The IRS has issued proposed regulations that answer some key interpretive questions about recent changes to the laws that govern hardship distributions.

The proposed regulations are generally scheduled to take effect for plan years beginning after December 31, 2018. Some hardship provisions, however, have special effective dates, including those applicable to casualty losses and to the six-month suspension period after a hardship distribution.

Once the regulations are finalized, plan sponsors will need to amend their plans. According to the IRS, the normal rules for determining the deadline for adopting amendments to fix a disqualifying provision apply. So, plan sponsors have until the end of the second calendar year after the changes appear in a future “Required Amendments List” to adopt the amendments. The IRS also indicates that even hardship plan amendments that do not correct a disqualifying provision will be treated as integrally related and thus must meet the same deadline.

Unless otherwise noted, the changes described also apply to 403(b) plans.

Hardship distributions

Under current rules, participants undergoing a financial hardship may take in-service distributions from their defined contribution plans, up to certain limits. To be eligible, the financial hardship must satisfy a two-pronged test:

1. The participant is experiencing an immediate and heavy financial need.
2. The distribution is necessary to satisfy that immediate and heavy financial need.

**Safe harbor “immediate and heavy” financial need.** This determination may be based on all relevant facts and circumstances or by meeting safe harbors that describe qualifying expenses. The proposed regulations update and expand the list of safe harbor expenses that qualify for hardship distributions.

- **Personal casualty loss.** Expenses to repair damage to the employee’s principal residence that qualify for the casualty deduction under the tax code are assumed to also be eligible for a hardship distribution. However, under the 2017 Tax Cuts and Jobs Act, for tax years 2018 through 2025, the deduction for a personal casualty loss is available only for losses arising from a federally declared disaster. This created some confusion about whether hardship distributions from retirement plans had to meet this more limited definition. Acknowledging that Congress did not intend this result, the proposed regulations confirm that the new limitation does not apply to hardship distributions.

  This treatment of casualty losses under the proposed regulations may be applied to hardship distributions as of January 1, 2018, but must be applied in 2019.
• Medical, educational and funeral expenses for a primary beneficiary. The tax code provides that certain medical, educational and funeral expenses constitute immediate and heavy financial needs. The proposed regulations would expand the safe harbor to apply the same criteria to the participant’s “primary beneficiary under the plan.”

• Expenses related to federally declared disasters. The proposed regulations add a new safe harbor hardship event for expenses and losses (including loss of income) arising from a federally declared disaster. This provision can be applied as of January 1, 2018.

**General standard regarding necessity of distribution to satisfy financial need.** The second prong of the eligibility test is for the hardship distribution to be necessary to satisfy the immediate and heavy financial need. To meet this standard, the participant must have exhausted all other resources reasonably available, which can be demonstrated by applying a facts-and-circumstances standard and the participant’s representation of having exhausted all other resources. Alternatively, the plan may utilize a safe harbor rule that requires the participant to stop contributing to the plan for six months after the distribution. The Bipartisan Budget Act of 2018 eliminated the six-month suspension requirement, thus essentially leaving just the general standard.

The IRS general standard for all hardship distributions encompasses three requirements. First, consistent with the current regulations, the hardship distribution may not exceed the amount of an employee’s need. Second, the employee must have obtained all other available distributions under the employer’s plans (qualified and nonqualified), although the budget act eliminated the requirement that participants take other available plan loans. Third, for any distribution made on or after January 1, 2020, the employee must represent (in writing or electronically) that he or she lacks sufficient cash or other liquid assets to satisfy the financial need. Notwithstanding these changes, a plan sponsor may still impose additional conditions on hardship distributions, such as requiring that all available loans be taken first.

**Elimination of six-month contribution suspension requirement.** The budget act directed the IRS to eliminate the six-month suspension period on participant contributions following a hardship distribution. While the act left open the possibility that plan sponsors could optionally retain the suspension period, the proposed regulations clarify that the six-month suspension of participant contributions after hardship withdrawals must be eliminated, starting January 1, 2020. Plans may eliminate the six-month suspension — even cutting the suspension period short on existing hardships — as early as January 1, 2019.

**Elimination of requirement to exhaust available plan loans before taking a hardship distribution for safe harbor.** As noted above, starting with the 2019 plan year, distributions will not be treated as having failed the hardship eligibility test solely because the employee did not take any available loan under the plan.

**Expansion of the types of contributions that qualify for hardship.** The budget act expanded the allowable sources for hardship distributions beyond participants’ elective contributions to include qualified non-elective contributions (QNECs), qualified matching contributions (QMACs) and earnings on these amounts, starting in 2019. The proposed regulations incorporate the expansion but also allow plan sponsors to continue limiting the types of contributions available for hardship distributions and decide
whether to include earnings on those contributions. Sponsors can include some, all or none of the expanded hardship distribution sources.

For 403(b) plans, earnings on elective deferrals remain ineligible for hardship distributions because the budget act did not amend the prohibition on hardship distributions of income attributable to elective contributions. Additionally, QNECs and QMACs held in 403(b) annuity contracts are eligible for hardship distributions whereas QNECs and QMACs in custodial accounts are not.

**Going forward**

Plan sponsors will need to amend their plans to conform with the rules after they are finalized and must decide whether to implement those changes that are optional. However, participant communications such as summary plan descriptions, election forms and call-center scripts may need to be modified sooner.

Comments on the proposed regulations are due by January 14, 2019.