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Tax Code Changes Require Examination of Hardship Withdrawals

Hardship withdrawals from 401(k) plans have been impacted by the recent legislative enactments revising the Internal Revenue Code (the "Code"). The Tax Cuts and Jobs Act, signed into law in late 2017, indirectly limited the scope of safe harbor hardship withdrawals arising from casualty losses and extended the hurricane distribution rights granted by previous legislation to victims of certain other natural disasters. (See our prior blog post about the TCJA changes here.) The Bipartisan Budget Act of 2018, enacted in early February this year, eased some hardship distribution requirements and extended the favorable distribution options that the TCJA had given to the natural disaster victims to victims of certain wildfire disasters. (See our prior blog post about the Budget Act changes here.)

As a result of these Code changes, many 401(k) plans may need plan amendments to either bring them into compliance with TCJA and the Budget Act, offer the distribution opportunities now permitted following this legislation, or comply with regulations implementing these provisions that have yet to be written. The deadline for adopting these amendments may not be until December 31, 2019, or later and some plans may not require amendments at all.

However, plan sponsors and administrators should not wait until 2019 to ensure they are complying with TCJA and the Budget Act in allowing hardship withdrawals from qualified plans. The Code allows 401(k) plans to make hardship distributions to participants who experience an immediate and heavy financial need. In the 401(k) regulations, 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. Plan sponsors may allow hardship distributions for any of these six reasons without conducting 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.

In light of TCJA, however, plan sponsors that have limited their hardship distributions to the safe harbors now must change their hardship distribution processes for casualty-related home repair expenses, due to an indirect change in Code section 165. These hardship distributions are now limited to home repair expenses caused by presidentially declared disasters only.

Treasury Regulation Section 1.401(k)-1(d)(3)(iii)(B)(6) provides 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."
TCJA did not directly amend the 401(k) hardship distribution options, but it did change Code Section 165 on which the home repair expense hardship safe harbor relies. The change limits the types of casualty losses that will meet that hardship safe harbor.
Before TCJA, Code Section 165 covered a wide range of casualty losses. Revisions to that Code section made by TCJA now limit casualty losses to those attributable to a presidentially declared disaster, such as a hurricane, flood, or wildfire. It is unclear if the effect to the casualty-related home repair safe-harbor hardship was deliberate, considered and accepted, or merely an unintended consequence of the broader tax reform policy goals of TCJA.
The real consequence of the enacted change, however, is that administrators of 401(k) plans that rely exclusively on the safe-harbor reasons for hardship distributions may no longer make those distributions for casualty-related home repair expenses that are not attributable to presidentially declared disasters. Plans could be amended to allow administrators to make non-safe-harbor hardship distributions, including for home repair expenses arising from casualties that are not presidentially declared disasters. But this provision would require the plan administrator to make an independent assessment of the facts and circumstances to determine if the participant has an immediate and heavy financial need. Plans that do allow the plan administrator to make hardship withdrawals beyond the safe harbors must independently determine whether a casualty-related home repair expenses not caused by a presidentially declared disaster has caused an immediate and heavy financial need.
Another aspect of the 401(k) hardship distribution regulation requires plans allowing these distributions to suspend participants who take a hardship distribution from making salary deferrals for 6 months after the distribution. As part of the hardship distribution revisions enacted in the Budget Act, Congress directed the IRS to remove this 6-month suspension requirement from the regulation.
The IRS may clarify the casualty-related home repair expense safe harbor when it revises the regulation as directed by Congress, or it may not. So far, regulators have been reticent in forecasting what the tax reform regulations may provide.
And speaking of removal of the 6-month suspension requirement, some plan sponsors have contemplated whether they can continue to keep this suspension requirement after the change mandated by the Budget Act becomes effective in 2019. Representatives from the IRS have reportedly opined at conferences that if a plan were to maintain a deferral suspension provision, it would be a benefit, right, or feature that must be tested to demonstrate that it did not impermissibly discriminate in favor of highly compensated employees.
IRS personnel usually preface their comments at conferences by stating that their words are their own and they are not speaking on behalf of the IRS or the Treasury Department. Nevertheless, these comments provide some insight into how the IRS might view a plan that kept its 6-month suspension provision if it were no longer required under the regulation.

Action required now

As a result of the changes enacted by TCJA and the Budget Act, sponsors and administrators of 401(k) plans need to act now to ensure that their plans remain in compliance, even if the required deadline for adopting plan amendments may seem far off.

The above is excerpted from an article prepared for publication in the July 2018 issue of BLR's newsletter, "The 401(k) Handbook."