

IRS Issues Proposed Regulations Modifying Hardship Distribution Rules

BRYAN CARD

FEBRUARY, 2019



The new year brings significant changes to hardship distributions under Section 401(k) plans and Section 403(b) plans. Following the passage of the Bipartisan Budget Act (the "Act") in February 2018, the Internal Revenue Service (IRS) released proposed regulations in November 2018 which provide implementing guidance for the new rules and modifications made by the Act.

The hardship distribution changes are effective for distributions made in plan years beginning after December 31, 2018, unless otherwise specified. Final comments on the proposed implementing regulations were due on January 14, 2019, and final regulations should be issued later this year. In the meantime, plan sponsors should look to the proposed regulations for implementing guidance.

Most of the changes made by the Act and the proposed regulations apply to the safe harbor rules for hardship distributions, and many plans have adopted those changes because they provide better assurance of compliance with the hardship distribution standards.

Current Hardship Distribution Rules

Under Internal Revenue Code (the "Code") Section 401(k)(2)(B)(iv), an active participant facing a financial hardship may obtain a distribution of their elective deferrals without a distributable event. In order for a distribution to qualify as a hardship, the distribution must satisfy two requirements:

- (i) The distribution must be made on account of an immediate and heavy financial need; and
- (ii) The amount must be necessary to satisfy the financial need.

Determinations under both prongs of this test must be made on the basis of all relevant facts and circumstances, and in accordance with nondiscriminatory and objective standards set forth in the plan.

“Immediate and Heavy Financial Need” Prong

Facts and Circumstances Test

Whether a participant has an immediate and heavy financial need is determined based on all relevant facts and circumstances. For example, the need to pay for funeral expenses would qualify as an immediate and heavy financial need, but a distribution for the purchase of a television or a boat would not. Note that the proposed regulations and the Act did not modify the facts and circumstances test for this prong of the hardship distribution test.

Safe Harbor

Under existing regulations, the immediate and heavy financial need prong of the hardship distribution test is satisfied if the expense falls within one of the six categories that the IRS considers to be a “deemed immediate and heavy financial need.” These are as follows:

1. Expenses for medical care;
2. Costs directly related to the purchase of a principal residence for the participant;
3. Post-secondary education expenses for the participant, the participant’s spouse, child or dependents;
4. Payments necessary to prevent the eviction of the participant from the participant’s principal residence or foreclosure on the mortgage on that residence;
5. Funeral expenses for the participant’s deceased parent, spouse, child or dependents; and
6. Expenses for the repair of damage to the employee’s principal residence that would qualify for the casualty deduction under Section 165.

“Distribution Necessary to Satisfy Financial Need” Prong

Facts and Circumstances Test

Under the existing regulations, a distribution is not treated as necessary to satisfy an immediate and heavy financial need of a participant to the extent the need may be relieved from other resources that are reasonably available to the participant. In making this determination, the employer may rely on the participant’s representation (unless the employer has actual knowledge to the contrary) that the need cannot reasonably be relieved from various sources specified in the regulations (e.g., liquidation of participant’s assets, cessation of elective deferrals or participant contributions under the plan).

Safe Harbor

In order to meet the safe harbor test for determining whether the distribution is “necessary to satisfy the financial need,” the following three requirements must be met:

- (i) The distribution does not exceed the amount of a participant’s need;
- (ii) The participant has obtained all other currently available distributions (including distribution of ESOP dividends under Section 404(k), but not hardship distributions)

and nontaxable loans under the plan, and all other plans maintained by the employer;
and

- (iii) The participant is prohibited from making elective deferrals or contributions to the plan or any other plan maintained by the employer for at least six months after receipt of a hardship distribution.

Modifications to the “Deemed Immediate and Heavy Financial Need” Prong

Safe Harbor Hardship Distribution Event – Federally Declared Disaster

The proposed regulations added an additional category to the list of events deemed to constitute “immediate and heavy financial need.” That category is for expenses and losses incurred by a participant for a disaster declared by the Federal Emergency Management Agency (FEMA), provided that the participant’s principal place of residence or employment is in the area declared a disaster by FEMA.

Casualty Loss Expense

The Tax Cuts and Jobs Act of 2017 added Code Section 165(h)(5), which provides that for taxable years 2018 through 2025, the deduction for a personal casualty loss generally is available only to the extent the loss is attributable to a nationally declared disaster. The proposed regulations clarified that the safe harbor withdrawal event allows for distributions for expenses for the repair of damage to the participant’s principal residence if those expenses would otherwise qualify for the casualty deduction under Code Section 165, thus indicating that the withdrawal event is not dependent on whether the loss is incurred due to a federally declared disaster.

Primary Beneficiary

The proposed regulations modified the safe harbor events for medical expenses, post-secondary education expenses and funeral expenses to include certain medical, educational and funeral expenses paid on behalf of a “primary beneficiary” under the plan (i.e., an individual who is named as a beneficiary under the plan and has an unconditional right, upon the death of the participant, to all or a portion of the participant’s account balance under the plan). The Pension Protection Act of 2006 previously provided hardship distributions on behalf of a primary beneficiary for these specified safe harbor events. Therefore, the proposed regulations do not make any substantive changes to hardship distributions, but rather make the regulations consistent with the law.

Relief for Victims of Hurricanes Michael and Florence

Announcement [2017-15](#) was a form of relief issued by the IRS in 2017 that allowed participants of tax-qualified employer plans to obtain a hardship distribution for needs arising from Hurricane Maria or the California Wildfires, provided that the participant’s principal place of residence was located in those disaster areas. This relief also relaxed certain procedural requirements for obtaining a hardship distribution. For example, plan administrators were permitted to rely upon representations from the participant as to the financial need and the amount of the financial need.

The preamble to the proposed regulations extended the relief provided under Announcement 2017-15 to similarly situated victims of Hurricanes Michael and Florence, except that the “Incident Dates” are as specified by FEMA for these 2018 hurricanes and relief is provided through March 15, 2019. Any necessary amendments must be made no later than the deadline for plan amendments set forth in the preamble to the proposed regulations.

Effective Date for Modifications Under the “Immediate and Heavy Financial Need” Prong

The modifications made to the safe harbor expenses may be applied to distributions occurring as early as January 1, 2018.

Modifications to the “Distribution Necessary to Satisfy the Financial Need” Prong

The proposed regulations revamped this prong by eliminating both the facts and circumstances test and the safe harbor test, and replacing it with just one general standard. Under the new standard, a distribution may be treated as necessary to satisfy an immediate and heavy financial need if the following three requirements are met:

- (i) The distribution does not exceed the amount of a participant’s need;
- (ii) The participant has obtained all other currently available distributions (including distributions of ESOP dividends under section 404(k), but not hardship distributions) under the plan and all other plans of deferred compensation (whether qualified or nonqualified) maintained by the employer; and
- (iii) For a distribution that is made on or after January 1, 2020, the participant must represent (in writing, by an electronic medium or in such other form as may be prescribed by the Commissioner) that he or she has insufficient cash or other liquid assets to satisfy the need. The plan administrator may rely on the participant’s representation unless the plan administrator has actual knowledge to the contrary.

Under this prong of the test, plans must discontinue the use of the facts and circumstances test and the safe harbor test, and implement the modified general standard by January 1, 2020, but may begin utilizing this standard on January 1, 2019. However, the proposed regulations specify that a plan generally may stipulate additional conditions to obtain a hardship distribution (e.g., the requirement to obtain loans).

Elimination of the Six-Month Deferral Suspension

Effective January 1, 2020, plans must cease suspension of elective deferrals or participant contributions following a hardship distribution. However, the elimination of deferral suspensions may be applied as of the first day of the first plan year beginning after December 31, 2018, even if the distributions were made in the prior plan year.

Elimination of Loan Requirement

Effective January 1, 2019, a plan participant will no longer be required to first take out a loan before receiving a hardship distribution. However, plan sponsors may choose to continue to require participants to obtain all nontaxable loans under the plan.

Expanded Sources for Hardship Distributions (QNECs, QMACs and Earnings)

Effective January 1, 2019, accounts available for withdrawal for a hardship distribution will include qualified nonelective contributions (QNECs), qualified matching contributions (QMACs) and earnings (including earnings on elective deferrals, QNECs and QMACs). However, plan sponsors are not required to expand the sources available for a hardship distribution.

It should be noted that the Act did not amend Section 403(b) (11); therefore, income attributable to Section 403(b) elective deferrals continues to be ineligible for distribution on account of hardship. In addition, QNECs and QMACs in a Section 403(b) plan that are in a custodial account are not eligible for withdrawal on account of hardship; however, QNECs and QMACs in a Section 403(b) plan not in a custodial account *are* eligible for withdrawal on account of hardship.

Plan Amendments

If the regulations are finalized, the Treasury Department and IRS anticipate that plan sponsors will need to amend a plan's hardship distribution provisions. The preamble to the proposed regulations states that [Rev. Proc. 2016-37](#) provides the applicable deadline for amending a disqualifying provision (i.e., the end of the second calendar year that begins after the issuance of the Required Amendments List described in section 9 of Rev. Proc. 2016-37 that includes the change). The preamble also states that a plan amendment that relates to the final regulations will be treated as an amendment to correct a disqualifying provision, even if it does not; therefore, all amendments that relate to the final regulations will have the same deadline.

Conclusion

In response to these proposed regulations, plan administrators should determine which changes will need to be made to ensure compliance with the mandatory provisions prescribed by the Act and the proposed regulations. Plan administrators should also review the optional modifications and implement those they believe will be most beneficial for administrative efficiency and convenience, as well as the needs of their plan participants. Once the IRS issues the final regulations, plan administrators should then determine if any further changes to the plan are necessary.