QUALIFIED PLAN CHANGES UNDER THE NEW TAX AND BUDGET ACTS

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I. INTRODUCTION

The Tax Cuts and Jobs Act of 2017, along with the two-year federal funding legislation known as the Bipartisan Budget Act of 2018, both contain changes to the rules governing qualified retirement plans.

While the changes are not numerous, they are significant and will require that plan sponsors and practitioners familiarize themselves with the changes and in some instances, amend plan documents and/or change plan procedures.

II. HARDSHIP DISTRIBUTIONS

A. Current Law

1. Background

Internal Revenue Code Section 401(k) plans (“Section 401(k) plans”), which allow participants to contribute to their own account either on a before-tax or after tax basis, are subject to significant restrictions on the distribution of those contributions. Specifically, participant contributions, known as elective deferrals, along with their attributable earnings, may not be distributed earlier than the earliest of:

- The participant’s severance from employment, death, or disability;
- The termination of the plan without the establishment of another “alternative defined contribution plan”;
- The attainment of age 59 ½ in the case of a profit sharing or stock bonus plan; or
- In the case of a profit sharing or stock bonus plan, on account of a hardship.

In addition, a Section 401(k) or 403(b) plan may also be drafted to allow distributions of elective deferrals to those called up to active duty in the reserves or National Guard for at least 179 days.1 Where distribution occurs due to a hardship, however, the distribution is generally limited to the participant’s elective deferrals excluding earnings. The term “alternative defined contribution plan” means any plan providing for participant individual accounts but excluding for this purpose, employee stock ownership plans, simplified employee pension plans, SIMPLE IRAs, tax-sheltered annuity arrangements under Section 403(b) and Section 457(b) and (f) plans.2

In addition to participant elective deferrals, an employer may also choose to contribute to a Section 401(k) plan. Employer contributions can be purely discretionary contributions, which if made for a plan year, are allocated to all eligible participants who satisfy the plan’s profit sharing allocation requirements without regard to whether those participants have contributed elective deferrals. In addition, the employer can make special contributions designed to make it easier for the plan to satisfy the special nondiscrimination rules applicable to elective deferrals. These special employer contributions can be either qualified non-elective contributions (“QNECs”) or qualified matching contributions (“QMACs”).

QNECs are contributions made for all otherwise eligible participants without regard to whether the employee makes elective deferrals. On the other hand, QMACs are made only on behalf of those eligible employees who contribute their own elective deferrals. However, unlike the employer’s profit sharing contributions, both QNECs and QMACs must be immediately and
fully vested and are subject to the same distribution restrictions that apply to elective deferrals.\(^3\)

2. Hardship Rules

a. Basic Requirements
In order to constitute a hardship withdrawal, two basic requirements must be met. First, the distribution must be made on account of an immediate and heavy financial need of the employee. Secondly, subject to the right to have the amount grossed up for taxes, the amount to be withdrawn must be no more than the amount necessary to satisfy the financial need.\(^4\) The need of the employee can in some instances also include the needs of the employee’s spouse or dependents.\(^5\) Each of these two requirements have optional safe harbor methods plans can use to satisfy the requirement.

b. Immediate and Heavy Financial Need
As to the first requirement, whether an employee has an immediate and heavy financial need is generally to be determined based upon all of the relevant facts and circumstances. While plans can use this standard provided they do so in an objective and nondiscriminatory way, the majority of plans instead rely upon an alternative “deemed immediate and heavy financial need” safe harbor.

Under the “deemed immediate and heavy financial need” safe harbor standard, a distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

• Expenses for (or necessary to obtain) medical care that would be deductible under Section 213(d) (determined without regard to whether the expenses exceed the threshold percentage of adjusted gross income to be deductible);
• 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, or the employee’s spouse, children, or dependents (as defined in Section 152, and, for taxable years beginning on or after January 1, 2005, without regard to Section 152(b)(1), (b)(2) and (d)(1) (B));
• 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, children or dependents (as defined in Section 152, and, for taxable years beginning on or after January 1, 2005, without regard to Section 152(d)(1)(B)); or
• Expenses for the repair of damage to the employee’s principal residence that would qualify for the casualty deduction under Section 165 (determined without regard to whether the loss exceeds 10 percent of adjusted gross income).\(^6\)

c. Necessary to Satisfy the Need
As to the second requirement, a distribution is not considered necessary to satisfy an immediate and heavy financial need if the employee has other resources available to meet the need, including assets of the employee’s spouse and in some instances those of any minor children.\(^7\)

The plan may rely upon an employee’s written representations that the amount does not exceed the amount of the need and that there are no other resources available. However, just as there is an optional safe harbor standard for the first requirement, there is also an alternative safe harbor available in lieu of relying upon employee representations.

Under this safe harbor, a distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if:

• The employee has obtained all other currently available distributions and loans under the plan and under all other plans maintained by the employer, other than hardship distributions; and
• The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least six months after receipt of the hardship distribution.\(^8\)

Finally, where the plan determines that an employee is eligible to obtain a hardship withdrawal, the maximum amount available is limited to the participant’s total elective deferrals as of the date of distribution,
reduced by the amount of previous distributions of elective contributions. Thus, the maximum available in the event of a hardship does not include earnings on the elective deferrals, QNECs or QMACs unless those amounts are grandfathered.\(^9\) In order to be grandfathered, these amounts would have to have been credited to the employee’s account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989.\(^10\) Special rules apply for purposes of determining the grandfathered amounts, if any, under a collectively bargained plan.\(^11\)

**B. Changes to the Hardship Rules**

1. **Indirect Change to the Deemed Immediate and Heavy Safe Harbor Standard**

   Among the six deemed immediate and heavy financial need safe harbor standards used by most plans is a distribution allowable to cover expenses for the repair of damage to the employee’s principal residence that would qualify for the casualty deduction under section 165 (determined without regard to whether the loss exceeds 10 percent of adjusted gross income).\(^12\)

   However, the Tax Cuts and Jobs Act of 2017 (“Tax Act”) amended the casualty loss provisions of Section 165. Specifically, for tax years 2018-2025, a personal casualty deduction for damage or loss to an individual’s home will only be available with respect to losses attributable to a federally declared disaster.\(^13\)

   It is unclear how the Internal Revenue Service (“IRS”) will ultimately interpret this provision for purposes of the hardship rules. The IRS could of course take the position that a participant who is foreclosed from taking a casualty deduction for damages to the individual’s home because the damage was attributable to an isolated event and not a federally declared disaster is equally and necessarily prevented from obtaining a hardship distribution as a result of that event. Alternatively, the IRS could follow the approach taken in its existing safe harbor regulations with respect to both the uninsured medical and casualty loss hardships and make availability contingent solely upon satisfying the substantive requirements of the statute even though other provisions of the statute would deny an actual deduction.

   Until the IRS clarifies the impact of this change on the hardship rules, plans will likely prefer to take a cautious approach and deny a casualty loss hardship withdrawal request absent a Federally declared disaster.

2. **Easing Access to Hardship Withdrawals**

   While the change made by the Tax Act may make it more difficult for those suffering home damage or loss as a result of an isolated event to obtain a hardship distribution, changes made by the Bipartisan Budget Act of 2018 (the “Budget Act”) generally make it easier for most other participants to obtain a hardship distribution.

   a. **Removing the Six-Month Suspension Rule**

   Where a plan uses the safe harbor to prove that the amount of the distribution requested does not exceed the amount of the financial need, one of the requirements that must be satisfied is that the plan prohibit the participant from making elective deferrals and other employee contributions to the plan and to all other plans maintained by the employer for at least six months after receipt of the hardship distribution.\(^14\)

   The Budget Act directs the Treasury, however, to modify its regulations to delete the six-month suspension requirement. The regulation is to be amended not later than one year after the date of enactment of the Budget Act and the revised regulations are to apply to plan years beginning after December 31, 2018.\(^15\)

   What is not clear is whether Congress’ directive will be read by the IRS as instructions to simply delete the suspension period entirely or instead to modify the period by, for example, reducing it from a six-month suspension period to some lesser period. Equally unclear is what happens to a participant who takes a hardship distribution in December, 2018 subject to the six-month suspension when the rules change in January, 2019. Is the suspension period to continue or will the new rules be deemed to apply immediately to that participant.

   Once the IRS amends the regulations, plans relying upon this safe harbor standard will also need to be amended to reflect the change. In the interim, given that the Budget Act did not itself remove the requirement, plans should continue in practice to impose the six-month suspension on elective deferrals following a hardship distribution.