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SKAPARS & ASSOCIATES, P.C.

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Client Alert

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JUST RELEASED IRS GUIDANCE ON HARDSHIP DISTRIBUTIONS

INSIDE THIS ISSUE:

In our Client Alert earlier this month [*click here to access*], we alerted you to certain changes made by two Acts of Congress—the Tax Cuts & Jobs Act ("TCJA") of 2017 and the Bipartisan Budget Act ("BBA") of 2018—to hardship distribution rules affecting employer defined contribution retirement plans (primarily 401(k) and 403(b) plans). As we noted there, although the effective dates for some of those changes were fast approaching (and some had already passed), a number of questions still remained unanswered because the Internal Revenue Service ("IRS") had not then yet issued the necessary guidance. Finally, on November 9, 2018, the U.S. Department of Treasury and IRS did release such guidance, in the form of proposed regulations ("Proposed Regulations," which were published at 83 Fed. Reg. 56763 (11/14/2018)). We believe that affected employers and other interested parties will find most of this guidance welcome and still timely enough for appropriate plan design changes to be made for 2019 and participants to be timely notified. The highlights of the Proposed Regulations are discussed below.

Key Provisions of the Proposed Regulations

As background to the changes made by the Proposed Regulations, the current rules, set forth in final 401(k) regulations issued in 2004, provide that a distribution is made on account of hardship—which might be the only way in which an active employee under age 59-1/2 can receive a distribution from his or her 401(k) or 403(b) plan—only if both of the following requirements are met: (i) the distribution is made on account of an "immediate and heavy financial need"; and (ii) the distribution does not exceed the "amount necessary" to satisfy that financial need. For each of these two requirements, the

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regulations permit the use of either a "general" standard (based on all facts and circumstances) or a "safe harbor" standard (under which a participant is "deemed" to satisfy the applicable requirement). Plan sponsors have often chosen in their plan documents the "safe harbor" approach under each prong because it is easier to administer and less likely to result in fiduciary issues. As discussed below, the Proposed Regulations would significantly affect both of these prongs.

The general effective date of the Proposed Regulations is for plan years that begin on or after January 1, 2019, but as noted below various other optional and mandatory effective dates could apply instead. Moreover, the changes apply generally to hardship distributions under both 401(k) plans and under 403(b) alike, with some differences (noted below) regarding 403(b) plans. These changes can be expected to generally simplify plan administration and expand the scope of hardship distributions. They include the following:

1. *Earnings Included.* Plans will now be allowed to make hardship distributions from all earnings on elective deferrals (pre-tax or Roth), whereas currently only pre-1989 earnings were eligible.
2. *QNECs, QMACs, Safe Harbor Contributions and Earnings on Such Included.* Plans will now be allowed to make hardship distributions from qualified nonelective contributions ("QNECs"), qualified matching contributions ("QMACs"), safe harbor contributions and earnings on any of them.
3. *Elimination of Six-Month Suspension.* Plans will no longer be required (or permitted) to suspend a participant from making employee deferrals for at least six months after taking a hardship distribution, which previously was required.
4. *Plan Loan Requirement Eliminated.* Plans will no longer need to require participants to take out all available plan loans before obtaining a hardship distribution.
5. *TCJA Restriction on Casualty Losses Ignored.* The Proposed Regulations would clarify that, for any hardship distribution related to damage to a principal residence that would qualify for a casualty loss deduction made on or after January 1, 2018, the TCJA restriction that the loss must be attributable to a federally declared disaster does not apply (and thus can be ignored). This corrects an apparently inadvertent consequence of the TCJA restriction.
6. *New Safe Harbor for Certain Disaster Expenses*. A new (seventh) safe-harbor hardship expense would be added for expenses or losses (including lost income) incurred due to a federally

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declared disaster if the employee's principal residence or principal place of employment is in an area designated by the Federal Emergency Management Agency ("FEMA") as eligible for individual assistance. In the past, the IRS issued individual announcements for this purpose, as it did recently for Hurricane Maria and the 2017 California Wildfires, which the preamble to the Proposed Regulations indicates would also be available for Hurricanes Florence and Michael though March 15, 2019. The addition of this general safe harbor should expedite availability of plan funds for future disasters.

7. *Clean-Up Revision Regarding "Primary Beneficiary Under the Plan."* As a clean-up revision of a rule already in effect from prior legislation and IRS guidance (but not formally made part of the regulations), a participant's "primary beneficiary under the Plan" is added as an individual for whom qualifying medical, educational and funeral expenses may be incurred under the hardship safe-harbors.

Complete Revision of "Amount Necessary" Requirement

Under current regulations, the "safe harbor" approach for the second ("amount necessary") prong for qualifying for a hardship distribution (discussed above in the **Key Provisions** section) requires that the following two conditions be satisfied in order for the distribution to be "deemed" to be "necessary": (i) that the participant has first obtained all available *loans* and *distributions* from all qualified (and non-qualified) plans of the employer; and (ii) that the participant is prohibited from making elective deferrals (or employee contributions) under any plan of the employer for the six-month period immediately following the hardship distribution. Because of the changes discussed in Item 3 and 4 of the **Key Provisions** section above, the only remaining requirement of this safe harbor would have been that the participant receive all available distributions under the employer's plans before taking a hardship. Instead of leaving the safe harbor so reduced, the Proposed Regulations completely eliminate it, together with the general "facts and circumstances" alternative standard, and replace them with the following single new standard with the following three requirements to meet the "amount necessary" prong:

1. That the distribution may not exceed the amount of the participant's financial need (plus anticipated taxes and penalties the participant would incur from the distribution);
2. That the participant must have obtained all other available *distributions* (but not loans) under the employer's retirement plans; and

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3. That the participant must represent, in writing (which can be electronically), that he or she has insufficient cash or liquid assets to satisfy the financial need. The Proposed Regulations make clear that the plan administrator is entitled to rely on the participant's written representation regarding this item, but only to the extent that it does not have actual knowledge to the contrary.

This new standard is generally effective for hardship distributions made in plan years beginning on or after January 1, 2019. The Proposed Regulations specifically provide that a plan may add additional conditions for distributions made on or after January 1, 2019 (such as the "loan first" requirement, making its elimination essentially optional), but may not impose the "six-month suspension" for distributions made after January 1, 2020 (making its removal mandatory as of that date). A participant's certification is not required until January 1, 2020, making it essentially optional in 2019.

Section 403(b) Plan Changes

As mentioned, the changes made by the Proposed Regulations applicable to 401(k) plans would also apply to 403(b) plans, with the following exceptions:

- Earnings on 403(b) deferrals remain ineligible for hardship distributions (since the BBA did not amend the statutory bar on such distributions); and
- QNECs and QMACs held in a *custodial account* in a 403(b) plan remain ineligible for hardship distributions, although QNECs and QMACs that are not held in such accounts may be so distributed.

Plan Sponsor Design Decisions and Plan Amendments

If adopted as proposed, the Proposed Regulations make clear that, for any of the changes required or permitted by them, plan amendments will be required by a uniform date for all such changes, which will not be before the end of the second calendar year that begins after the issuance of the "Required Amendments List" by the IRS listing such changes. Since no such List has been issued yet, plan sponsors will have at least until December 31, 2021 to complete such amendments. However, plan sponsors will need to make a number of decisions regarding their choices and the effective dates of the optional and mandatory changes provided pursuant to the Proposed Regulations discussed above well before the amendment deadline and will need to keep clear track of those decisions both for proper plan administration and the eventual adoption

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of plan amendments.

Most critical will be the following two mandatory changes, which must be effective no later than for distributions made on or after January 1, 2020: (i) that plans can no longer impose the six-month suspension of employee deferrals or contributions following a hardship distribution; and (ii) that plan administrators must begin obtaining representations from each affected participant that he or she does not have any available cash or other liquid assets to satisfy the hardship. Both of these changes, however, could be made effective as early as January 1, 2019 (for calendar year plans). The Proposed Regulations also make clear that if desired the removal of the six-month suspension provision could be applied to hardship distributions made in the last half of 2018 (for calendar year plans), e.g., ending all suspensions on January 1, 2019, or the plan sponsor could choose to let the suspensions continue on such 2018 distributions for the full six months. Plan sponsors could also choose some other uniform date in 2019 for the suspension rule to be removed, which would make sense for such plans if the January 1, 2019 date is too early to implement administratively.

Since the other Proposed Regulations changes are essentially optional, a plan sponsor might simply decide not to take advantage of any or all of those other, more liberalizing hardship distribution rule changes, e.g., by leaving in to some later date (or indefinitely) current restrictions on using QNECS, QMACs, safe harbor contributions, or earnings on any of them or on post-1988 elective deferrals, or by continuing to require that all other plan loans be used first.

Those plan sponsors that might have continued to apply the casualty loss safe harbor under the pre-TCJA rules for 2018 (see Item 5 the **Key Provisions** section above) can continue to do so, with no plan administrative changes necessary. If a different approach was taken, the plan sponsor may now revert back to prior practice if it so chooses.

Now that the IRS guidance, by way of the Proposed Regulations, has been issued, plan sponsors of plans containing hardship distributions should expect to be contacted (or updated if previously already contacted) soon regarding their choices applicable to them under such guidance by the sponsors of their pre-approved (prototype or volume submitter) 401(k) plans or the third party administrators of such plans or 403(b) plans. Importantly, however, such plan sponsors will want to notify participants regarding the choices they make for the plan, presumably before the end of

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2018 if there are changes in the plan rules effective as of January 1, 2019.

Please let us know (e.g., by calling us at 508-785-0250) if we can be of any assistance regarding those choices or regarding any individually designed plans that you maintain that might be affected.

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