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EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

OVERVIEW OF 2018-2019 HARDSHIP WITHDRAWAL UPDATES

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, and making some additional changes to the regulatory rules governing hardship withdrawal administration. The statutory and regulatory revisions were intended to give plan participants and administrators more flexibility and reduce the operational burdens associated with hardship withdrawals. The IRS issued final regulations on September 19, 2019, which are largely identical to the proposed regulations. The IRS also confirmed that plans which have complied with the proposed regulations also satisfied the final regulations.

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. Under previous law, the IRS also offered a "safe harbor" that permitted a plan administrator to consider the participant's circumstances sufficient to qualify for a hardship withdrawal in connection with one of the defined events so long as the participant had taken all other available distributions and non-taxable loans from the employer's plans and suspended 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Even if the hardship standards were met, however, some amounts could not be withdrawn under prior law. Previously, plans could not 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").

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Bipartisan Budget Act Changes

Under the Bipartisan Budget Act and the new regulations:

- More types of contributions can be made available for hardship withdrawal from a 401(k) plan. The Act removed the prohibition on withdrawals from elective deferral investment earnings, QNECs, QMACs and safe harbor contributions, although the IRS confirmed in the regulations that this change is optional, not mandatory.
  - The 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 addition, hardship withdrawals from QNECs and QMACs held in 403(b) custodial accounts remain prohibited.
  - The 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 participating in 401(k), 403(b) and eligible governmental 457(b) plans will *not* be required to suspend contributions because they have taken a hardship withdrawal.
  - This requirement will take effect for hardship withdrawals on or after January 1, 2020, though plans could implement it earlier. 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.
    - Other types of plans are not subject to this prohibition on future suspensions, so a nonqualified plan may retain or remove a suspension linked to 401(k) or 403(b) hardship withdrawals so long as any action it takes complies with Section 409A of the Internal Revenue Code.
    - Suspension provisions in a plan that are related to non-hardship withdrawals are not covered by the regulations
  - For hardship withdrawals processed prior to the beginning of 2020, a plan could (i) continue to impose the suspension under the current rules for distributions processed before January 1, 2020 (or an earlier transition date, if the employer decided to eliminate the suspension mid-year), (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.
- Plans are no longer required to insist that a participant requesting a hardship withdrawal first take any available plan loans, effective for hardship withdrawals processed in 2019, although a plan 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 reasonably available to satisfy the hardship, and the plan administrator will be allowed to rely on that certification in the absence of contrary knowledge. (Plan administrators should take note that the January 1, 2020 effective date

applies regardless of the plan year.) A plan administrator may, but need not, require that participants provide this certification in 2019 as well.

- The final regulations added the phrase "reasonably available" to the certification language in the proposed regulations, to address concerns that a participant may have cash on hand but needs that cash for another purpose (e.g., payment of rent).

Disaster Relief

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 Hurricanes Harvey, Irma and Maria. 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 could be made available through March 15, 2019.

The IRS also created a new, permanent, 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.

This new permanent hardship event was intentionally drafted to be narrower than special hardship access rights for particular disasters (such as Hurricanes Harvey, Irma, Maria, Michael and Florence) that the IRS had previously granted. The new permanent withdrawal event does not cover losses incurred by relatives living or working in those areas, and does not specifically excuse collection of supporting documentation. However, the IRS added in the final regulations that it anticipates that employers will be flexible in their documentation requirements in the wake of a disaster.

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 2004 regulations had allowed 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 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, or an employer can opt to implement it at a later date.

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 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 previous 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 and the implementation of the enhanced certification requirement 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 having already eliminated 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 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, with most sponsors implementing it in January 2019.
  - 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 already have opted to implement this change. The change simplifies recordkeeping and communication. (As noted above, this change is not available to 403(b) plans.)
- 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. Once those questions were resolved, some employers that had originally decided not to allow access to these contributions changed their minds and have made those contributions available, or have decided to do so for 2020. 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.
  - QNECs and QMACs in 403(b) custodial accounts remain ineligible for hardship withdrawals.

Once a plan sponsor has made its decisions, the plan fiduciaries will need to work with the recordkeeper to implement and communicate the new rules. In most cases, a plan amendment will be required.

- Plan sponsors using individually designed documents must amend their plans to reflect mandatory changes (removal of any contribution suspension provisions associated with hardship withdrawals and, if an amendment to the plan's language is necessary, the IRS' new certification requirement) by the end of the second calendar year beginning after these changes appear in the IRS' Required Amendments List (i.e., December 31, 2021, since the regulations were included in the 2019 list), and amendments relating to any optional hardship withdrawal changes that the employer has chosen to implement are also due by that date. 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 originally stated that plans using IRS pre-approved documents must complete interim amendments in accordance with the normal rules (generally, the later of the end of the plan year of implementation of the change or the deadline for the employer's tax return for the taxable year in which the change is implemented), but that the IRS would measure the deadline for all the hardship changes from the deadline for the required changes, even if some of the changes were put into effect earlier. However, in revenue Procedure 2020-9, the IRS extended the deadline for these plans to December 31, 2021 as well.
- The deadline for Section 403(b) amendments currently is March 31, 2020, but the IRS is considering granting additional time.

Safe harbor plans should be sure to include any 2020 updates in their safe harbor notices for 2020. In the event that an employer decides to make changes during 2020 and did not include those changes in its notice, the plan will be subject to the normal requirements that an updated notice be provided, and participants be allowed to change their deferral elections. Generally, the updated notice is due 30 days in advance of a change.

If you have any questions regarding this alert, please contact a member of the Employee Benefits and Executive Compensation Group at 585.232.6500, 716.853.1616, or visit www.hselaw.com.

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