Client Alert

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IRS Proposes New Rules for Hardship Withdrawals

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Over the past several years, Congress has made certain changes to the rules that govern financial hardship withdrawals from 401(k) plans. A number of these changes override provisions in existing IRS regulations, and with several significant changes due to take effect next year, the IRS has proposed updated regulations to take these requirements into account. This alert will describe these changes and how the sponsors of 401(k) and 403(b) plans should be preparing for their implementation. Sponsors need to be considering how to implement these changes now, because they can go into effect as soon as January 1, 2019.

Background. Most 401(k) and 403(b) plans allow an active participant to withdraw his or her elective contributions to alleviate a financial hardship. The 2004 comprehensive regulations under Section 401(k) list six "safe harbor" categories of hardship expenses, such as medical care, certain casualty losses, and college tuition. These regulations also provide that an employee cannot qualify for a hardship withdrawal if he or she can satisfy the expenses through participant loans or other distributions available under the plan, and that an employee who takes a hardship withdrawal is prohibited from making elective contributions to the plan for a period of six months after the hardship withdrawal.

Since 2004, legislation has modified some of the hardship withdrawal rules. For example, the Pension Protection Act of 2006 permits hardship distributions to be made in the event of certain financial needs for a participant's beneficiary, and added a "qualified reservist distribution" that allows 401(k) contributions to be withdrawn by a reservist who has been called to active duty. The Heroes Earnings Assistance and Tax Relief Act of 2008 (the HEART Act) allows an individual who is performing service in the uniformed services to withdraw 401(k) contributions, but imposes a 6-month suspension on contributions for any individual who makes such a withdrawal.

The Tax Cuts and Jobs Act and the Bipartisan Budget Act of 2018 made significant changes to the rules governing hardship withdrawals and directed the IRS to modify these rules for plan years beginning on or after January 1, 2019. Specifically, the changes were to:

- Delete the 6-month suspension on contributions for a participant who takes a hardship withdrawal
- Allow qualified non-elective contributions (QNECs) and qualified matching contributions (QMACs) to be available for hardship withdrawals
- Allow earnings on 401(k) contributions, QNECs and QMACs to be available for hardship withdrawals
- Allow a hardship withdrawal to be taken even if a participant can obtain a loan under the plan; and
- Limit deductions for casualty losses to events that occur within a federally declared disaster area, which could have impacted hardship withdrawals because one of the "safe harbor" hardship events is damage to a participant's principal residence that qualifies for a casualty loss deduction.

The New Regulations. The main purpose behind the proposed regulations is to reflect the legislative changes described above. Under the proposed new regulations:

- For 2019 and future years, participants will be able to take a hardship distribution even if a loan under the plan is available.
- Participants will also be able to receive a hardship distribution from QNECs and QMACs, along with earnings on 401(k) deferrals.
- The suspension on deferrals after a hardship distribution will no longer be required (and in fact will be prohibited beginning in 2020).
- The safe harbor for withdrawals that would qualify for the casualty loss will continue to be permitted, even if a deduction for the loss is not allowed due to the changes made by the Tax Cuts and Jobs Act.

In addition to incorporating the provisions required by the legislation, the IRS took the opportunity to add a few unexpected items to the regulations:

- A seventh safe harbor hardship event was added. A hardship will include expenses and losses, including a loss of income, incurred as a result of a disaster declared by FEMA, as long as the participant's principal residence or principal place of employment was within the FEMA disaster area at the time of the disaster.
- The regulations will require an employee to represent that he or she he or she has insufficient cash or liquid assets to satisfy the financial need, and a plan administrator can rely on this representation absent actual knowledge to the contrary. This replaces the current rule which provides that the determination of whether a distribution is necessary to satisfy the financial need is based on the relevant facts and circumstances.

403(b) Plans. It's important to note that some of these changes do not apply to 403(b) plans. Although the hardship withdrawal rules for 403(b) plans generally follow the rules for 401(k) plans, there are some differences. The IRS stated that the statutory prohibition on the distribution of earnings from 403(b) contributions was not changed, so those amounts remain ineligible for a hardship distribution. Additionally, QNECs and QMACs held in a 403(b) plan custodial account remain ineligible for hardship withdrawals, but QNECs and QMACs that are not held in a custodial account can be distributed.

Effective Dates. Generally, the proposed rules are effective for plan years beginning after December 31, 2018. However, there are some exceptions:

- The changes related to distributions relating to casualty losses and for losses related to FEMA disasters may be applied to distributions made on or after January 1, 2018.
- For a participant who took a hardship withdrawal in the last six months of 2018, a plan can choose to eliminate the remainder of the suspension of deferrals that extends into 2019. For example, if a participant took a hardship withdrawal on October 15, 2018, the plan can either end the suspension on January 1, 2019, or allow it to extend for the entire six-month period until April 15, 2019 (as would be required under existing rules).
- For withdrawals on or after January 1, 2020, a plan can no longer enforce any suspension on deferrals for a participant who takes a hardship withdrawal.
- For withdrawals on or after January 1, 2020, a plan must obtain the representation from a participant who requests a hardship withdrawal that he or she does not have the necessary cash or liquid assets to satisfy the hardship. Obtaining this representation is optional before January 1, 2020.

Next Steps. All sponsors of 401(k) and 403(b) plans, whether they have individually-designed or prototype documents, should be working with their recordkeepers so that they can coordinate administration of the new rules starting on January 1 (for calendar year plans). Recordkeepers have had some time to prepare for some of the changes since the Bipartisan Budget Act was passed in February, so this process has probably been well underway. Still, sponsors have some decisions to make because not all of the provisions in the regulations are mandatory. For instance, 401(k) plans can still require a participant to take a loan before a hardship distribution and can limit hardship withdrawals to 401(k) contributions (and not the earnings on those contributions, or QNECs and QMACs). Plans can also choose to end hardship suspensions that extend into 2019 as soon as January 1, 2019.

Sponsors of individually-designed plans will need to adopt an amendment their plans to implement these changes, but the deadline for adopting this amendment is not immediate. Amendments of this nature are generally required by the end of the second calendar year beginning after the publication of the annual IRS Required Amendments List that includes the change, and this change was not included in the 2018 Required Amendments List. The IRS occasionally provides model amendments for sponsors to use, although we do not know if it will provide one for these regulations. Sponsors of prototype plans will also need to adopt an amendment that will be drafted by the provider of their prototype document. Again, the timing of this amendment will be well into the future.

If you also sponsor a non-qualified deferred compensation plan subject to Code Section 409A, you should review how the elimination of the six-month suspension affects your non-qualified plan. The rules in the existing 401(k) regulations require that upon a hardship withdrawal, all elective deferrals, including those made to a non-qualified plan, must be suspended. This will no longer be required by the 401(k) regulations, although the Section 409A regulations state that a cancellation of deferrals to a non-qualified plan after a hardship withdrawal is permitted, but not required. Non-qualified plans frequently reference the rules under the 401(k) plan, so the plan should be reviewed to determine how the change to the 401(k) plan will affect the non-qualified plan.

If you have any questions about these changes or how they may impact your plan, please contact John Burgess in Tampa at jburgess@slk-law.com, Eric Britton in Toledo at ebritton@slk-law.com, or Jim Culbreth in Charlotte at jculbreth@slk-law.com.