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Client Alert

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IRS Issues Proposed Regulations Amending Rules for Hardship Distributions

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On November 14, 2018, the IRS published new proposed regulations relating to hardship distributions from 401(k) plans and 403(b) plans. The proposed regulations primarily respond to issues raised by changes to hardship distributions in the Bipartisan Budget Act of 2018 ("BBA) and the Tax Cuts and Jobs Act of 2017 (TCJA). (For our client alert summarizing the changes to hardship distributions under the BBA and TCJA please click here.) The proposed regulations also implement changes previously made by the Pension Protection Act of 2006 and the Heroes Earnings Assistance and Relief Tax Act of 2008.

Most of the changes in the proposed regulations modify the hardship distribution "safe harbor" rules and have the effect of making the rules less restrictive for a plan participant to obtain a hardship distribution.

As background, a hardship distribution may be taken from a 401(k) or 403(b) plan only when a participant demonstrates that (i) the participant has an immediate and heavy financial need, and (ii) the distribution is necessary to satisfy the financial need. The law establishes a set of "safe harbor" rules that a plan can follow to determine that a hardship distribution does, in fact, meet these requirements.

Under the current safe harbor hardship rules, a distribution:

- Is deemed to be on account of an immediate and heavy financial need if the participant demonstrates that the expenses result from one of six events.
- Is deemed necessary to satisfy an immediate and heavy financial need if, among other requirements, a participant is (i) required to obtain all nontaxable plan loans before receiving the hardship distribution, and (ii) suspended from making contributions to the plan and all other plans maintained in the controlled group for at least six months following the hardship distribution.

The proposed regulations include the following changes:

- Elimination of the Six-Month Suspension Requirement
- Elimination of the Plan Loan Requirement
- Modifications to the List of Hardship Distribution Events
- Addition of Participant Representation Requirement
- Expansion of Sources Available for Hardship Distributions

Safe Harbor Change – Six-Month Suspension Requirement Eliminated

Under the current safe harbor rules, after receiving a hardship distribution, a participant must be suspended for at least six months from making elective and employee contributions to the plan from which the hardship distribution is made, plus any other employer plan maintained within the plan sponsor's controlled group. The proposed regulations eliminate this six-month suspension requirement.

- The proposed regulations allow this change to be effective for new hardship distributions requested in the first plan year beginning after December 31, 2018. In addition, for calendar year plans, if a hardship distribution was made in the second half of 2018 and the six-month suspension rule applied, the plan may be amended to either: (i) shorten the participant's suspension period to end December 31, 2018, or (ii) continue to suspend contributions through the originally scheduled six months. For example, if a hardship distribution was made on October 1, 2018, the plan could either: (i) suspend contributions through December 31, 2018 (*i.e.*, permit the participant to restart contributions three months earlier than would have been permitted otherwise); or (ii) suspend contributions through March 31, 2018.
- The elimination of the six-month suspension requirement may also impact nonqualified deferred compensation plans subject to Code Section 409A. The 409A regulations permit a nonqualified deferred compensation plan participant to cancel a deferral election in the event the participant takes a hardship distribution from a 401(k) plan. Plan administrators of nonqualified deferred compensation plans should take into account the elimination of the six-month suspension requirement in administering their plans.

Plan sponsors should note that, although this change is optional for 2019, effective for hardship distributions made on or after January 1, 2020, the change will become mandatory – at that point, plans will not be permitted to suspend participant contributions in connection with hardship distributions.

Safe Harbor Change – Plan Loan Requirement Eliminated

Under the current safe harbor rules, a participant is required to exhaust all available loans under any employer plans maintained within the plan sponsor's controlled group prior to obtaining a hardship distribution. The proposed regulations eliminate this requirement effective as of the first plan year starting after December 31, 2018. However, the proposed regulations are clear that plans may continue to require participants to obtain all nontaxable loans available under controlled group plans as a condition to receiving a hardship distribution.

Safe Harbor Change – Modifications to List of Hardship Distribution Events

The proposed regulations make several revisions to the list of safe harbor expenses for which distributions are deemed to meet an immediate and heavy financial need. The revisions include:

- Adding that for purposes of medical expenses, post-secondary educational expenses, and funeral expenses, expenses incurred by the participant's "primary beneficiary under the plan" will justify a hardship distribution. (Note that this change to the law was made by the Pension Protection Act of 2006; therefore, most plan sponsors previously considered whether to add primary beneficiary expenses for these safe harbor events).
- Clarifying that property casualty losses can justify a hardship distribution even if the losses are not attributable to a federally declared disaster (*i.e.*, do not qualify for a casualty loss deduction under Code Section 165(h) as amended by the TCJA). This revision eliminates confusion raised by the TCJA changes to Code Section 165(h).
- Adding a new category of permitted hardship distribution events for expenses and losses incurred on account of FEMA-declared disasters.

Plans may be amended to apply one or more of these changes to hardship distributions made from January 1, 2018, onward.

Safe Harbor Change – New Participant Representation Requirement

The proposed regulations eliminate the safe harbor standard for determining that the amount of a hardship distribution is necessary to satisfy the immediate and heavy financial need. This is accomplished by eliminating the loan requirement and six-month contribution suspension requirement. In place of the safe harbor standard, the proposed regulations apply a general standard to determine that a hardship distribution is necessary to satisfy the financial need. The general standard requires that:

- The amount of the hardship distribution is not in excess of the amount required to satisfy the financial need (including adjustment for taxes and penalties).
- The participant has obtained all other currently available distributions under the plan and all plans maintained within the controlled group (but no longer including plan loans).
- Effective January 1, 2020, the participant represents (in writing or by electronic medium) that he or she has insufficient cash or other liquid assets to satisfy the financial need. The plan administrator may rely on such representation unless it has actual knowledge to the contrary.

As noted above, the proposed regulations permit a plan to continue to apply additional conditions, such as requiring participants to obtain plan loans prior to receiving a hardship distribution. The proposed regulations also permit a plan to implement the participant representation requirement beginning as of January 1, 2019.

Non-Safe Harbor Change – Additional Sources Available for Hardship Distribution

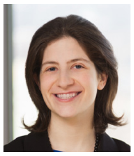
- With respect to 401(k) plans, the proposed regulations expand the sources that can be available for hardship distributions to include QNECs, QMACs, earnings on QNECs and QMACs, and earnings on elective deferrals.
- With respect to 403(b) plans, only QNECs and QMACs that are not in a custodial account are eligible for hardship distribution (QNECs and QMACs held in a custodial account and earnings on pre-tax deferrals remain ineligible for hardship distributions).

Amendments Required and Deadline to Amend

The preamble to the proposed regulations provides that the Treasury Department and IRS expect that plans will need to amend their hardship distribution provisions to reflect some or all of the changes in the proposed regulations. Generally, the deadline for amending a plan to reflect a change in qualification requirements is the end of the second calendar year that begins after the issuance of the Required Amendments List. In addition, all amendments that relate to the final regulations will have the same amendment deadline (such as the change to Code Section 165(h) relating to casualty losses or the addition of the new safe harbor expense relating to federally declared disasters).

Employee Benefits and Executive Compensation Team

Primary Contacts



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