IRS PUBLISHES NEWLY PROPOSED HARDSHIP WITHDRAWAL REGULATIONS

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The Pension Protection Act of 2006 (PPA), the Tax Cuts and Jobs Act of 2017 (TCJA), and the Bipartisan Budget Act of 2018 (the Budget Act) included statutory changes affecting the hardship withdrawal rules for 401(k) plans. In connection with those changes, the IRS published newly proposed regulations incorporating the following new hardship withdrawal rules which generally apply to hardship distributions made in plan years starting after December 31, 2018, unless otherwise specified:

- *Expanded Sources for Hardship Distributions*. The proposed regulations permit hardship distributions from 401(k) plans of earnings on elective contributions, qualified non-elective contributions (QNECs) (including earnings), and qualified matching contributions (QMACs) (including earnings), regardless of when contributed or earned. However, plans still may choose to limit the type of contributions available for hardship distributions and whether earnings on those contributions are included. Safe harbor contributions made to a plan may also be distributed on account of an employee's hardship (because these contributions are subject to the same distribution limitations applicable to QNECs and QMACs).
- Note that the proposed regulations do *not* eliminate the prohibition on hardship distributions of earnings on 403(b) elective deferrals; therefore, income attributable to elective deferrals contributed to a 403(b) plan continues to be ineligible for distribution on account of hardship. Furthermore, QNECs and QMACs in a 403(b) plan that are *not* in a custodial account may be distributed on account of hardship, but QNECs and QMACs in a 403(b) plan that are in a custodial account continue to be ineligible for distribution on account of hardship.
- *Distribution Necessary to Satisfy Financial Need.* The proposed regulations modify the rules for determining whether a distribution is necessary to satisfy an immediate and heavy financial need by:
  - Eliminating the "deemed necessary" standard under which an employee is prohibited from making elective contributions and employee contributions for six months after receipt of a hardship distribution. Plans may elect to (but are not required to) eliminate this rule for plan years after December 31, 2018. But, any required suspension of elective contributions and employee contributions after receipt of a hardship distribution *must* be prohibited for distributions made on or after January 1, 2020.

- Eliminating the "deemed necessary" standard under which an employee first must take available plan loans prior to obtaining a hardship distribution. Plans may elect to (but are not required to) eliminate this rule for plan years after December 31, 2018.
- Eliminating the current rules 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 by providing one general standard for determining whether a distribution is necessary under which –
  - 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.
  - The employee must represent (in writing or by an electronic medium) that he or she has insufficient cash or other liquid assets to satisfy the financial need. A plan administrator may rely on that representation unless the plan administrator has actual knowledge to the contrary. The requirement to obtain this representation would only apply for a distribution that is made on or after January 1, 2020.

- *Deemed Immediate and Heavy Financial Need.* The proposed regulations modify the safe harbor list of expenses in current 401(k) regulations for which distributions are deemed to be made on account of an immediate and heavy financial need by:
  - Adding the "primary beneficiary under the plan" as an individual for whom qualifying medical, educational, and funeral expenses may be incurred.
  - Modifying the safe harbor hardship withdrawal expense relating to damage to a principal residence that would qualify for a casualty deduction under Internal Revenue Code §165. For hardship withdrawal purposes, the damage to the residence for which the withdrawal is requested will not need to be the result of a federally-declared disaster. This rule modification may be applied to distributions made on or after a date that is as early as January 1, 2018.
  - Adding a new type of safe harbor expense for expenses and losses (including loss of income) incurred by the employee on account of a federally-declared disaster, provided that the employee's principal residence or principal place of employment at the time of the disaster was located in an area designated for by the Federal Emergency Management Agency (FEMA) for individual disaster assistance. The modification is intended to eliminate any delay or uncertainty concerning access to plan funds following a disaster that occurs in an area designated by FEMA for individual assistance, and may be applied to distributions made on or after a date that is as early as January 1, 2018.

If the proposed regulations are finalized (which seems all but certain), plan sponsors will need to amend their plans' hardship distribution provisions. Plans technically may have until as long as the end of the second calendar year beginning after the issuance of the periodically published Required Amendments List that includes the rule changes to adopt the necessary amendments. As a practical matter, however, we anticipate most plans will want to adopt hardship withdrawal amendments well before then. In the meantime, plan sponsors should be reviewing their plans' hardship withdrawal provisions, assessing which of the hardship withdrawal rule changes are mandatory or desirable, identifying the effective date for those changes, and making arrangements to administer hardship withdrawals under the new rules.