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US

Volume 41 | Issue 16 | February 15, 2018

New Tax Law Causes Uncertainty for Some Hardship Distributions

The Tax Cuts and Jobs Act indirectly changed one of the safe harbor bases for hardship distributions. For tax years 2018-2025, the new law limits casualty loss deductions to those occurring in a federally declared disaster area. Plans that use hardship distribution safe harbors that reference this deduction, or otherwise refer to deductible casualty damage to a principal residence as a reason for a hardship distribution, should consider how they will address requests for losses that occur outside of a federally declared disaster area.

Background

As an exception to plan qualification rules that generally discourage participants from tapping into retirement funds for other reasons, a plan can allow in-service withdrawals of elective deferrals for narrowly framed “hardship” situations. To satisfy the requirements, the participant must have a hardship event — which regulations describe as being “on account of an immediate and heavy financial need” — and the distribution must be necessary to meet that need. Plans may use either safe harbors that the IRS deems to meet these criteria or a “facts and circumstances” analysis, which may consider some or all of the safe harbor categories. See our March 7, 2017 *For Your Information* to learn about hardship documentation requirements.

Under the safe harbors, an employee is automatically considered to have an immediate and heavy financial need if the distribution is for “[e]xpenses 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% of adjusted gross income).” However, the Tax Cuts & Jobs Act amended the section 165 requirement so that, for tax years 2018 through 2025, a casualty deduction is available only for losses attributable to a federally declared disaster (for example, Hurricane Maria). This means that property damage not in a federally declared disaster area will no longer qualify under section 165. (See our *Legislate* from December 20, 2017 for background on the Tax Cuts & Jobs Act of 2017.)

For example, a literal interpretation of the safe harbor standard would now mean that a participant who loses his or her home in 2018 in a house flood that is not in a federally declared disaster area would not be considered to have an immediate and heavy financial need for purposes of hardship withdrawal eligibility.

It is unclear whether legislators intended the cross-reference to section 165 to trigger a change in the hardship withdrawal rule.

Recent legislation affecting hardship distributions

The Bipartisan Budget Act that Congress passed last week also impacted hardship withdrawal rules by directing the IRS to modify its regulations for those distributions, including deleting the six-month suspension of deferrals after a hardship distributions for plan years beginning after 2018. It also exempted up to $100,000 of qualified distributions relating to the October through December 2017 California wildfires from the 10% early distribution penalty. Please see our **February 9, 2018** *Legislate* for more information on this legislation.

How should plans handle this change?

Stakeholders have asked the IRS to provide guidance on this issue. In the meantime, plans that use the safe harbors or otherwise allow hardship withdrawals for casualty damage to a principal residence should consider how to handle requests for losses outside of federally declared disaster areas.

One option is to deny a hardship request for repair to a primary residence if the loss occurs on or after January 1, 2018 and is outside of a federally declared disaster area. To account for this change, a plan may need to modify the instructions provided as part of hardship request materials as well as the guidelines used for reviewing and approving hardship requests.

No change to retirement plan limits

Although the new tax law changed the CPI basis for adjusting basic income tax thresholds, it did not change the basis for adjusting benefit plan limits that reference the Code section 415 adjustments that are based on Social Security adjustments. In **News Release IR-2018-1**, IRS confirmed this distinction. Thus, nothing changes for 2018 limits previously announced in **Notice 2017-64.** The IRA caps are done on the new basic income tax basis for 2018, but due to rounding conventions, there is no change for the 2018 IRA limits.

Alternatively, a plan could opt to ignore the section 165 amendment — and maintain the status quo — when determining hardship eligibility, unless and until the IRS issues guidance to the contrary. This approach would mean continuing to grant hardship requests for a repair to a primary residence for a loss occurring on or after January 1, 2018 without considering whether the loss occurred inside or outside of a federally declared disaster area. If the plan chooses this approach, no change would be necessary to either the instructions or the review and approval procedures. However, plans taking this approach may want to consult with counsel about the need for a plan amendment; as a “discretionary” amendment, the due date would be the last day of the plan year the option is implemented administratively.

In either case, plans should provide written instructions to their recordkeepers on how to handle the change to section 165.

In Closing

Plans that use hardship distribution safe harbors or otherwise allow casualty damage to a principal residence to be the basis for a hardship distribution should review current plan procedures and determine how they will handle requests for losses outside of a federally declared disaster area.

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