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IRS PROPOSES UPDATES TO RULES ON HARDSHIP DISTRIBUTIONS FROM DEFINED CONTRIBUTION PLANS

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In This Article

[Current Hardship Distribution Rules](#) | [Changes to Expense Safe Harbors](#) | [Changes on Limiting Hardship Distributions to Financial Need](#) | [Expanded Sources of Hardship Distributions](#) | [Application of Hardship Changes to 403\(b\) Plans](#) | [Changes to Other Rules for Members of the Military](#) | [Plan Amendments](#) | [Related Resources](#)

Recent Internal Revenue Service (IRS) [proposed regulations](#) would update the hardship distribution rules for 401(k) and 403(b) plans to reflect statutory changes made by the [Bipartisan Budget Act of 2018](#) (BBA 2018) and the [Tax Cuts and Jobs Act of 2017](#) (TCJA). The proposal would also update the 401(k) regulations for certain changes affecting military service members under the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) and Pension Protection Act of 2006 (PPA). Comments on the proposal are due by Jan. 14, 2019.

CURRENT HARDSHIP DISTRIBUTION RULES

Under existing Code Section 401(k) regulations, plans can make hardship distributions only if an employee has an "immediate and heavy financial need" and the distribution is necessary to satisfy the need.

Immediate and Heavy Financial Need

Whether an employee has an immediate and heavy financial need is determined by considering all relevant facts and circumstances. However, a safe harbor rule deems this requirement satisfied when a distribution is for any one of six categories of specified expenses (the "expense safe harbors"). Plans can use the facts-and-circumstances test, the expense safe harbors or both for handling hardship distribution requests.

Distribution Necessary to Satisfy the Need

A distribution is treated as necessary to satisfy an immediate and heavy financial need only to the extent that:

- The distribution doesn't exceed the amount required to satisfy the financial need, including amounts necessary to pay federal, state and local taxes as well as penalties on the distribution.
- The employee has no other resources that are "reasonably available" to satisfy the need. A plan can rely on the employee's written representations that other resources aren't available.

IRS PROPOSES UPDATES TO RULES ON HARDSHIP DISTRIBUTIONS FROM DEFINED CONTRIBUTION PLANS

Another safe harbor — the "necessity safe harbor" — deems this requirement satisfied if the employee takes all available distributions, including nontaxable loans, from all of the employer's plans and is prohibited from making contributions to all of the employer's plans for six months after the distribution.

CHANGES TO EXPENSE SAFE HARBORS

The proposed rules make several changes to the expense safe harbors.

Casualty Losses Deductible Under Section 165

One safe harbor category of expenses includes costs to repair damage to an employee's principal residence that qualify as deductible casualty losses under Section 165 (determined without regard to Section 165's income requirements). TCJA amended Section 165 to limit the deduction for personal casualty losses incurred from Jan. 1, 2018, to Dec. 31, 2025, to losses caused by a federally declared disaster.

The proposed rules state that TCJA's deduction limitations do not apply for purposes of the hardship rules. Thus, costs to repair an employee's principal residence — even if the damage is not caused by a federally declared disaster — should continue to qualify for the expense safe harbor, assuming they would have been deductible under Section 165 before the TCJA changes.

Impact on 2018 year-end amendments. Plans that rely on the casualty-loss safe harbor may have inadvertently made hardship distributions in 2018 for casualty losses that aren't deductible under TCJA. These distributions may not have complied with plan terms requiring Section 165 deductibility unless the plan also allowed hardship distributions under the non-safe harbor facts-and-circumstances test. Before the proposed regulations, these sponsors may have been considering amending their plans to add the facts-and-circumstances test to avoid the operational failure. Sponsors now may feel such an amendment is no longer necessary since IRS says the proposed change to the casualty-loss safe harbor will apply retroactively to Jan. 1, 2018. Still, sponsors may want to consult with counsel.

Medical, Educational and Funeral Expenses for Primary Beneficiary

Three other categories of safe harbor expenses include certain medical, educational and funeral expenses for employees, their spouses, parents, children or dependents. The proposed rules expand these safe harbors to permit hardship distributions for these expenses when incurred for the employee's "primary beneficiary under the plan." For this purpose, the employee's primary beneficiary is "an individual who is named as a beneficiary under the plan and has an unconditional right, upon the death of the employee, to all or a portion of the employee's account balance under the plan." This proposal reflects PPA changes that took effect for hardship distributions made on or after Aug. 17, 2006.

New Expense Safe Harbor for Losses in Federal Disasters

The proposed rules would add a new safe harbor category: an employee's expenses and losses incurred due to a federally declared disaster where the employee's principal residence or principal place of employment is located. This safe harbor is not limited to casualty losses and could include, for example, an employee's loss of income. In the past, IRS has allowed these hardship distributions on an ad hoc basis

IRS PROPOSES UPDATES TO RULES ON HARDSHIP DISTRIBUTIONS FROM DEFINED CONTRIBUTION PLANS

with certain federally declared disasters. Now, sponsors don't have to wait for IRS disaster announcements and can make hardship distributions for these losses without applying a facts-and-circumstances analysis.

Reliance on Proposal

The preamble to the proposal states that "the revised list of safe harbor expenses may be applied to distributions made on or after a date that is as early as January 1, 2018." This language seems to say that employers can rely on the proposed changes to the expense safe harbors until IRS issues final rules, even though IRS didn't include its typical statement allowing reliance on proposed regulations.

CHANGES ON LIMITING HARDSHIP DISTRIBUTIONS TO FINANCIAL NEED

The proposed regulations implement several changes made by BBA 2018 to the 401(k) rules to limit hardship distributions to an employee's financial need, and in doing so, overhaul those rules. Like BBA 2018, the proposed rules' changes are effective for plan years starting after 2018 (unlike the changes to the safe harbor expenses, which can be applied this year), with certain delays noted below.

One New General Standard Applies

The proposed regulations replace the facts-and-circumstances test and necessity safe harbor with a single general standard:

- *Distribution limited to amount of need.* A hardship distribution may not exceed the amount of an employee's need (including any federal, state and local income taxes as well as penalties reasonably anticipated to result from the distribution).
- *Employee must take all available distributions, but not loans.* The employee must have obtained all other available distributions under the employer's plans (including nonqualified plans). Current rules impose a similar requirement but also require the employee to take all nontaxable loans.
- *Employee must have insufficient cash and liquidity to satisfy need.* The employee must represent in writing that he or she has insufficient cash or other liquid assets to satisfy the financial need. The plan administrator can rely on this representation unless it has actual knowledge to the contrary. Unlike current rules, the proposal does not say assets belonging to the employee's spouse and minor children are considered available to the employee for this purpose. The written representation would be required for distributions on or after Jan. 1, 2020, but presumably plans could apply it earlier.

Additional Conditions Allowed, Including Exhausting Plan Loans

The regulations permit plans to apply other conditions, including a condition that participants must exhaust all available nontaxable plan loans.

Post-Hardship Suspension of Contributions Prohibited

The proposed regulations prohibit plans from imposing a suspension of elective and employee contributions following a hardship distribution made on or after Jan. 1, 2020. Under BBA 2018, plans can apply this change in the first plan year starting after Dec. 31, 2018. For suspensions in progress when the change takes effect, the proposal says the sponsor can choose to cut the suspension short or let the

IRS PROPOSES UPDATES TO RULES ON HARDSHIP DISTRIBUTIONS FROM DEFINED CONTRIBUTION PLANS

suspension run its course. This is true even for employers that choose to eliminate suspensions after hardship distributions in 2019, before doing so becomes mandatory on Jan. 1, 2020.

EXPANDED SOURCES OF HARDSHIP DISTRIBUTIONS

Under current rules, participants can take hardship distributions only from their own contributions, but generally not from earnings on their contributions or from qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs). The proposal updates the rules for BBA 2018, which amended Section 401(k) to permit (but not require) hardship distributions from QNECs and QMACs (including any made under a safe harbor 401(k) plan) and earnings on elective contributions, QNECs and QMACs.

Proposal allows hardships from QACA safe harbor contributions. The proposal also allows hardship distributions of safe harbor matching and nonelective contributions made under a qualified automatic contribution arrangement (QACA).

APPLICATION OF HARDSHIP CHANGES TO 403(B) PLANS

Section 403(b) plans generally follow the hardship distribution rules in the 401(k) regulations. Therefore, the proposed rules apply to hardship distributions from 403(b) plans, except as follows:

- Section 403(b)(11) allows hardship distributions from an employee's elective deferrals but not from earnings on those contributions. BBA 2018 did not change that restriction for 403(b) plans, so earnings on an employee's 403(b) elective deferrals remain ineligible for hardship distributions.
- QNECs and QMACs in a 403(b) plan that are not in a custodial account may be distributed on account of hardship. However, QNECs and QMACs in a 403(b) plan that are in a custodial account remain ineligible for hardship distributions (because custodial accounts don't allow hardship distributions of any contributions other than elective deferrals).

CHANGES TO OTHER RULES FOR MEMBERS OF THE MILITARY

Distributions to qualified reservists. PPA amended Sections 401(k) and 403(b) to allow distributions to qualified reservists. The proposal updates the 401(k) regulations (but not the 403(b) regulations) to reflect this change by adding a "qualified reservist distribution" (as defined in Section 72(t)(2)(G)(iii)) to the list of permissible distribution events.

Safe harbor plans with QMACs that suspend deferrals to comply with HEART Act. Under the HEART Act, an employee receiving differential wage payments from the employer during military service can take a distribution from the employer's plan but cannot make elective deferrals for six months after the distribution. This required suspension conflicts with the rules for safe harbor 401(k) plans that make QMACs: Those plans generally cannot restrict deferrals by eligible nonhighly compensated employees (NHCEs), with a few specified exceptions. The proposed rules would modify the safe harbor requirements to permit HEART Act suspensions.

PLAN AMENDMENTS

Amendments required to conform to the regulations, once finalized, will have to satisfy the timing rules in [Rev. Proc. 2016-37](#). Thus, required amendments will be due by the end of the second calendar year after the year in which the hardship changes appear on the IRS's Requirement Amendments List. This calendar-year timing applies regardless of a plan's plan year.

IRS says this timing rule also will apply to amendments related to the new hardship rules, even if an amendment isn't necessary to comply with the changes. For example, an amendment allowing hardship distributions from QNECs and QMACs is permitted, but not required, under the new rules. IRS states such an amendment will be subject to same timing rules that apply to required amendments.

RELATED RESOURCES

Non-Mercer Resources

- [Proposed IRS regulations updating 401\(k\) plan hardship distribution rules](#) (Federal Register, Oct. 23, 2018)
- [PL 115-123, Bipartisan Budget Act of 2018](#) (GPO, Feb. 9, 2018)
- [PL 115-97, Tax Cuts and Jobs Act](#) (GPO, Dec. 22, 2017)
- [Rev. Proc. 2016-37](#) (IRS, June 29, 2016)

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