

Publications

Labor and Employment Alert: Treasury Department Releases Proposed Regulations Addressing Awaited Guidance On Hardship Distributions

Related Professionals

Jennifer Bibart Dunsizer

Christine M. Poth

Margaret "Peggy" M. Baron

Elizabeth Howard

Related Services

Employee Benefits and Executive Compensation

Labor and Employment

CLIENT ALERT | 11.13.2018

Late Friday afternoon, the Treasury Department released **proposed regulations** affecting hardship distributions (regulations to be published on November 14, 2018 and subject to a 60 day comment period).

BACKGROUND

The proposed regulations reflect statutory changes previously passed by Congress in the Bipartisan Budget Act of 2018; undo the unintended effect on hardship withdrawals of the change to the casualty loss deduction rules under the Tax Cuts and Jobs Act; and implement other guidance issued following the Pension Protection Act of 2006.

Generally, contributions in a 401(k) plan may be distributed only upon the occurrence of certain events, including upon a financial hardship incurred by a plan participant. Under the current rules, a distribution on account of a hardship can be made only if the distribution is on account of an "immediate and heavy financial need" and the amount of the distribution is not in excess of the amount necessary to satisfy that need (plus amounts necessary to pay taxes or penalties that result from the distribution). The determination must be made based on all relevant facts and circumstances under nondiscriminatory and objective standards set forth in the plan.

The current rules provide a safe harbor under which a hardship distribution is deemed to be for an "immediate and heavy financial need" if it is for one of six types of expenses: (1) medical care expenses for the employee, the employee's spouse, dependents or beneficiary; (2) costs directly related to the purchase of an employee's principal residence (excluding mortgage payments); (3) tuition, related educational fees and room and board expenses for the next 12 months of postsecondary education for the employee or the employee's spouse, children, dependents or beneficiary; (4) payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence; (5) funeral expenses for the employee, the employee's spouse, children,

dependents, or beneficiary; and (6) certain expenses to repair damage to the employee's principal residence that would qualify for a deduction under Section 165 of the Internal Revenue Code ("Code"). A second part of the current safe harbor requires the participant to first obtain all currently available distributions and nontaxable plan loans from the plan (and any other plan maintained by the employer) and to suspend the participant's elective deferrals to the plan (and any other plan maintained by the employer) for at least 6 months after receipt of the hardship distribution.

The Tax Cuts and Jobs Act narrowed the casualty losses that may be deducted after January 1, 2018. Under the revised Code Section 165, the deduction for a personal casualty loss is available only to the extent that the loss occurs during a federally declared disaster. This had the unintended consequence of narrowing the hardship distributions available to pay for expenses to repair damage to the participant's principal residence.

Also, under current rules, hardship distributions are not permitted to be withdrawn from QNEC and QMAC sources or from earnings on employee deferrals (except for certain grandfathered amounts).

WHAT ARE THE CHANGES?

The proposed regulations include the following changes:

- **ADDITIONAL SOURCES:** hardship distributions may be taken from additional sources (deferrals, QNECs, QMACs, safe harbor matching contributions and earnings) for 401(k) plans.
Please Note: 403(b) plans may allow hardship distributions from safe harbor matching contributions but not earnings on these contributions. A 403(b) plan may allow hardship distributions from QNECs and QMACs only if they are not held in a custodial account.
- **EXPANDED HARDSHIP EXPENSES:** most plans use the "safe harbor" list of the six expenses (outlined above) for which hardship distributions may be taken "on account of an immediate and heavy financial need." The safe harbor list of hardship expenses has been expanded by adding/restoring the following expense categories (a plan does not have to allow every category):
 - qualifying medical, educational, and funeral expenses for a "**primary beneficiary** under the plan";
 - **casualty losses relating to a principal residence** (removing the impact of the Tax Cuts and Jobs Act change to the rules for the deduction of casualty losses that limited this trigger to casualty losses occurring in a federally declared disaster area); and
 - expenses incurred as a result of a **federally declared disaster** if either the participant's principal residence or principal place of employment at the time of the disaster is located in an area designated by FEMA for individual assistance (such as Hurricane Florence and Michael).
- **REVISED FINANCIAL NEEDS TEST:** a distribution is deemed "necessary to satisfy a financial need" if it meets the following three requirements:
 - amount of the hardship distribution does not exceed the amount of the financial need plus expected federal, state, local and excise taxes or penalties reasonably anticipated to result from the distribution;
 - the participant must have taken all other available plan distributions (other than loans); and

- the participant must represent that he/she has insufficient cash or other liquid assets to satisfy the financial need for the distribution (the plan administrator may rely on the representation of the participant unless the plan administrator has actual knowledge to the contrary).

The old requirements that the participant must suspend deferrals for 6 months and take plan loans before taking a hardship distribution have been eliminated. The proposed regulations permit a plan to continue to apply additional conditions before a participant may take a hardship distribution (so a plan could keep the loan requirement) but all hardship related suspensions of contributions must be eliminated for hardship distributions that are made on or after January 1, 2020.

Reminder: even though the 6 month suspension will be eliminated for hardship distributions, the 6 month suspension will still apply following a military withdrawal.

WHEN ARE THE CHANGES EFFECTIVE AND WHAT MUST PLAN ADMINISTRATORS DO TODAY?

Plan Administrators will need to decide what features to change and when. Under the proposed rules, the expanded hardship triggers may be applied to distributions made on or after January 1, 2018. The elimination of the 6 month suspension may be applied as early as January 1, 2019, even for hardship distributions taken in 2018. For example, if a participant took a hardship distribution on September 1, 2018, the plan could be amended to end the suspension of deferrals as of January 1, 2019 (instead of waiting until March 1, 2019).

As mentioned above, all related suspensions of contributions must be eliminated for hardship distributions that are made on or after January 1, 2020. Additionally, the requirement that the participant must represent that he/she has insufficient cash or other liquid assets to satisfy the financial need for the distribution is effective for distributions made on or after January 1, 2020.

A plan could also phase in the changes over time. For example, the plan could add the casualty loss trigger effective January 1, 2018, add the other hardship triggers on January 1, 2019, eliminate the loan and suspension requirements on January 1, 2020, and adopt the actual plan amendment during 2020. It will be important to document when each change is implemented so that the amendment (when it is drafted) reflects those effective dates.

Plan sponsors will have at least two years to amend their plan documents to reflect the changes made to hardship distributions. If you have questions about the proposed regulations or would like assistance with amending your plans, contact your Vorys attorney.