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EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

IRS ISSUES HARDSHIP WITHDRAWALS CHANGES

On November 9, 2018, the Internal Revenue Service issued proposed regulations reflecting the Bipartisan Budget Act's changes to the rules for "hardship" withdrawals from 401(k) plans and in some respects from 403(b) plans as well. The updated regulations should allow plan sponsors and recordkeepers to simplify hardship administration, and give more flexibility to plan participants who need a hardship withdrawal.

Hardship Withdrawals

Participants generally cannot take payment of amounts they contribute to a plan on a pre-tax or Roth basis prior to severance from employment, except in certain defined circumstances. Most plans impose similar restrictions on other types of plan contributions. However, a plan is allowed to include provisions granting participants access to their contributions in the event of a qualifying hardship, and many plans do in fact permit these hardship withdrawals from participant contributions and/or company contributions. The IRS has provided a list of circumstances that can qualify as a "hardship" if certain requirements are met (often referred to as hardship "triggers"), and most plans restrict hardship withdrawals to some or all of the events on the pre-approved list. The IRS also allows a plan administrator to consider the participant's circumstances sufficient to qualify for a hardship withdrawal if the participant has taken all other available distributions and non-taxable loans from the employer's plans and suspends future contributions to the employer's plans (other than contributions to health and welfare plans and mandatory contributions to a defined benefit plan) for six months.

Even if the hardship standards are met, however, some amounts cannot be withdrawn under current law. At present, plans cannot allow hardship withdrawals from post-1988 earnings on elective deferrals, post-1988 qualified nonelective contributions ("QNECs") or post-1988 qualified matching contributions ("QMACs"), including QNECs and QMACs used as "safe harbor" contributions for plans exempt from ADP and/or ACP testing, or from contributions used as "safe harbor" contributions under a Qualified Automatic Contribution Arrangement ("QACA").

Bipartisan Budget Act Changes

Under the Bipartisan Budget Act and the regulations as proposed:

- More types of contributions can be made available for hardship withdrawal from a 401(k) plan. The new legislation removes the prohibition on withdrawals from elective deferral investment earnings, QNECs, QMACs, and safe harbor contributions, although the IRS has confirmed in the proposed regulations that this change is optional, not mandatory.
  - The proposed regulations confirm that due to technical errors in the statute, investment earnings on elective deferrals made to 403(b) plans still cannot be made available for hardship withdrawal. In

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addition, hardship withdrawals from QNECs and QMACs held in 403(b) custodial accounts remain prohibited.

- The proposed regulations confirm that "safe harbor" QNECs and QMACs and "safe harbor" QACA contributions can be made available for withdrawal on the same terms as regular QNECs and QMACs, resolving concerns expressed by some practitioners on this point.

- Employees who take a hardship withdrawal will no longer be required to suspend future contributions to the plan and most other employer plans for six months.
  - This change will be mandatory for hardship withdrawals in calendar year 2020 and later. It is important to note that the effective date of this change is not dependent on the plan year, and instead will be January 1, 2020 for all plans.
  - For hardship withdrawals prior to the beginning of 2020, a plan can (i) continue to impose the suspension under the current rules until January 1, 2020, (ii) decline to impose the suspension on withdrawals processed during the 2019 plan year but require anyone who took a hardship withdrawal in the last six months of the 2018 plan year to complete the original suspension period, or (iii) decline to impose the suspension on hardship withdrawals in the 2019 plan year and allow anyone who was in a suspension period as of the first day of that plan year to resume deferrals.
    - In contrast to the timing of the mandatory elimination of the suspension, the timing of permissible optional elimination of the suspension for a plan that currently requires suspension is a function of the plan year.
- A plan will no longer be required to insist that a participant requesting a hardship withdrawal first take any available plan loans, effective for hardship withdrawals processed in 2019, although it can continue to impose this requirement if the plan sponsor prefers.
  - Effective for hardship withdrawals in 2020 or later, a participant seeking a hardship withdrawal will be required to certify that he/she has insufficient cash or other liquid assets to satisfy the hardship, and the plan administrator will be allowed to rely on that certification in the absence of contrary knowledge. A plan administrator may, but need not, require that participants provide this certification in 2019 as well. (Plan administrators should note that the certification requirement is another change effective January 1, 2020, regardless of the plan year.)

Disaster Relief

The IRS included a new pre-approved hardship event, which plans can rely on retroactively to January 1, 2018 or can opt to implement at a later date.

- Expenses and losses (including loss of income) incurred by the employee on account of a disaster declared by the Federal Emergency Management Agency (FEMA) under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, Pub. L. 100-707, provided that the employee's principal residence or principal place of employment at the time of the disaster was located in an area designated by FEMA for individual assistance with respect to the disaster.

In addition, the IRS granted plan sponsors the right to give victims of Hurricanes Florence and Michael streamlined access to hardship withdrawals, in keeping with the administrative relief granted last year to

victims of Hurricane Maria (and before that, Hurricanes Harvey and Irma). Victims must have lived or worked (or had qualifying family living or working) in one of the areas designated for individual assistance by FEMA on the "incident date" identified by FEMA. Streamlined access can be made available through March 15, 2019.

The IRS also reversed the impact on access to hardship withdrawals of statutory changes to the Internal Revenue Code's definition of a deductible "casualty loss." The existing regulations allow a hardship withdrawal in connection with damage to a principal residence that qualifies for the casualty loss deduction (whether or not the loss meets the minimum 10%-of-adjusted-gross-income threshold required for a tax deduction). Effective for 2018 through 2025, the Tax Cuts and Jobs Act restricts casualty loss deductions to losses attributable to a federally declared disaster. However, the proposed regulations waive that restriction for purposes of the hardship withdrawal analysis, restoring the previous standard for hardship withdrawal eligibility determinations. This waiver can be applied retroactively to withdrawals processed in 2018.

Hardship Standards

In order to receive a hardship withdrawal, a participant still must demonstrate a qualifying need. As noted above, most plans restrict the list of qualifying needs to the IRS' list of pre-approved triggers, although some use a more general standard and other plans, conversely, only allow hardship withdrawals with respect to some (or even only one) of the pre-approved triggers.

The amount of the hardship withdrawal must not exceed the amount of money necessary to satisfy the hardship and applicable taxes and tax penalties. The participant must first access all other non-hardship distributions available under the employer's plans. The proposed regulations add an explicit statement that the "plans" from which available distributions must be taken include all other plans of deferred compensation (nonqualified plans as well as other tax-qualified plans).

Prior to the 2020 plan year, except as noted above, existing rules apply to demonstrate satisfaction of the applicable standard. The plan administrator must either receive and retain documentation supporting the need for the hardship withdrawal or have the participant provide an appropriate certification. For this purpose, the plan administrator can opt to implement the certification requirement that otherwise would take effect January 1, 2020.

Other Changes to the Regulations

The IRS took the opportunity to incorporate into the regulations a number of statutory changes enacted after the current regulations were issued in 2004. Accordingly, the regulations now reflect the following rules that have already been implemented:

- The provision of the Pension Protection Act allowing a participant to receive a hardship withdrawal with respect to medical expenses, qualifying post-secondary education expenses, or funeral expenses of the participant's primary beneficiary.
- The availability of qualified reservist distributions from 401(k) and 403(b) elective deferrals, also enacted by the Pension Protection Act.

- "Deemed severance from employment" access to certain contributions for individuals absent for qualifying military service, subject to a six-month suspension of contributions, as permitted by the Heroes Earnings Assistance and Relief Tax Act.

Next Steps

Plan sponsors and fiduciaries of plans that offer, or would like to offer, hardship withdrawals should discuss their options with their recordkeepers. Aside from the mandatory elimination of the contribution suspension period in 2020, the changes described above are optional. Accordingly, the plan sponsor should decide which design options best meet its needs. Typical considerations include:

- Timing of elimination of contribution suspension: This has been a popular change, with many plan sponsors planning on eliminating it as of the beginning of the 2019 plan year. Eliminating this suspension simplifies administration, minimizes the risk of an error (such as a failure to start or stop a suspension on time), and allows participants to begin rebuilding their retirement savings as soon as possible. A plan sponsor that decides to eliminate the suspension should work with its recordkeeper to settle on an effective date and decide how to handle individuals in suspension as of that date.
- Elimination of the "loan first" requirement: Plan sponsors have expressed some concern at potentially encouraging employees to deplete retirement savings permanently and incur immediate taxation rather than using a method of access that will avoid taxation (if the loan is repaid) and allow funds to be restored to the plan as the loan is paid down. Despite these concerns, this has also been a popular change.
  - As was the case for the elimination of the suspension, removing this requirement simplifies administration and removes a potential cause of administrative error.
  - Many employers have also concluded that the loan requirement was too easily circumvented to be a valuable safeguard. For example, since most plans limit the number of loans outstanding, an employee might take a nominal loan and then apply for a large hardship withdrawal.
  - Removing this requirement allows participants to decide for themselves whether the ongoing cashflow requirement of repaying a loan is manageable in their circumstances and, if it is, whether it is nonetheless more advantageous to resolve the hardship immediately, pay taxes, and avoid an ongoing cash drain from loan repayment obligations.
- Expansion of hardship access to investment earnings on elective deferrals: As with the previous two changes, many plan sponsors have opted to implement this change. The change simplifies recordkeeping and communication.
- Expansion of hardship access to QNECs, QMACs and safe harbor contributions: Prior to the issuance of the proposed regulations, there were a number of open questions surrounding the extent to which hardship withdrawals from these contributions would in fact be permissible. In light of that, many sponsors and recordkeepers took a cautious approach to expanding access. Now that those questions have been resolved, some employers that had originally decided not to allow access to these contributions may change their minds. However, many plans currently do not allow access to company contributions at all, restricting access to the amounts the participant contributed.

- For companies that currently do not allow access to company money in the event of hardship, continuing to prohibit access to QNECs, QMACs and safe harbor contributions would be consistent with the existing approach. However, the plan sponsor nonetheless can opt to make these contributions available if it decides this approach is desirable.
- Companies that currently do allow access to company money for hardship withdrawals are more likely to open up access to these contributions as well. However, there is no requirement that they do so. Each company can decide what makes the most sense in light of its retirement program's philosophy, administrative needs and participant expectations.

Once a plan sponsor has made its decision, the plan fiduciaries will need to work with the recordkeeper to implement and communicate the new rules. In most cases, as well, a plan amendment will be required. Plan sponsors using IRS-preapproved plan documents (prototypes and volume submitters) should coordinate with their plan vendors, and generally will need to adopt amendments by the deadline for their tax returns for the relevant plan year. Plan sponsors using individually designed documents must amend their plans by the end of the second calendar year beginning after these changes appear in the IRS' Required Amendments List. The IRS will allow amendments relating to the administrative relief for Hurricane Michael and Hurricane Florence to be made by the same deadline applicable to amendments reflecting the regulatory changes.

The IRS did not address the notice rules applicable to "safe harbor" plans which make a change during a plan year to information provided in the safe harbor notice (a category that includes hardship withdrawal rights). Accordingly, to the extent that a plan's safe harbor notice did not accurately reflect the hardship withdrawal rules that will be in effect for 2019, or to the extent the plan sponsor makes a change after the 2019 plan year has begun, an updated safe harbor notice may be required.

For More Information

If you have any questions regarding this alert, please do not hesitate to contact any member of the Employee Benefits and Executive Compensation group at 585.232.6500 or visit www.hselaw.com.

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