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Employee Benefits Corner

Much Anticipated Hardship Guidance Is Here

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Following the Bipartisan Budget Act of 2018, plan sponsors and recordkeepers have been eagerly awaiting guidance on the hardship distribution changes set forth in the Act, which are effective for plan years beginning on or after January 1, 2019. The wait is over. The IRS recently issued proposed regulations to address a number of changes impacting 401(k) and 403(b) plans that offer hardship distributions to plan participants. Importantly, no operational changes are required for 2018–2019, but come 2020 certain changes will be mandatory. Below is a summary of the rules and what to expect next.

Summary of the Changes

A summary of the key change is set forth below—some of these changes were anticipated, and some were not.

- *Elimination of 6-Month Suspension and Prior Loans Requirements.* Pre-2019, the 401(k) regulations provided that to fall within the safe harbor for a distribution to be deemed necessary to satisfy an immediate and heavy financial need, (1) the employee must first obtain all currently available distributions (including ESOP dividends) and nontaxable plan loans from the plan and any other plan maintained by the employer and (2) an employee's ability to make elective contributions and employee contributions to the plan (and any other plan maintained by the employer) must be suspended for at least 6 months after receipt of the hardship distribution (for a safe harbor 401(k)12) or 401(k) (13) plan, the suspension period could not exceed 6 months). Post-2019, the Budget Act eliminated the need to take a loan first (this is now optional), and eliminated the 6-month suspension period (which is optional for 2019 for all plans, but is required to be eliminated for post-2019 distributions).
- *Types of Contributions Eligible for Hardship Distribution.* Pre-2019, the maximum amount that may be distributed on account of hardship is the total of the employee's elective contributions that have not previously been distributed (plus earnings, QNECs, and QMACs credited before a specified grandfathered date that generally was before 1989). Post-2019, the Budget Act permits (but does not require) elective deferrals, QNECs, QMACs, QLAC, and traditional safe harbor contributions, and all earnings thereon, to be eligible for distribution in the event of a hardship.

- **Casualty Loss.** Pre-2018, Code Sec. 165 casualty loss was not contingent on the loss being incurred due to a federally declared disaster, which the 401(k) regulations incorporate Code Sec. 165 by reference for a casualty loss. Post-2018 through 2025, the Tax Reform Act of 2017 provides that the casualty loss deduction is only available to the extent the loss is attributable to a federally declared disaster. Effective for hardship distributions made no earlier than January 1, 2018 and no later than January 1, 2019, the 401(k) regulations provide that the casualty loss reference is determined without regard to Code Sec. 165(h)(5) (*i.e.*, determined without regard to whether there was a federally declared disaster).

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- **Disaster Event.** Pre-2018, the safe harbor hardship withdrawal reasons do not expressly include an expense due to a federally declared disaster. Effective for hardship distribution made no earlier than January 1, 2018, hardship distributions can be made 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 with respect to the disaster. The preamble to the regulations explains that this new safe harbor expense is similar to (but notably not as broad as) the hardship relief given in Announcements for certain Hurricanes (*e.g.*, Ann. 2017-15 for Hurricane Maria and California wildfires) and is intended to eliminate any delay or uncertainty concerning access to Plan funds following a federally declared disaster. Presumably, plans that follow or incorporate the hardship safe harbor 401(k) regulations will want to add this provision effective for distributions on or after January 1, 2019 (assuming that the provision is retained in the final regulations).

- **Facts and Circumstances Test.** For distributions made on or after January 1, 2020, the proposed regulations eliminate the rules in the existing 401(k) regulations under which the determination of whether a distribution is necessary to satisfy a financial need is based on all the relevant facts and circumstances and replaces it with a single, general standard for determining whether a distribution is necessary. Specifically, 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), 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 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.

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

Impacted Plans

This guidance impacts all 401(k) plans in the same manner. Although we anticipated a different result for safe harbor 401(k)/(m) plans following the prior EGTRRA changes, all types of 401(k) plans are subject to the same rules.

Regarding 403(b) plans, they track the same rules as 401(k) plans, except the following special rules apply: (1) income attributable to Code Sec. 403(b) elective deferrals continues to be ineligible for a hardship distribution (as Code Sec. 403(b)(11) was not amended), and (2) QNEC and QMACs in a 403(b) plan that are in a custodial account continue to be ineligible for hardship distributions (*versus* QNECs and QMACs in a non-custodial 403(b) plan which are eligible for hardship distribution).

Plan Amendments

Plan amendments will be needed to reflect these changes. The preamble to the regulations indicates that the normal rules for disqualifying provisions (which the IRS indicated these changes fall within) apply. This means that for individually designed plans, we have until the end of the second calendar year that begins after the issuance of the Required Amendment List that includes these changes, and as these changes involve hardship changes which are not subject to anti-cutback relief, there should be no requirement to adopt plan amendments in the near term. For pre-approved plans, sponsors of these programs will need to adopt interim amendments to address these changes, which 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).

Effective Date

The proposed regulation is to be effective for distributions made in plan years beginning after December 31, 2018, with certain exceptions set forth below for as earlier as January 1, 2018 effective date (which is optional and should be consistent with plan operations):

- *Suspension.* The elimination of the 6-month suspension can apply to hardship distributions made after July 1, 2018 (this is optional).
- *Casualty Loss.* The change to the deemed immediate and heavy financial need safe harbor to provide that the casualty loss deduction reference to Code Sec. 165 is determined without regard to Code Sec. 165(h)(5) (which is the Tax Reform Act provision that requires casualty losses to result only from a federally declared disaster).
- *Federally Declared Disasters.* The change to the deemed immediate and heavy financial need safe harbor to provide for expenses and loss incurred by the employee on account of a disaster declared by FEMA for the 2018 disasters (such as Hurricanes Florence and Michael).

Notably, the proposed regulations provide that for hardship distributions on or after January 1, 2020, the following rules *must* apply:

- *Suspension.* No suspension on employee contributions is permissible.
- *Facts and Circumstances Test for Financial Need.* Plan administrators can no longer make a facts and circumstances determination that the participant is in need of the funds from the plan. Hardship distribution must include a representation from the employee as noted above.

Unfortunately, these proposed regulations do not include language that the proposed regulations can be relied upon prior to issuance of final regulations. Therefore, it might be premature to finalize plan amendments and operations pending the final guidance (at least with respect to changes that fall outside the Budget Act).

Comment Period

Comments on the proposed regulation are due January 14, 2019, and the IRS expressly requested comments on the participant representation regarding financial need: (i) whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility; (ii) the accuracy of the estimated burden associated with the proposed collection of information; (iii) how the quality, utility, and clarity of the information to be collected may be enhanced; (iv) how the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and (v) estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

Next Steps

Plan sponsors and recordkeepers should review their hardship procedures by year-end in light of the proposed regulations, and determine which changes will be implemented, and when, and then determine the timing for reflecting these changes into the plan document. But as these are only proposed regulations (with no clear reliance protection), we will also want to revisit these hardship procedures next year when the final regulations are issued.

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