



Legislation Impacts Hardship Withdrawals and Loans under Qualified Retirement Plans

The Tax Cuts and Jobs Act of 2017 (Tax Act) and the Bipartisan Budget Act of 2018 (Budget Act) include changes to certain rules relating to hardship withdrawals and plan loans under qualified retirement plans. Some of these rules are effective now, while others are effective in 2019. Practitioners and plan sponsors will need to make important decisions on how plans should comply with the new rules. Unfortunately, clarification of some of the new rules is necessary for these decisions to be made.

In this Alert, we describe the recent legislative changes affecting hardship withdrawals and plan loans and some of the issues plan sponsors and practitioners must confront. Topics include:

- Tax Act changes affecting qualified retirement plans, including “safe harbor” hardship withdrawals for casualty losses and the extension of the rollover period for plan loan offsets upon termination of employment;
- Budget Act changes to the hardship withdrawal rules; and
- The impact of the Tax Act and Budget Act rules on 403(b) plans.

Tax Act changes affecting qualified retirement plans

While the Tax Act did not have a significant impact on qualified retirement plans, two changes raise important issues for plan sponsors, participants and practitioners.

Revisions to the rules for casualty loss deduction under Code §165 affect “safe harbor” hardship withdrawals

Effective January 1, 2018, the Tax Act changed the rules for casualty loss deductions under Code §165. The definition now requires that, in order to qualify for a casualty loss deduction, a person’s principal residence must be located in a federally declared disaster area. This change in the casualty loss deduction rules under Code §165 may indirectly affect participants in 401(k) plans because one of the six “safe harbor” hardship withdrawal events for determining

“immediate and heavy financial need” is tied to Code §165.

Treas. Reg. §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 Code §165 (determined without regard to whether the loss exceeds 10% of adjusted gross income).” With the Tax Act’s amendment of Code §165, the ability to receive hardship withdrawals under the “safe harbor” casualty event would appear to be restricted based on the location of the casualty loss.

ASC Insight: ASC believes that the Tax Act’s impact on safe harbor hardship withdrawals was unintentional. However, until Congress makes a technical correction to the law or the IRS issues clarifying guidance, plan sponsors should take a conservative approach to granting hardship distributions under the casualty loss safe harbor standard.

With respect to plan document amendments to reflect the change under Code §165, most plan documents, such as the ASC 401(k) plan documents, address the safe harbor hardship withdrawal casualty event by incorporating the regulatory language as set forth above. Although amendments to the plan appear unnecessary, plan sponsors should review and, if necessary, modify current hardship applications to ensure they are clear with respect to the new Code §165 deduction requirement. Hopefully, the IRS will provide guidance on the need for plan amendments.

Extension of the rollover period for plan loan offsets upon termination of employment

Effective January 1, 2018, the Tax Act extended the rollover period for qualified retirement plan participants who have had their accounts offset by the amount of an outstanding loan balance (plan loan offset) due to termination of employment or plan termination. Prior to the change,

terminated participants had 60 days to rollover (to an IRA or another eligible retirement plan) a plan loan offset to avoid taxation and possible early withdrawal penalties.

A participant now has until the due date (including extensions) for the filing of the participant's federal income tax return for the year of the plan loan offset to complete the rollover.

ASC Insight: Plan sponsors should provide an updated Special Tax Notice Regarding Plan Distributions (i.e., 402(f) Notice) to reflect the extended rollover period for plan loan offsets. (ASC has updated the 402(f) Notice on the DGEM Download page.)

The change also raises other issues for plan sponsors and participants, including reporting and other administrative issues. Hopefully, the IRS will also provide guidance on these matters.

Budget Act changes to the hardship withdrawal rules

The Budget Act made several significant changes to the hardship withdrawal rules. These changes are effective for plan years beginning on or after January 1, 2019.

ASC Insight: While the rules become operationally effective for the 2019 plan year, plan sponsors do not need to execute plan amendments until the end of the 2019 plan year. Document providers, including mass submitters such as ASC, must decide whether to make interim amendments to plan documents BEFORE the 2019 plan year so that plan sponsors may make appropriate elections before they become operationally effective. As will be discussed below, there are a number of unanswered questions concerning the implementation of the Budget Act changes. If the IRS does not issue the guidance in a timely fashion, plan amendment drafters and plan sponsors are at a distinct disadvantage in anticipating the IRS guidance.

Hardship withdrawals allowed without first taking a loan from the plan

Under current regulatory rules, in order for a plan to allow a hardship withdrawal under the safe harbor hardship withdrawal rules for determining financial need, a participant must receive all distributions and loans from any plan maintained by the employer. Under the Budget Act, a distribution (including a hardship withdrawal under the financial need safe harbor rules) shall not be treated as failing to be made due to the hardship of an employee "solely because the employee does not take any available loan under the plan."

ASC Insight: The law does not apparently change the current regulatory requirement that a participant must receive all other available distributions from any plan maintained by employer before receiving a hardship distribution under the financial need safe harbor rule.

Elimination of the six-month suspension period for elective deferral contributions after a participant has taken a safe harbor hardship withdrawal

Current IRS regulations on the safe harbor hardship withdrawal rules for determining financial need include a requirement that a plan must prohibit a participant who receives a hardship withdrawal from making elective deferrals (and/or after-tax employee contributions) for at least a 6-month period. The Budget Act directs the IRS to remove this regulatory condition, effective for plan years beginning after December 31, 2018. However, the law also provides that the IRS has until one year after enactment of the Budget Act (i.e., February 9, 2019) to actually modify the regulations.

ASC Insight: The removal of the 6-month suspension requirement raises a number of issues. Although most plan sponsors will likely want to drop the 6-month suspension requirement from their plans, it is uncertain whether the change is mandatory or discretionary. Further, transition questions arise as to the actual application of the removal of the 6-month suspension requirement. For example, how does the removal of the rule affect participants who took a safe harbor hardship withdrawal during the last six months of 2018?

Clearly, we need IRS guidance on the removal of the 6-month suspension requirement. The concern is that, since the IRS has until February 8, 2019 to modify the regulations, the guidance will not be available before the effective date of the change.

The ability to take hardship withdrawals from QNEC, QMAC and earnings on elective deferral contributions

Under current rules, the maximum hardship withdrawal from a participant's elective deferral account is limited to a participant's aggregate elective deferrals under the plan. A hardship withdrawal may not include earnings on deferrals (except generally for separately-accounted for earnings credited as of December 31, 1988).

Under the Budget Act, in addition to elective deferrals, a plan may allow for hardship withdrawals from qualified nonelective employer contributions (QNECs), qualified matching contributions (QMACs) and earnings in such accounts (including post-1988 earnings on elective deferral contributions).

ASC Insight: Of all the changes made by the Tax Act and the Budget Act, the opening of available sources for hardship withdrawals is perhaps most problematic. Plan sponsors will need to decide if they would like to provide access to additional hardship withdrawal sources starting in the 2019 plan year. Access to earnings may solve the accounting problem under current rules; however, making QNEC and QMAC accounts available may ultimately reduce the retirement savings for plan participants. Plan sponsors should carefully consider the decision to open up hardship distribution sources.

While plan sponsors are not required to execute conforming plan amendments until the end of the 2019 plan year, the rules can be operational before amendments are made. When amended, plan amendments will need to reflect plan operation and the effective date of the changes.

Practitioners will need to update administrative systems to accommodate the additional hardship withdrawal sources. The timing of the availability of this administrative functionality may prevent plan sponsors from immediately implementing the new rules.

The IRS must provide guidance in this area before plan sponsors and service providers can make decisions relating to the new rules. The impact on safe harbor 401(k) plans and qualified automatic contributions arrangements are still uncertain.

Impact on 403(b) Plans

While the impacts of certain law changes on 403(b) plans are relatively clear, others are not. The Tax Act changes (i.e., the changes in the rules for casualty loss hardship distributions and the plan loan offset rollover rules) should apply to 403(b) plans just as they apply to qualified retirement plans under Code §401(a).

On the other hand, the impact of the Budget Act changes to the hardship distribution rules is somewhat uncertain. This is because the Budget Act did not specifically change the statutory rules under Code §403(b) relating to hardship distributions. This is especially problematic for the expansion of sources (QNECs, QMACs and earnings) available for hardship distributions.

ASC Insight: ASC believes that Congress intended to apply the same changes to 403(b) plans as it did for 401(k) plans. Clarification of the Budget Act's applicability to 403(b) plans, either through a technical correction to the law or IRS guidance, is necessary.

Next Steps

Plan sponsors and service providers need to fully assess the impact of the new rules on their plans. As we have discussed, numerous issues need resolution and IRS guidance or legislative technical corrections will be needed to make informed decisions. ASC will keep you abreast of the latest developments.

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