared disaster, there was some uncertainty regarding the impact on hardship withdrawals. The proposed regulations address this concern by clarifying that the Tax Act change does not apply to hardship distributions (i.e., a hardship distribution regarding damages to the principal residence is not tied to a federally declared disaster). And for 2018 hardship withdrawals, if that limitation was applied to such withdrawals, that is also permissible, i.e., either approach is acceptable for 2018.

- **Specific Relief for Victims of Hurricanes Florence and Michael (Optional).** The optional relief provided in Announcement 2017-15 (regarding hardship distributions and loans) is extended to similarly situated victims of Hurricanes Florence and Michael, except that the "Incident Dates" (i.e., start dates) are as specified by FEMA and the relief is available through March 15, 2019.

- **New Withdrawal Reason - Disaster Event (Optional Beginning With 2019 Plan Year).** As described above, the safe harbor hardship withdrawal reasons do not expressly include an expense due to a federally declared disaster. Typically, such relief has been granted following a particular disaster (e.g., Announcement 2017-15 for Hurricane Maria and the California Wildfires). The proposed regulations would now permit hardship distributions on account of a federally declared disaster by the Federal Emergency Management Agency (FEMA), provided that the employee's principal residence or principal place of employment at the time of the disaster was located in the area designated by FEMA for individual assistance due to the particular disaster.

This new safe harbor expense is similar to (but not as expansive as) the hardship relief given in prior guidance, like Announcement 2017-15, and is intended to eliminate any delay or uncertainty concerning access to plan funds following a federally declared disaster. The Preamble to the regulations states that this provision may be applied to distributions made on or after a date that is as early as January 1, 2018. For example, this provision can be extended to disasters that occur in 2018 (such as Hurricane Florence or Hurricane Michael), provided that the employee's principal residence or principal place of employment at the time of the disaster was located in an area designated by FEMA for individual assistance with respect to the disaster.

- **Catch-all Facts and Circumstances Test Eliminated (Optional for 2019 Plan Year, Mandatory Beginning 1/1/2020).** The proposed regulations change the provisions for determining whether a distribution is necessary to satisfy a financial need. For hardship distributions made on or after January 1, 2020, the proposed regulations eliminate the rules in the existing 401(k) regulations permitting the determination of whether a distribution is necessary to satisfy a financial need to be based on all the relevant facts and circumstances, and replace this subjective determination with a single, general, and more objective standard. The determination under the new standard includes the following requirements that are similar to those under the current regulations:

  (1) a hardship distribution may not exceed the amount of the employee's need (including any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution),

  (2) the employee must have obtained other available distributions under the employer's plans (this includes all currently available distributions (including ESOP dividends, but not hardship distributions or loans) under the plan and all other plans of deferred compensation maintained by the employer, whether qualified or nonqualified), and

  (3) the employee must represent (in writing, by an electronic medium, or other forms as prescribed by the IRS) that he or she has insufficient cash or liquid assets to satisfy the financial need.

  A plan administrator may rely on such a representation unless the plan administrator has actual knowledge to the contrary. The written certification is not required for hardship withdrawals prior to 2020, but a plan sponsor may implement it for the 2019 plan year. The plan sponsor can also impose additional conditions to meet this standard, if desired (such as requiring plan loans to be taken first but no suspension period, or the prior facts and circumstances/representation provisions, as noted above).

Plan Amendments

Plan amendments will be needed to reflect these changes. The preamble to the proposed regulations indicates that the normal rules for determining the deadline to adopt an amendment to fix a disqualifying provision (which the IRS indicated these changes fall within) apply. Therefore, for individually designed 401(k) plans, we should have until the end of the second calendar year that begins after the issuance of the Required Amendment List that includes these changes to adopt amendments.

Sponsors of pre-approved plan programs will need to adopt interim amendments to address these changes, which for 401(k) plans we anticipate will be required next year after the final regulations are issued (unless the pre-approved plan has a 2018 effective date for certain changes, which may warrant an earlier interim amendment).

Action Steps/Observations

At this point, plan sponsors and recordkeepers should

- promptly review their hardship distribution procedures in light of the proposed regulations,
- determine (coordinating with the plan recordkeeper) which changes will be implemented in operations, and as of what date, and
- if on a pre-approved plan document, check with your plan provider to see if any amendments are needed.

As there are a number of decision points and time is really short, a determination of the process for January 1, 2019 (for calendar year plans) should be top priority with plan operations reviewed for compliance. And once the final regulations are issued, the procedures should be again revisited to ensure compliance, and a reminder set for adopting conforming plan amendments.

Comments on the proposed regulations are due January 14, 2019. The IRS expressly requested comments on the participant representation regarding financial need. Please contact your Groom attorney to review how the rules apply to your plan, address any concerns, etc.