



Proposed Amendments to the Hardship Distribution Regulations

On Friday, November 9, 2018, the IRS released proposed amendments to the hardship distribution regulations applicable to 401(k) plans (“Proposed Regulations”). These amendments reflect changes in the law under the Tax Cuts and Jobs Act of 2017 (“Tax Act”) and the Bipartisan Budget Act of 2018 (“Budget Act”). In addition, the regulations make other changes that reflect other laws and revise positions on regulatory requirements.

The Proposed Regulations “amend” current IRS regulations relating to hardship distributions. While the Proposed Regulations would not completely replace the hardship distribution regulations, the regulations would be changed substantially. The substantial changes include a complete rewrite of the distribution provisions under Treas. Reg. §1.401(k)-1(d) relating to the interpretation of the two requirements for a hardship distribution (i.e., a distribution is made on account of hardship only if the distribution is made on account of both (1) an immediate and heavy financial need of the employee and (2) is necessary to satisfy the financial need). Other changes are made to the regulations under Treas. Reg. §1.401(k) – 3 and Treas. Reg. §1.401(m) – 3 (relating to safe harbor plans), and Treas. Reg. §1.401(k) – 6 (relating to definitions).

The regulations generally take a pragmatic approach to the new hardship distribution rules. For example, while the Proposed Regulations are generally applicable for the 2019 plan year, they allow many of the rules to either be retroactively applied (e.g., the definition of casualty loss under Code §165) or not applied until the 2020 plan year (e.g., the application of the elimination of the 6-month suspension requirement).

ASC Insight: The effective/applicability rules under the Proposed Regulations are somewhat complicated. At the end of this ASC Alert, we provide a table reflecting the various effective/applicability dates.

Safe harbor list of hardship events. The Proposed Regulations completely revise the list of safe harbor hardship events for showing that a distribution is made on account of an immediate and heavy financial need. The changes include:

1. Adding “primary beneficiary under the plan” as an individual for whom qualifying medical, educational, and funeral expenses may be incurred.

ASC Insight: This change reflects the PPA change that allowed a hardship distribution on account of medical, educational and funeral expenses incurred by a “primary beneficiary.” Plans generally have already been amended to reflect this regulation.

2. Modifying the expense listed in Treas. Reg. §1.401(k)-1(d) (3)(iii)(B)(6) (relating to damage to a principal residence that would qualify for a casualty deduction under Code §165) to provide that for this purpose the new limitations in Code §165(h)(5) (added by §11044 of the Tax Act) do not apply.

ASC Insight: This is an important clarification. The Proposed Regulations allow plans to provide casualty loss hardship distributions under the standard that applied prior to the Tax Act (i.e., it is not necessary to meet the requirement under newly-added Code §165(h)(5) requiring the loss to be attributable to a federally declared disaster. In addition, the Proposed Regulations allow a plan to retroactively apply the regulatory casualty loss standard for 2018.

3. Adding a new type of expense to the list, relating to expenses incurred as a result of certain disasters.

ASC Insight: This is a new and very helpful addition to the list of hardship distribution events. The Proposed Regulations make it automatic that a hardship distribution for those in FEMA-designated areas is permissible when there is a major federally declared disaster (e.g., Hurricane Maria under Announcement 2017-15). There will no longer be a need to make interim amendments to allow these hardship distributions. Like the new rules for casualty losses, the Proposed Regulations allow a plan to retroactively apply the new disaster event for 2018.

Distribution necessary to satisfy financial need. The Proposed Regulations include revisions mandated by the Budget Act relating to the rules for determining whether a distribution is necessary to satisfy an immediate and heavy financial need by eliminating:

1. Any requirement that an employee be prohibited from making elective deferrals and after-tax employee contributions after receipt of a hardship distribution and eliminating the 6-month suspension requirement under the financial need safe harbor approach.

ASC Insight: These regulations reflect the elimination of the 6-month suspension rule. It is clear that no plan (safe harbor or not) may impose a suspension period on any hardship distributions taken on or after the first day of the 2020 plan year. Generally, this rule is effective for the 2019 plan year, meaning plans can immediately eliminate the 6-month suspension requirement. However, the regulations allow plans to wait until the 2020 plan year to comply with this requirement. This means that a plan may continue to apply suspensions for the 2019 plan year. With respect to participants who received a hardship distribution during the 2018 plan year, the plan may either continue to apply the current suspension or eliminate it as of the beginning of the 2019 plan year. Plan Sponsors will need to decide when and how to apply or to eliminate the 6-month suspension for hardship distributions prior to January 1, 2020 and operate their plans accordingly. Ultimately, a plan amendment will need to reflect the operational decisions.

2. Any requirement to take plan loans prior to obtaining a hardship distribution.

ASC Insight: The requirement to take a loan prior to a hardship is eliminated for all hardship distribution determinations (i.e., under the general facts and circumstances approach and the safe harbor approach). However, in another regulatory provision, the regulations specifically allow for a plan to include a requirement for a participant to take a loan as a condition of receiving a hardship distribution.

Facts and circumstances determination of financial need.

The Proposed Regulations eliminate the rules in current Treas. Reg. §1.401(k)-1(d)(3)(iv)(B) (under which the determination of whether a distribution is necessary to satisfy a financial need is based on all the relevant facts and circumstances) and provide one general standard for determining whether a distribution is necessary. Under this 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 represent that he or she has insufficient cash or other liquid assets to satisfy the financial need. A plan administrator may rely on such a representation unless the plan administrator has actual knowledge to the contrary.

ASC Insight: This is a significant change in the procedures necessary for a plan administrator to determine whether a distribution is necessary to satisfy a financial need based on all the relevant facts and circumstances. This is a much easier standard to apply since participant can self-certify that "he or she has insufficient cash or other liquid assets to satisfy the financial need." The prior standard was more extensive and required the Plan Administrator to ask employees about personal financial data, including amounts of other loans, balances of cash in bank accounts, and other assets. Plans can wait to apply the self-certification standard for distributions made after December 31, 2019.

This regulation also answers the question about whether participants must take available non-hardship distributions before receiving a hardship distribution. (They must!)

Expansion of sources for hardship distributions. The Proposed Regulations modify Treas. Reg. §1.401(k)-1(d)(3) to permit hardship distributions from 401(k) plans from elective deferrals, QNECs, QMACs, and earnings on these amounts, regardless of when contributed or earned. The regulations make clear that safe harbor plans (including QACAs) may also make hardship distributions from safe harbor sources.

ASC Insight: The regulations clarify that allowing hardship distributions from these sources is discretionary and a plan may restrict access to any particular source. This means that plans may, but are not required to, allow access to the newly available sources, starting with the 2019 plan year. Of course, a plan sponsor may decide to take a different approach at a later date.

Application to 403(b) plans. The Proposed Regulations GENERALLY apply to 403(b) plans. However, the statutory requirement that 403(b) plans cannot distribute earnings on elective deferrals, as required under Code §403(b)(11), continues to apply.

ASC Insight: This is a welcomed clarification as to the application of the new regulations to 403(b) plans. All of the options and rules under the new Code §401(k) regulations are available to 403(b) plans, except the ability to distribute earnings on elective deferrals. Without the law changing Code §403(b) (11), the IRS had no option to allow the distribution of earnings on elective deferrals.

The IRS did confirm in the preamble that the ability for 403(b) plans to make hardship distributions from the QNEC, QMAC and safe harbor plan sources is limited to annuity contracts under Code §403(b)(1) and does not apply to custodial accounts under Code §403(b)(7). Hardship is not a permissible distribution event for amounts in 403(b) custodial accounts, except for elective deferrals (not including earnings).

Plan Amendments. The preamble of the regulations indicates that plan amendments reflecting the Proposed Regulations will be necessary. However, it only discusses the timing of the amendments for individually designed plans (i.e, the amendments will be required for individually designed plans after the IRS lists the requirement in the Required Amendments List).

ASC Insight: The preamble discussion is not informative as to the timing of amendments for pre-approved plans. The Required Amendments List does not apply to pre-approved plans. Pre-approved plans are subject to the interim amendment requirements under the IRS procedures, which require interim amendments before similar amendments are necessary for individually designed plans. We will ask for additional guidance, but, most likely, an interim amendment will be necessary in 2019 for pre-approved defined contribution plans.

Employers will need to make operational decisions to implement changes under the Proposed Regulations prior to adopting a plan amendment. Plans will need to conform the plan amendments to their operation prior to the plan amendment. A Hardship Distribution Operational Checklist will be helpful in this regard.

With regard to plan amendments for pre-approved 403(b) plans, the rules for interim amendments are unclear. However, we believe the best approach will be for pre-approved 403(b) plan providers and their adopting employers to adopt interim amendments at the same time (likely during 2019) that 401(k) plan providers and adopting employers adopt interim amendments.

Comments on the Proposed Regulations. The IRS is soliciting comments on the Proposed Regulations. The comments are due within 60 days of the publication of the Proposed Regulations in the Federal Register.

ASC Insight: The IRS could revise the Proposed Regulations based on the comments that the IRS receives. Likely, the final regulations will not significantly change the Proposed Regulations. Hopefully, the final regulations (or at least the preamble to the final regulations) will provide additional clarifying guidance, especially with regard to the amendment timing for pre-approved plans.

Proposed Regulation Change	Effective/Applicability Dates
Safe harbor hardship events, including revised casualty loss event and the disaster relief event	May be made effective for distributions made on or after January 1, 2018.
Prohibition on the suspension of elective deferrals and after-tax employee contributions for <u>participants who receive hardship distributions on or after the first day of the 2019 plan year</u>	Generally, effective for plan years beginning after December 31, 2018. However, employers may decide to apply the prohibition on suspending elective deferrals and after-tax employee contributions only to a hardship distribution made on or after January 1, 2020. No plans may provide for a suspension on elective deferrals and after-tax employee contributions for hardship distributions made on or after January 1, 2020
Application of the prohibition on the suspension of elective deferrals and after-tax employee contributions for <u>participants who received hardship distributions prior to the first day of the 2019 plan year</u>	Employer may EITHER continue to apply the suspension on elective deferrals and after-tax employee contributions OR may discontinue the suspension on the first day of the 2019 plan year
Requiring participants to take available loans as a condition of receiving a hardship distribution	Employer may EITHER eliminate the need to take available loans as of the first day of the 2019 plan year OR continue to apply this as a condition of receiving a hardship distribution
New standard for facts and circumstances determination of financial need	Generally, effective for plan years beginning after December 31, 2018. However, the requirement that the plan administrator obtain an employee representation that he/she has insufficient cash or other liquid assets applies only for a hardship distribution made on or after January 1, 2020
Expansion of sources for hardship distributions	Generally, effective for plan years beginning after December 31, 2018
Application to 403(b) plans	Same effective/applicability dates as for 401(k) plans, except that 403(b) plans cannot allow for the distribution of earnings on elective deferrals
Plan amendments	For individually designed plans, amendments will be required after the IRS lists the requirements in the Required Amendments List. For pre-approved plans, the IRS provides no guidance, but interim amendments will likely be needed during the 2019 plan year

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