

Planning for 2020: Changes to Hardship Distribution Rules and Amendment Deadlines

On September 23, 2019, the Department of Treasury published the final regulations relating to changes to the hardship distribution rules that apply to qualified retirement plans and 403(b) plans, that were enacted under the Bipartisan Budget Act of 2018 (the "BBA of 2018"). Further guidance was issued in September 2019 and on December 12, 2019 regarding deadlines for the adoption of related plan amendments.

Background on Hardship Distributions

401(k) plans and 403(b) plans can (but are not required to) permit participants to take in-service hardship distributions from certain amounts¹ in a participant's account if it is due to an immediate and heavy financial need if the distribution is limited to the amount necessary to satisfy that need. Under the prior rules, among other requirements, the "immediate and heavy financial need" was generally based on a facts and circumstances test, a participant was required to take all available plan loans before taking a hardship distribution, and was required to suspend elective deferrals for a six month period after taking a hardship distribution. There were also various safe harbor and non-safe harbor methods for identifying hardship events and evidencing satisfaction of financial need requirements. Generally, hardship distributions are subject to income taxes (unless the hardship distribution is of Roth contributions) and may also be subject to an additional 10% tax on early distributions (if taken before age 59 ½). Hardship distributions are not eligible for rollover.

Changes to Hardship Distribution Rules under the Bipartisan Budget Act of 2018 and Final Regulations

Under the recently issued final regulations implementing the changes to the hardship distribution rules under the BBA of 2018, for retirement plans that permit hardship distributions, there are two mandatory changes that must be made beginning January 1, 2020 and several other voluntary changes that may (but are not required to be) made by plan sponsors.

Mandatory Changes

For retirement plans that permit hardship distributions, the final regulations provide that those plans must implement the following changes beginning on January 1, 2020 (but were generally permitted to implement these changes on a voluntary basis beginning with the 2019 plan year):

1. A plan must eliminate the 6-month suspension of elective deferral contributions following a hardship distribution made on or after January 1, 2020 (note that this change was optional for the 2019 plan year).
2. For determining when a distribution can be made on account of an "immediate and heavy financial need" (for hardship distributions made on or after January 1, 2020), a plan cannot continue to use a facts and circumstances standard or prior safe harbor standards and must instead use the following standard and ensure that:

¹ Prior to the BBA of 2018, employee elective deferrals, employer nonelective contributions, and regular matching contributions were eligible to be taken as hardship distributions, but not earnings on elective deferrals, qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), safe harbor contributions, or earnings on QNECs, QMACs or safe harbor contributions.

- a. A hardship distribution not exceed the amount of the employee's need;
- b. The employee first obtains other available distributions under the plan and all other qualified or nonqualified deferred compensation plans; and
- c. The employee must represent in writing that he or she has insufficient cash or liquid assets reasonably available to satisfy the financial need.²

Optional Changes

For 401(k) and 403(b) plans that permit hardship distributions, the final regulations provide that those plans can (but were not required to) implement the following changes generally beginning with the 2019 plan year, or any later year:

1. A plan may, but need not, remove any 6-month suspension of elective deferral contributions that may be in effect due to a hardship distribution taken prior to January 1, 2020. (Prior suspensions of contributions that began in 2019 may continue into 2020.)
2. A plan may be amended to eliminate the requirement that available plan loans must be taken by a participant before a hardship distribution is taken.
3. A plan may expand the amounts eligible for hardship distributions to include any or all of elective deferrals, QNECs, QMACs, safe harbor contributions, QACA safe harbor contributions, and earnings on all of the foregoing amounts. However, (i) for 403(b) plans, earnings on elective deferrals are not eligible for hardship distributions, and (ii) for 403(b)(7) custodial accounts only, QNECs and QMACs are not eligible for hardship distribution.
4. A 401(k) plan may permit hardship distributions under "safe harbor" hardship provisions to participants seeking to repair a primary residence, even if that repair would not otherwise qualify for a casualty loss deduction (under Section 165 of the Code, which generally permits a deduction only for those casualty losses that are incurred as a result of a federally declared disaster).³
5. A plan may allow hardship withdrawals under a new safe harbor hardship event, which allows participants to take a hardship distribution for an immediate and heavy financial need to cover expenses and losses (including loss of income) incurred on account of a Federal Emergency Management Agency (FEMA) declared disaster, so long as the participant's principal residence or principal place of employment was in an area designated by FEMA that is eligible for individual assistance for the disaster.

Timing of Plan Amendments

The mandatory changes described above must take effect on and after January 1, 2020 (but were generally permitted to be implemented on a voluntary basis beginning with the 2019 plan year). In terms of when plan amendments must be adopted to reflect these new provisions, the IRS has generally indicated that deadlines will generally follow the remedial amendment deadlines for 401(k) plans under Revenue Procedure 2016-37 (as modified by Revenue Procedure 2020-9) and for 403(b) plans under the recently issued Revenue Procedure 2019-39. This means that the precise deadline for the plan amendment will depend on a number of different factors,

² A plan administrator can rely on the participant's representation unless it has actual knowledge to the contrary (but is not required to inquire into the participant's financial status).

³ The Tax Cut and Jobs Act of 2017 made changes to Section 165 of the Code and required that "casualty losses" be incurred due to a federally declared disaster. The application of this disaster limitation to hardship withdrawals based on "casualty losses" was initially unclear, but the IRS permitted the disaster limitation to be ignored for hardship distributions taken in 2018 and 2019. The disaster limitation more clearly is not required to be applied for hardship distributions beginning on or after January 1, 2020.

including one or more of the following: whether a 401(k) or 403(b) plan is involved, when the taxable year of the plan sponsor ends, when the plan year ends, whether the amendment is mandatory or discretionary, and whether the plan is an individually designed plan or an IRS pre-approved plan.⁴

Generally speaking, the earliest date by which plan amendments reflecting these new hardship distribution rules would need to be adopted is (i) for 401(k) plans, December 31, 2021 and (ii) for 403(b) plans, December 31, 2020. For some plans, particularly if optional changes were not implemented prior to 2020, the deadline to adopt a plan amendment may be a later date. However, due to some uncertainty in the interpretation of guidance provided by the IRS and the complexity of the amendment deadline rules, plan sponsors who intend to adopt plan amendments beyond the earliest deadline above should consult with their legal counsel.

Next Steps for Plan Sponsors

For the upcoming year, plan sponsors should prepare to operationally implement the mandatory changes required by the BBA of 2018 and the final hardship regulations, and if other operational changes were not already made, consider whether to implement any of the optional changes permitted by these new rules. Plan sponsors who use IRS pre-approved plan documents should look out for plan amendments from their plan document provider, in order to make certain that they are timely adopted.

⁴ We note that there remains some uncertainty in the interpretation of the IRS's guidance on plan amendment deadlines as they apply to 403(b) plans, arising from statements the IRS made in the preambles to the proposed regulations and the final regulations, the subsequently issued Revenue Procedure 2019-39 applicable to 403(b) plans and its lack of a specific reference to hardship distributions, and informal non-binding statements made by a representative of the IRS at a recent ASPPA Annual Conference held on October 22, 2019.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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