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Hardship Withdrawals After BBA 2018

New rules will bring major changes and present issues for regulators and plan sponsors alike.

The Bipartisan Budget Act of 2018 (BBA 2018), signed into law by President Trump on February 9, 2018, included several modifications to the 401(k) hardship withdrawal rules. While the changes are generally not effective until the 2019 plan year, they will fundamentally alter how hardship withdrawals work and present issues both for regulators and plan sponsors.

In this article, we briefly review the changes and the issues they present, beginning with some background on current law.

Current Restrictions on 401(k) Distributions

Under current rules, in a 401(k) plan, generally (though subject to some exceptions) amounts "attributable" to 401(k) elective deferrals may not be distributed earlier than severance from employment, death or disability. Under IRS regulations, this distribution restriction is applicable not only to 401(k) contributions but also to qualified non-elective contributions (QNECs) and qualified matching contributions (QMACs), and earnings on 401(k) contributions, QNECs and QMACs.

The federal tax code provides an exception to this rule for distributions "upon hardship of the employee." The maximum hardship distribution is, however, limited to the amount of a participant's actual 401(k) contributions, without taking into account earnings, QNECs or QMACs.

Current Hardship 'Safe Harbors'

IRS regulations break the hardship distribution analysis into two separate issues: (i) The distribution must be on account of an "immediate and heavy financial need;" and (ii) it must be "necessary to satisfy [that] financial need."

With regard to issue (i), the regulations provide a list of "deemed immediate and heavy financial needs," including, for example, "costs directly related to the purchase of a principal residence."

With regard to issue (ii), under IRS regulations, a distribution is deemed necessary to satisfy immediate and heavy financial need if:

1. The employee has obtained all available distributions and nontaxable loans under all plans of the employer; and
2. The employee is prohibited from making contributions to all employer plans for at least six months (the "six-month holdout" rule).

With respect to this "deemed necessary" rule, the Internal Revenue Manual imposes an additional requirement: The distribution cannot exceed the amount needed to satisfy the need.

Changes Made by BBA 2018

BBA 2018 has made three significant changes to these rules, as follows:

1. BBA 2018 includes a provision that "[a] distribution shall not be treated as failing to be made upon the hardship of an employee solely because the employee does not take any available loan under the plan."
2. It instructs the Secretary of the Treasury, by February 9, 2019, to modify the IRS "deemed necessary" regulation to "delete the six-month prohibition on contributions."
3. It provides that QNECs, QMACs and earnings on 401(k) contributions, QNECs and QMACs may be distributed on account of a hardship.

These changes will generally go into effect in 2019.

Status of the 'Deemed Necessary' Safe Harbor After BBA 2018

These changes present an issue with respect to the "deemed necessary" safe harbor. Currently, the two requirements of that safe harbor are (as noted) (1) taking all available loans and (2) the six-month holdout. Congress, in BBA 2018, has explicitly instructed IRS to eliminate requirement (2) (the six-month holdout). What happens with requirement (1) (taking all available loans) may be a little less clear, but it seems like Congress also wanted this requirement eliminated.

Those changes leave IRS's "deemed necessary" rule without any substantial criteria.

IRS is currently considering what modifications to make to its hardship withdrawal regulations in response to the BBA 2018 changes to its "deemed necessary" rule. Its options would seem to include: (1) creating a new "deemed necessary" safe harbor with new criteria, although it is not obvious what those new criteria would be; (2) getting rid of the safe harbor (it was in the first instance created by IRS) and reverting to some sort of "facts and circumstances" process for establishing necessity, (3) no longer applying a "necessary to satisfy the financial need" test that considers the availability of other resources or perhaps simply substituting an employee representation to meet this requirement.

For Sponsors

While there is no change to current rules for 2018, the rules with respect to hardship distributions are going to change significantly beginning in 2019.

Starting next year, participants may legally take hardship distributions from QNECs and QMACs and earnings on 401(k) contributions, QNECs and QMACs, if the plan permits them to. Sponsors will want to review their hardship distribution policy and consider whether they wish to extend it to these amounts.

There will also be new rules (of some sort) for determining whether a participant has a hardship.

An obvious outstanding issue: To what extent may a sponsor continue to apply old rules, for example, requiring that a participant take all available loans before a hardship distribution, even if no longer required to do so under new IRS rules?

Any of these changes will have to be explained to participants. And they are likely to require a revision to administrative procedures.

We expect the release of guidance on what the new rules will be, hopefully soon enough before 2019, so that any changes in hardship distribution policy can be communicated to participants and necessary administrative changes can be made.

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We will continue to follow this issue.

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