Client Alert *November 29, 2018*

PROPOSED REGULATIONS LIBERALIZE REQUIREMENTS FOR 401(K) AND 403(B) PLAN HARDSHIP DISTRIBUTIONS

Most 401(k) and 403(b) plans allow plan participants to take in-service hardship distributions. In response to various pieces of tax legislation, the Department of the Treasury and the Internal Revenue Service this month proposed new Treasury Regulations governing hardship distributions effective generally for plan years beginning after December 31, 2018.

Existing Treasury Regulations permit hardship distributions from 401(k) and 403(b) plans only if the hardship distribution (i) is made on account of an immediate and heavy financial need, and (ii) is necessary to satisfy that financial need. The existing hardship distribution rules include a safe harbor for each of these requirements, and a requirement is deemed to be satisfied if the safe harbor for that requirement has been met. The proposed regulations modify these safe harbors and make certain other changes.

I. Safe Harbor for Necessity to Satisfy Financial Need

Under existing regulations, a distribution is deemed necessary to satisfy an immediate and heavy financial need if (i) the employee has obtained all currently available distributions and nontaxable plan loans from the plan and any other plan maintained by the employer, and (ii) the employee's ability to make elective contributions and employee contributions to the plan (and all other plans maintained by the employer) is suspended for at least six months after receipt of the distribution.

Under the proposed regulations, beginning no later than January 1, 2020, a plan cannot suspend an employee's ability to make elective contributions and employee contributions on account of a hardship distribution. In the event of six-month suspensions of an employee's ability to make contributions that commence under existing rules in the last half of the 2018 plan year, the suspensions either may continue to run for their respective six-month periods or may be lifted as of the first day of the first plan year beginning after December 31, 2018.

For a hardship distribution on or after January 1, 2020, the proposed regulations eliminate any requirement that a plan must require an employee to take all available nontaxable plan loans prior to taking a hardship distribution. Nevertheless, a plan may require an employee to take all available nontaxable plan loans prior to taking a hardship distribution. Thus, a plan may (but is not required to) condition an employee's hardship distribution on or after January 1, 2020, on the employee first taking all available nontaxable plan loans.

According to the proposed regulations, three requirements will make up a new minimum standard to determine whether a hardship distribution is necessary to satisfy a financial need. First, a hardship distribution may not exceed the amount of the 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). Second, the employee must have obtained other available distributions under the employer's plans. Third, for a hardship distribution on or after January 1, 2020, the employee must represent that he or she does not have sufficient cash or other liquid assets to satisfy the financial need. A plan administrator may rely on such a representation unless the plan administrator has actual knowledge to the contrary.

II. Safe Harbor for Immediate and Heavy Financial Need

The proposed regulations expand the list of expenses for which a distribution from a plan may be deemed to be on account of an immediate and heavy financial need. The expansion (i) adds an employee's primary beneficiary under the plan as an individual for whom qualifying medical, educational, and funeral expenses may be incurred; (ii) modifies the casualty loss expense under existing regulations to provide that the new limitation added by the Tax Cuts and Jobs Act, which limits the personal income tax deduction for casualty losses to federally-declared disasters, does not apply for hardship distribution purposes; and (iii) adds a seventh type of expense for expenses and losses incurred as a result of certain disasters (see last bullet below).

The expanded list of expenses, which may apply retroactively as early as January 1, 2018, is as follows:

- Expenses for (or necessary to obtain) medical care that would be deductible under Section 213(d) of the Internal Revenue Code ("Code") (determined without regard to the limitations in Code Section 213(a) (relating to the applicable percentage of adjusted gross income and the recipients of the medical care)), provided that if the recipient of the medical care is not listed in Code Section 213(a), the recipient is a primary beneficiary under the plan;

- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

- Payment of tuition, related educational fees, and room and board expenses for up to the next 12 months of post-secondary education for the employee, the employee's spouse, child, or dependent (as defined in Code Section 152 without regard to Code Sections 152(b)(1), (b)(2), and (d)(1)(B)), or for a primary beneficiary under the plan;

- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;

- Payments for burial or funeral expenses for the employee's deceased parent, spouse, child, or dependent (as defined in Code Section 152 without regard to Code Section 152(d)(1)(B)) or for a deceased primary beneficiary under the plan;

- Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under Code Section 165 (determined without regard to Code Section 165(h)(5) and whether the loss exceeds 10 percent of adjusted gross income); and

- 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, 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.

III. Expanded Sources for Hardship Distributions

The proposed regulations expand the 401(k) plan sources from which employees may take plan hardship distributions for plan years beginning after December 31, 2018. The proposed regulations permit 401(k) plan hardship distributions from elective contributions, qualified nonelective contributions ("QNECs"), qualified matching contributions ("QMACs"), and earnings on those amounts, regardless of when contributed or earned. However, 401(k) plans may limit the type of contributions available for hardship distributions and whether earnings on those contributions are included. Furthermore, safe harbor contributions made to a plan described in Code Section 401(k)(13) (relating to qualified automatic contribution arrangements) also may be distributed on account of an employee's hardship.

The above-described expansions for 401(k) plans do not carry over completely to 403(b) plans. Income attributable to 403(b) elective deferrals continues to be ineligible for distribution on account of hardship. 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.

IV. Plan Amendments

If the new regulations are finalized as they have been proposed, plan sponsors will need to amend their plans' hardship distribution provisions by the deadline prescribed by applicable tax law. For example, with respect to an individually designed plan that is not a governmental plan, the deadline for amending the plan to reflect changes in qualification requirements is the end of the second calendar year that begins after the issuance of the Required Amendments List described in Revenue Procedure 2016-37 that includes the change. A plan amendment with a retroactive effective date will need to reflect actual plan administration.

Please contact the Thompson & Knight attorney with whom you regularly work or any of the following employee benefits attorneys to discuss the proposed regulations.

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