NOVEMBER 12, 2018

IRS Proposes New Hardship Distribution Regulations; Regulations to Prohibit Deferral Suspensions Beginning 2020 and Provide a New Hardship Safe Harbor for Natural Disasters Available Now

The Internal Revenue Service ("IRS") has issued proposed regulations that would change the rules for hardship distributions from 401(k) and 403(b) plans. The hardship distribution rules allow participants in these plans who experience an immediate and heavy financial need access to their account balances while still employed and before they reach age 59-½. Hardship distributions are includable in income and are usually subject to a 10% early withdrawal penalty, unless an exception applies. The proposed regulations were published in the Federal Register on November 14, 2018.

Regulations Needed to Implement Recent Code Changes for Hardship Distributions

The proposed regulations implement changes made to the Internal Revenue Code by the Tax Cuts and Jobs Act ("TCJA") signed into law in December 2017 and the Bipartisan Budget Act ("Budget Act") signed into law in February 2018, as well as certain provisions of previous enactments and guidance. Most of the changes are effective January 1, 2019. The proposed regulations also would create new rules for hardships distributions made after January 1, 2020. The IRS is requesting comments on the proposed regulations within 60 days.

The TCJA made a change to the deductibility of casualty losses under section 165 of the Internal Revenue Code ("Code") that indirectly impacted the casualty loss hardship safe harbor that references section 165, which we discussed in our blog entry found here. The IRS has identified six circumstances, known as "safe harbor" hardships, that are deemed to meet the requirements of being an immediate and heavy financial need without requiring plan administrators to conduct an independent evaluation of whether such a need exists.

Plans also may allow hardship distributions for other reasons (if the plan document so provides), but the plan administrator must make an independent assessment that the reasons the participant cites are actually necessary to meet an immediate and heavy financial need. Some plan sponsors have decided not to undertake this analysis and limit hardship distributions exclusively to the six safe harbors.

The current hardship distribution regulations provide that a distribution is deemed to satisfy a participant's immediate and heavy financial need if the distribution is for "expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income." Before TCJA, Code section 165 covered a wide range of casualty losses. Revisions to that Code section

made by TCJA now limit deductible casualty losses to only those casualty losses attributable to a presidentially declared disaster.

The most significant changes to the hardship distribution rules came in the Budget Act. As we reported in our prior Blog entry found here, the Budget Act eased hardship distribution requirements for plan years beginning after December 31, 2018. For calendar year plans, beginning January 1, 2019:

- Plans may allow participants to take hardship withdrawals from participant elective deferrals, qualified nonelective contributions, qualified matching contributions and the earnings on each of these contributions sources. Prior to the Budget Act, only participant elective deferrals—but not earnings on those deferrals—were eligible for distribution upon hardship;
- Participants will not be required to take loans available under the plan to establish the need for a hardship;
- Plans will no longer need to suspend participants who take hardship distributions from making elective deferrals for a period of six months following the distribution.

Proposed Regulations Update Hardship Distribution Requirements

The proposed regulations make the changes required by TCJA and the Budget Act, but also make additional revisions to implement changes made by prior enactments, incorporate prior guidance, simplify the standard for determining if hardship distributions are necessary, and provide additional options for hardship withdrawals. These changes include:

- **New Standard for Determining Whether Hardship Exists.** The current regulations require plan administrators to take into account all relevant facts and circumstances to determine whether a hardship distribution is necessary to satisfy an immediate and heavy financial need. The proposed regulations would replace the facts and circumstances test with a three part general standard. The general standard would require that a hardship distribution not exceed the amount of an employee's need (including any amounts necessary to pay any taxes or penalties reasonably anticipated to result from the distribution), the employee must have obtained other available distributions under the employer's plans before taking the hardship distribution, and the employee must represent that he or she has insufficient cash or other liquid assets to satisfy the financial need. Consistent with the current standard, a plan administrator will be allowed to rely on a participant's representation of the need unless the plan administrator has actual knowledge to the contrary. Plan administrators may begin applying this general standard on or after January 1, 2019, but the requirement to obtain a participant's representation will become mandatory for hardship distributions made on or after January 1, 2020.

- **Deferral Suspension Prohibited Following Hardship Distribution.** In addition to removing the requirement that plans suspend participants from making deferral contributions for six months

following a hardship distribution as directed by the Budget Act, the proposed regulations go further and actually prohibit plans from suspending participants from making deferral contributions following a hardship distribution. Some plan sponsors had contemplated whether they could continue to suspend participants, even though they would be no longer required to do so. The proposed regulations say no, and in the preamble the IRS explains that Congress wanted participants to have the opportunity to replace the funds that are withdrawn by a hardship distribution. However, this prohibition would only become mandatory for hardship distributions made on or after January 1, 2020. The IRS further states that for hardship distributions that were made in the second half of 2018, plans may continue to enforce a six-month suspension that extends past January 1, 2019, but plans are not required to do so and could end the suspension January 1, 2019.

- **Expanded Sources for Hardship Distributions.** The proposed regulations implement the expanded contribution sources available for hardship distributions as provided in the Budget Act. But the preamble to the proposed regulations also states that plans may continue to limit the contribution sources available for hardship distributions, including earnings on those distributions. As a result, plans need not make all possible contribution sources available for distribution and may restrict the sources available under a plan to a subset of all permissible contribution sources. The preamble also verifies that safe harbor matching or nonelective contributions made under Code section 401(k)(13) may be made available for hardship distributions because these contributions are subject to the same distribution limitations applicable to QNECs and QMACs.
- **403(b) Plans May Not Distribute Earnings on Deferrals or Custodial Account QNECs and QMACs for Hardships**. The hardship distribution rules for 403(b) plans are generally the same for 401(k) plans. However, the preamble points out that Code section 403(b)(11) was not amended by the Budget Act to allow for hardship distribution of income attributable to section 403(b) elective deferrals. As a result, earnings on 403(b) elective deferrals continue to be ineligible for distribution on account of hardship. In addition, the IRS points out that QNECs and QMACs in a section 403(b) plan that are held in a custodial account continue to be ineligible for distribution on account of hardship, but QNECs and QMACs in a section 403(b) plan that are not in a custodial account may be distributed on account of hardship.
- **Certain Hardships Incurred by a Primary Beneficiary.** The current hardship distribution safe harbors allow a participant to take a hardship if their dependent incurs a qualifying medical, educational, or funeral expense. The proposed regulations would add the participant's primary beneficiary under the plan as an individual for whom qualifying medical, educational, and funeral expenses may be incurred as well. This provision has been permitted since the Pension Protection Act was enacted in 2006, in accordance with Section III of Notice 2007-07, but had not been included previously in the text of the hardship regulations.

- **Casualty Loss Safe Harbor Restored to Disregard Changes Made by TCJA.** The proposed regulations modify the hardship safe harbor relating to damage to a principal residence that would qualify for a casualty deduction under section 165 to disregard the new limitations on deductibility for only presidentially declared disasters added to section 165 by the TCJA and restore this safe harbor to the pre-TCJA provision. Additionally, the IRS has provided that plans may be amended to conform to the practice of the plan, including retroactively to January 1, 2018, if the plan provided hardship distributions for non-presidentially declared casualty related losses in 2018 (see discussion below concerning amendment dates).
- **New Safe Harbor for Natural Disasters.** The proposed regulations add new type of expense to the existing list of safe harbors for expenses incurred as a result of certain natural disasters. The preamble provides that the intent is "to eliminate any delay or uncertainty concerning access to plan funds following a disaster that occurs in an area designated by the Federal Emergency Management Agency (FEMA) for individual assistance." Plans may allow for the new safe harbor effective anytime after January 1, 2018, if the plan is properly amended (see discussion below concerning amendment dates).
- **Relief for Victims of Hurricanes Florence and Michael.** The preamble to the proposed regulations also extends the relief provided after Hurricane Maria and the California wildfires to similarly situated victims of Hurricanes Florence and Michael through March 15, 2019 (see discussion below concerning amendment dates).

Plan Amendments

The IRS expects that plan sponsors will need to amend their plan's hardship provisions if the proposed regulations become final. Given the 60-day comment period before the proposed regulations could become final, the earliest plan amendment deadline to conform to the required provisions of final regulations would be December 31, 2020, for calendar year plans. But since the revised hardship distribution regulations are provided in proposed form, there is no current required deadline to amend plans for those provisions. However, the preamble points out that if the regulations become final, Rev. Proc. 2016-37 provides that for individually designed, non-governmental plans, the deadline for amending the 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 described in section 9 of Rev. Proc. 2016-37 that includes the change.

The preamble further states that when the regulations become final, "all amendments that relate to the final regulations will have the same amendment deadline." However, some plans sponsors may need or desire to amend their plans earlier and before the regulations, and the amendment deadline, become final. For plans that provided relief for hurricane and wildfire victims in 2017, the previously published deadline for amending a plan for any amendments needed to allow for that relief (i.e., to allow for hardships or provide loans) is December 31, 2018, for calendar year plans.

Also, Rev. Proc. 2016-37 provides that for discretionary amendments to individually designed, non-governmental plans, “the plan amendment deadline is the end of the plan year in which the plan amendment is operationally put into effect. An amendment is operationally put into effect when the plan is administered in a manner consistent with the intended plan amendment (rather than existing plan terms).” Accordingly, to the extent a plan puts into effect any optional provision of the proposed regulations in 2019, the plan may need to be amended by December 31, 2019, for calendar year plans to reflect that provision. Further, if a plan has been operated in accordance with the casualty loss deduction safe harbor that was in place prior to changes made to Code section 165 by TCJA in 2018, or wishes to adopt the new natural disaster safe harbor for any part of 2018, an amendment may be required by December 31, 2018, for calendar year plans.