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LEGAL DEVELOPMENTS

Proposed Hardship Withdrawal Regulations Facilitate Hardships

Proposed regulations from both the IRS and Treasury affect participant hardship withdrawals from DC plans. The author outlines those proposed changes and provides information essential to preparing for the release of the final regulations.

BY ELIZABETH THOMAS DOLD

Elizabeth Thomas Dold is a principal attorney at Groom Law Group, Chartered in Washington, DC. For nearly 20 years, her work has focused on employee benefits and compensation matters, including employment taxes and related reporting and withholding requirements. She regularly advises Fortune 500 companies (including corporate and tax-exempt employers, financial institutions, and third-party administrators) on plan qualification and employment tax issues. Ms. Dold is a past Chairperson of the Information Reporting Program Advisory Committee (IRPAC) and a former adjunct professor at Georgetown Law Center.

Hardship withdrawals have historically been a popular plan design choice for defined contribution plans, which allow otherwise

impermissible in-service distributions of pre-tax/Roth deferrals prior to age 59½ for those in need. The 401(k) regulations contain detailed rules regarding the process for receiving a hardship withdrawal, as well as several safe harbor provisions to facilitate compliance. In early 2018, the Bipartisan Budget Act of 2018 (the Act) provided a number of changes to these rules, to be effective for 2019 plan years, and the IRS and Treasury recently issued proposed regulations—83 Fed. Reg. 56763 (Nov. 14, 2018)—to implement these changes, and to further alter these longstanding rules. While we await the final regulations, it is important to understand these changes and consider what modifications to plan operations are desired to facilitate hardship withdrawals. Below, in

question-and-answer format, we review the proposed changes and consider action steps to implement these changes, which are largely optional until January 1, 2020.

1. What plans are impacted?

Defined contribution plans (401(k), profit sharing) and 403(b) plans that provide for hardship distributions. Defined benefit plans and money purchase pension plans are not affected.

2. What hardship rules changed?

The key changes are highlighted below:

- a. *Six-month suspension.* For the 2019 plan year, a plan sponsor can eliminate the six-month required suspension period on employee contributions. This can be extended to hardships taken in 2018 that are still subject to suspension as of the first day of the 2019 plan year, if so elected by the plan sponsor. However, for hardship distributions made on or after January 1, 2020, plans may not suspend participants' deferral election due to a hardship distribution.
- b. *Loans first requirement.* Beginning in the 2019 plan year, hardship distributions may be made without requiring the participant to first take any available plan loan. This is an optional provision.
- c. *Accounts eligible for hardship.* Beginning in the 2019 plan year, 401(k) hardship withdrawals may be made from elective deferrals, qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), safe harbor contributions (both traditional and QACA), and all earnings thereon. For non-custodial 403(b) annuity plans, hardship withdrawals are available from QNECs, QMACs, and safe harbor contributions (both traditional and QACA), but no other changes apply for 403(b) plans.
- d. *Casualty loss.* Beginning in the 2019 plan year, the safe harbor hardship expense for a casualty loss is determined without regard to Code section 165(h)(5) (which was added with the Tax Cuts and Jobs Act of 2017), and, therefore, the loss does not need to be attributable to a federally declared disaster. At the plan sponsor's option, this rule can be extended to 2018 if that is consistent with plan operations.
- e. *Hurricanes Florence and Michael relief.* The preamble to the proposed regulations

expands Announcement 2017-15 (regarding special relief for hardship distributions and loans) to victims of Hurricanes Florence and Michael. The "Incident Dates" (start dates of the relief) are as specified by the Federal Emergency Management Agency (FEMA), and the relief is available through March 15, 2019. This relief is optional, and, if the plan already has loan and hardship provisions, no plan amendment is required.

- f. *Disaster event.* Beginning in the 2018 plan year, a plan sponsor can add a new safe harbor category to the list of approved expenses. This new item will cover expenses on account of a federally declared disaster by 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 is an optional provision designed to help facilitate hardship withdrawals without having to wait for specific disaster guidance.
- g. *Necessary to satisfy a financial need.* In light of the first two changes above, the facts and circumstances test and safe harbor provision to determine if the withdrawal is necessary to satisfy a financial need are being eliminated. These tests are replaced with the following requirements for the 2019 plan year. The last item must be implemented by January 1, 2020 (and additional conditions, including the prior rules, may be imposed at the plan sponsor's option):
 - 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 any other currently available distributions under the employer's plans (this includes ESOP dividends, but not hardship distributions or loans) and under 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. The plan administrator may rely on the representation unless the plan administrator has actual knowledge to the contrary.

3. What operational changes may be made effective in 2018?

Plan sponsors may elect to implement the Code section 165 casualty loss change, the new disaster event safe harbor expense in 2018, and the expansion of the IRS hurricane announcement in 2018.

4. What operational changes may be made effective until the 2019 plan year?

A number of changes may be made effective for the 2019 plan year, including (1) elimination of the loan first requirement, (2) elimination of the six-month suspension period, (3) expansion of the types of accounts and earnings eligible for withdrawal, and (4) participant new certification for documenting that the withdrawal is necessary to satisfy the financial need.

5. What operational changes are *required* as of January 1, 2020?

You must follow the new standard, including the participant certification, for making sure the withdrawal is necessary to satisfy the financial need. You also must prohibit any suspension of employee contributions to the qualified plan following a hardship withdrawal.

6. Can I rely on the proposed regulations?

Although there is no clear indication that we can rely on the proposed regulations, we anticipate that the IRS intended to allow for reliance in 2018, as some of the provisions are expressly available in that year.

7. Are plan amendments required?

Yes, plan amendments will be required to reflect these changes.

8. When are plan amendments required?

For individually designed plans, we have several years to adopt plan amendments, but the plan

operations must be implemented by the effective dates noted above, to the extent the provisions are mandatory. Specifically, once the final regulations are issued and reflected on the Required Amendment List (RAL) that is published by the IRS, we must amend our plans by December 31 of the second year following the RAL listing. For pre-approved plans, we anticipate interim amendments to be largely adopted in 2019 by the pre-approved plan sponsors.

9. May I continue to rely on my determination letter for the plan after I amend the plan for these changes?

Unfortunately not for these changes, but, thankfully, the determination letter will continue to cover other provisions that have not been changed by the law or by plan design. Until the IRS expands the determination letter, these changes to the plan document will not be protected by the plan sponsor's last determination letter. Therefore, careful attention should be given to drafting these changes.

10. What action steps should I be taking in light of these proposed changes?

Plan sponsors and record-keepers should review and update their hardship procedures—including the hardship request form, the processing steps, the documentation that is required, and any employee notices and summary plan description that describes the hardship provision, to ensure that they accurately reflect the changes that are intended or have already been made to the plan, and the appropriate effective date of the changes. Also, remember to amend your plan documents timely for the approaches taken (and be mindful of mid-year amendments to a safe harbor 401(k) plan that have additional considerations), and consider appropriate employee communications to provide notice of the changes.

And stay tuned for the final regulations in 2019. ■

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