

# Management Alert



## IRS Releases Proposed Hardship Distribution Regulations

*By Jake Downing and Jessica Stricklin*

Hopefully still in time for 2019 plan design discussions, on November 9, 2018, the Department of the Treasury and the Internal Revenue Service (IRS) issued a Notice of Proposed Rulemaking to amend IRS regulations related to hardship distributions from 401(k) and 403(b) plans. In particular, the proposed amendments would reflect statutory changes affecting 401(k) and 403(b) plans, including recent changes under the Bipartisan Budget Act of 2018 (the Budget Act) and the Tax Cuts and Jobs Act (TCJA). Plan sponsors have been awaiting this guidance for several months while contemplating design changes for the 2019 plan year that would ease plan administration and be participant friendly.

### Background on Hardship Distributions

The Internal Revenue Code (Code) and associated IRS regulations place restrictions on the ability of actively employed participants to withdraw their elective contributions from 401(k) and 403(b) plans except in certain circumstances, including hardship. A distribution is made on account of a hardship only if the distribution is made to satisfy an immediate and heavy financial need and if the amount of the distribution is not in excess of the amount necessary to satisfy that need. Hardship distributions had been limited to the participant's elective deferrals and could not be taken from the participant's qualified nonelective contributions (QNECs); qualified matching contributions (QMACs); or earnings on elective deferrals, QNECS, or QMACs credited after 1988.

IRS regulations have provided a safe harbor that specifies six types of expenses that are deemed to be made on account of an immediate and heavy financial need, such as medical care expenses and expenses for the repair of damage to a participant's principal residence that would qualify for a casualty deduction under Code Section 165. Additionally, the requirement that the distribution is not in excess of the amount necessary to satisfy that need has been deemed satisfied under IRS regulations if (i) the participant takes all available distributions and nontaxable loans under the employer's plans and (ii) the participant is prohibited from making employee contributions to any of the employer's plans for a six month suspension period following the hardship distribution.

The Budget Act and TCJA relaxed certain of these constraints effective for plan years beginning on or after January 1, 2019. The proposed regulations reflect these changes by modifying certain of the above rules with slight differences for 401(k) plans as compared to 403(b) plans.

## Section 401(k) Plan Changes under Proposed Regulations

The proposed regulations would make a number of changes to the current rules for 401(k) plans related to hardship distributions, such as:

- Adopting the changes directed by the Budget Act, including:
  - Eliminating the six month suspension requirement for employee contributions under all employer plans following a hardship distribution.
  - Eliminating the requirement that a participant must take any available plan loans prior to requesting a hardship distribution.
  - Expanding sources of the plan assets from which a participant may take a hardship distribution to include QNECs, QMACs and earnings on QNECs, QMACs and elective deferrals credited after 1988.
- Modifying the safe harbor list of expenses that are deemed to be made on account of an immediate and heavy financial need by:
  - Providing that qualifying medical, educational, or funeral expenses of a participant's primary beneficiary under the plan constitute a permissible expense.
  - Adding a seventh safe harbor to the list for expenses incurred following a federally declared disaster that occurs in an area designated by the Federal Emergency Management Agency (FEMA). This addition is intended to eliminate uncertainty or delays in receiving distributions in the absence of special IRS guidance, which has historically been issued in these situations.
  - Clarifying that the meaning of "casualty loss" to a principal residence for purposes of a hardship withdrawal is unaffected by the new Code Section 165(h)(5) limit added by the TCJA. (This limited the deduction for casualty losses to those attributable to federally declared disaster areas for taxable years 2018 through 2025.) As a result, the safe harbor for casualty losses would continue to operate as it had and would be available for expenses for repairs to the principal residence that would qualify for the casualty deduction under Section 165.
- Providing a general standard for plan administrators to determine whether a distribution is necessary to satisfy a financial need. To satisfy this proposed standard, a plan administrator would (i) limit the amount of a distribution to the participant's need (including amounts necessary to pay taxes or penalties on the distribution), (ii) verify that the participant has taken all available distributions under the employer's plans (other than nontaxable loans), and (iii) obtain a representation from the participant that he or she has insufficient cash or other liquid assets to satisfy the need (and the plan administrator does not have actual knowledge otherwise).

In addition, the Notice of Proposed Rulemaking separately provides relief for certain hurricanes, by extending relief relating to Hurricane Maria and the California wildfires provided in IRS Announcement 2017-15 to similarly-situated victims of Hurricane Florence and Hurricane Michael. The "Incident Dates" for such hurricanes are as specified by FEMA and relief is provided through March 15, 2019.

## Section 403(b) Plan Changes under the Proposed Regulations

The proposed regulations apply the same rules to 403(b) plans as provided above for 401(k) plans except that:

- Earnings on 403(b) elective deferrals remain ineligible for hardship distribution because the Budget Act did not amend the statutory prohibition on such distributions.

- QNECs and QMACs held in a custodial account in a 403(b) plan remain ineligible for hardship distributions. QNECs and QMACs may be distributed on account of hardship in a section 403(b) plan that are not held in a custodial account.

## Effective Dates

The proposed regulations generally would become effective for plan years beginning after December 31, 2018, which is the same effective date as the statutory changes made by the Budget Act. However, plans must eliminate the six month suspension period on participant contributions and implement the participation representation requirement under the proposed general standard by no later than January 1, 2020. As raised in our [previous alert](#), the proposed regulations clarify an outstanding question by confirming that the removal of the of the six month suspension requirement may be applied to a suspension that began in 2018 and continues into the 2019 plan year.

The proposed changes related to safe harbor distributions with respect to casualty losses and federally declared disaster areas may be applied to distributions on or after January 1, 2018.

## Takeaways and Plan Amendments

If the proposed regulations are finalized as they have been proposed, plan sponsors will need to amend their plans' hardship distribution provisions. While certain sponsors may have viewed these changes as voluntary design-based changes, the proposed regulations make it clear that certain changes are mandatory. Most critically, on and after January 1, 2020, (i) plans may no longer impose a six month suspension period on participant contributions following a hardship distribution and (ii) plan administrators must begin obtaining representations from each affected participant that he or she does not have the necessary cash or liquid assets available to satisfy the hardship. Amendments must be completed by the end of the second calendar year that begins after the issuance of the Required Amendments List. Since the proposed changes have not yet been listed in the Required Amendments List, plan sponsors will have time before such written amendments are required. Plan sponsors may nevertheless begin planning to ensure that the six month suspension requirement and participant representation requirements are timely adopted by January 1, 2020, or for the 2019 plan year if desired.

The other changes will be considered optional design decisions for plan sponsors to consider. Accordingly, plan sponsors may consider if and how soon to implement these optional changes under the proposed regulations. Notably, the notice clarifies that plans may continue to impose stricter requirements for demonstrating an immediately and heavy financial need, such as requiring a participant to obtain a loan prior to requesting a hardship distribution. 401(k) plans may also continue to prohibit hardship withdrawals on QNECs, QMACs, and earnings on these amounts and elective deferrals. As provided above, 403(b) plans will be required to maintain these restrictions.

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