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IRS Issues Proposed Regulations on Hardship Distributions

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Just in time for 2019, the IRS has complied with a directive it was given by Congress in the Bipartisan Budget Act of 2018 (BBA 2018) and provided needed guidance on changes to 401(k) hardship withdrawal rules. These changes increase a participant's access to hardship withdrawals and eliminate some burdensome administrative requirements. The guidance was issued in the form of proposed regulations. However, given the need 401(k) plan sponsors have to address these issues, it is reasonable to assume that the final regulations will not change much. Below is a summary of the guidance.

Deemed Immediate and Heavy Financial Need Safe Harbor

In determining whether a participant has incurred a hardship that would permit a withdrawal from a 401(k) plan, most plans follow the IRS safe harbor rules for determining what constitutes a deemed immediate and financial need. The newly proposed regulations modify this safe harbor list of expenses by:

- adding "primary beneficiary under the plan" as an individual for whom qualifying medical, educational, and funeral expenses may be incurred. This updates the regulations to include a change made by the Pension Protection Act of 2006 that the IRS did not address in previous guidance.
- modifying the expense listed in existing regulations that relates to damage to a principal residence that would qualify for a casualty deduction under Code Section 165 to eliminate, for this purpose, the new limitations to casualty loss deduction rules added by the Tax Cuts and Jobs Act, which required that the loss be attributable to a federally declared disaster.
- adding a new type of expense to the list relating to expenses and losses incurred as a result of certain disasters if the participant's principal residence or principal place of employment is in a federally declared disaster area.

Special applicability rule. Under a special applicability provision, the revised list of safe harbor expenses may be applied to distributions made on or after a date that is as early as January 1, 2018.

Distribution Necessary to Satisfy Financial Need Safe Harbor

Most 401(k) plans follow the IRS safe harbor rules for determining whether a distribution is necessary to satisfy the participant's financial need rather than relying on the more complicated facts and circumstances test. Before 2019, IRS guidance provided that plans using this safe harbor had to:

- require a participant first take out any plan loan that was available, and
- suspend 401(k) contributions for a period of 6 months after a participant's hardship withdrawal.

BBA 2018 specifically instructs the IRS to eliminate these two requirements from the safe harbor standard. The IRS responded to this directive by replacing the safe harbor and the facts and circumstances tests with one general standard for determining whether a distribution is necessary to satisfy a participant's financial need. Under this new general standard:

- a hardship distribution may not exceed the amount of an employee's need (including any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution);
- the employee must have obtained other available distributions under the employer's plans; and
- the employee must show that he/she has insufficient cash or other liquid assets to satisfy the financial need. A plan administrator may rely on such representation unless the plan administrator has actual knowledge to the contrary. The requirement to obtain this representation only applies to a distribution made on or after January 1, 2020.

Further information on suspensions – Although BBA 2018 makes the elimination of the 6-month hardship suspension effective January 1, 2019, the IRS clearly recognizes the administrative burden that some plans will face to implement system changes. Therefore, the IRS provides plan sponsors some flexibility in implementing the elimination of hardship suspensions as follows:

- Plans may be amended to eliminate hardship suspensions on or after January 1, 2019.
- The plan amendment may provide that all suspensions be immediately lifted (including for participants whose hardship suspension began in the second half of 2018). Alternatively, a plan may require that participants under a 6-month suspension have to complete that suspension period.
- All plans must eliminate the 6-month suspension by January 1, 2020.

Expanded Sources for Hardship Distributions

The proposed regulations expand the sources of contributions that a plan may make available for a hardship withdrawal. After 2019, the amounts available may include QNECs, QMACs, safe harbor contributions, and earnings on all amounts available (including earnings on elective deferrals), regardless of when contributed or earned. This expansion of sources of funds available for hardship withdrawal is ***not*** a requirement. Plan sponsors may want to continue to limit the type of contributions available and whether earnings on those contributions are included.

403(b) Plans

The IRS generally extends these new hardship rules to 403(b) plans while noting that BBA 2018 did not actually amend Section 403(b)(11). Since Congress did not change the 403(b) plan rules, the IRS takes the position it has no authority to make certain changes to 403(b) plan rules. This results in a couple of operational differences between 401(k) and 403(b) plans with respect to these hardship changes:

- Income attributable to 403(b) plans continues to be ineligible for hardship withdrawals; and
- QNECs and QMACs that are held in a custodial account are not eligible for hardship withdrawal.

Applicability Dates

The proposed regulations generally apply to distributions made in plan years beginning after December 31, 2018. Certain special applicability rules are discussed above for (1) the safe harbor list of expenses and (2) suspensions.

The elimination of suspensions is the only required change made by these regulations and it must be done by January 1, 2020. The other rules that expand access to hardship withdrawals are optional provisions the plan sponsor can choose to change or leave as they are.

Plan Amendments

The IRS expects that if the proposed regulations are finalized as they have been proposed, plan sponsors will need to amend their plans' hardship distribution provisions. Revenue Procedure 2016-37 specifies the deadline for amending a disqualifying provision. For example, for an individually designed plan that is not a governmental plan, 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 that includes the change. A plan provision that is not a disqualifying provision, but is integrally related to a plan provision that is a disqualifying provision, may be amended by the same deadline applicable to a disqualifying provision. The annual Required Amendments List is generally issued each December.

A plan amendment that is related to the final regulations, but does not contain a disqualifying provision, including a plan amendment reflecting (1) the change to Code Section 165 (relating to casualty losses) or (2) the addition of the new safe harbor expense (relating to expenses incurred as a result of certain federally declared disasters), will be treated as integrally related to a disqualifying provision. Therefore, all amendments that relate to the final regulations will have the same amendment deadline.

Proposed Regulations, Subject to Change

This IRS guidance is in the form of **proposed** regulations that are subject to change. The IRS has requested public comments on the proposed regulations and will schedule a public hearing, if requested in writing by any person that timely submits written comments.

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