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Loans and Hardship Withdrawals: New Rules for Employees Dealing With Natural Disasters and Other Financial Emergencies

Natural disasters including Hurricanes Harvey, Irma and Maria, as well as the California wildfires, caused a record-breaking $283 billion in damage to homes and other property in 2017, according to the National Oceanic and Atmospheric Administration.

Meanwhile, more than a third of participants surveyed in the 2017 Global Benefits Attitudes Survey by consulting firm Willis Towers Watson said they suffered a moderate to severe financial hardship last year. About 80 percent of the survey respondents said they were living paycheck to paycheck.

Whether due to a natural disaster or otherwise, it's clear that many participants need access to cash to pay for unexpected expenses. Two new laws—the Tax Cuts and Jobs Act (TCJA) and the Bipartisan Budget Act of 2018 (BBA)—coupled with new Internal Revenue Service (IRS) rules for victims of natural disasters have helped broaden defined contribution loan and withdrawal options for participants who find themselves in financial distress.

There are key nuances to the rules affecting loans and hardship withdrawals, so it's important that plan sponsors familiarize themselves with the changes. In many cases, the new rules provide flexibility not only for participants but for plan sponsors too. Reporting requirements for plan sponsors have been eased, but it's important to gather the necessary materials as soon as possible, because federal regulators have up to three years to look back on the transactions.

To help plan sponsors understand how these changes affect them and their employees, we outline the old procedures and identifies the notable differences for loans and withdrawals made to victims of natural disasters, as well as participants needing access to their defined contribution plans.

Changes to Loans from Defined Contribution Plans

Participants in 401(k), 403(b) and 457(b) plans can take loans under normal conditions if the plan document specifies that as an option. In general, the total amount allowed is the lesser of 50 percent of the participant's present vested amount or $50,000. The loan needs to be repaid within five years (except if, as permitted by the plan, used and documented for the purchase of a primary residence), and payments must be made quarterly at a minimum. In some cases, spouses must sign off on the loan and its amount.

For "qualified individuals" living in specified areas affected by 2017's hurricanes and wildfires, the loan limit increases to the lesser of 100 percent of the participant's present vested amount or $100,000. These loans are available only through December 31, 2018. Again, in some cases, spouses must give approval of the loan and its amount.

For "traditional" loans, participants must repay the amount borrowed within five years. For disaster victims, the loan repayments can be suspended for one year, but interest on the loan will accrue during that time. If a participant chooses to use the one-year suspension, the participant has five years to repay the amount. Like traditional loans, loans for disaster victims must have a reasonable interest rate.

Plan sponsors can start these loans immediately, but plan documents must be amended to show the new terms. Plan sponsors have until the last day of the first plan year beginning on or after Jan. 1, 2019 to submit the changes.

Additionally, the TCJA extended the loan repayment schedule for advances under normal, non-disaster circumstances. Previously, employees who had an outstanding loan when they left a job had 60 days to pay off the loan. If the participant failed to do this, the loan would be considered a withdrawal and would be subject to income tax plus a 10 percent penalty. For loans taken on or after Jan. 1, 2018, the TCJA changes the deadline

to repay loans to the participant's tax filing date, which could be as late as October of the following year if the extension is taken.

Changes to Hardship Withdrawals from Defined Contribution Plans

Under the previous rules, participants had to take a loan out before moving to the hardship withdrawal. If the plan permitted hardship withdrawals, participants needed to offer proof that there was a severe financial hardship resulting from an extraordinary circumstance—such as an accident or to avoid eviction from a home—to qualify. Participants could take out what was necessary to pay for the expense, and they would not be allowed to contribute to 401(k) and 403(b) plans for six months after the withdrawal. (Participants to 457(b) plans, however, could continue contributing to the plan without delay.) In some cases, spousal consent would be required. The distribution was subject to income tax in addition to a 10 percent withholding tax.

The BBA has loosened some of the old withdrawal rules and has made those changes permanent for all hardships. For plan years beginning after Dec. 31, 2018, participants with hardship withdrawals can contribute to their defined contribution plan without having to wait six months. In addition, participants don't have to take out a loan first; they can use the hardship withdrawal as their first option.

Participants with 401(k), 403(b) and 457(b) plans who lived in specified natural disaster areas during the time of the event are now allowed to take "Qualified Hurricane Distributions" and "Qualified Wildfires Distributions" (Special hardship withdrawals above the IRS allowed safe harbor hardship withdrawals). Distributions are available through December 2018. Both laws specify that participants can ask for up to $100,000 in total from all of their plans. Qualified disaster distributions are not subject to the 10 percent tax on early withdrawals. Participants are allowed to take out what they've contributed, plus interest earned and employer contributions to their accounts, not to exceed the total amount limits.

Participants may, but are not required to, repay the special hardship distribution tax-free. If participants want to take advantage of the opportunity to repay the withdrawal tax-free, they must repay the funds within three years of the withdrawal. There are some exceptions to this rule.

As with the changes to the rules related to normal hardship withdrawals, disaster victims can make contributions to their defined contribution plan during the six months after the distribution. In addition, if the participant is unable to use the distribution to purchase a home prior to the disaster event, the amount withdrawn can be recontributed to an eligible retirement plan.

Plans sponsors are allowed to rely on a reasonable representation of need from the participant to make the loan or distribution. The IRS requires that the plan sponsor make realistic attempts to obtain the missing information as soon as possible. For example, if a spousal consent is required, and the spouse dies, the plan sponsor can make the loan or distribution if there is a reasonable belief that the spouse has died. As soon as possible, though, the plan sponsor must collect a death certificate confirming the event.

Plan sponsors must amend the plan to show the new terms. Form 8915B is available on the IRS website, along with instructions explaining the details of the form.

Insight: Plan Ahead to Help Participants Deal with Hardships

The federal government is providing more flexibility to defined contribution loans and hardship withdrawals and is making a considerable effort to help victims of disasters and their plan sponsors in expediting access to funds needed to rebuild lives. Plan sponsors that want to help their participants gain access to their funds should review plan documents to make sure loans and hardship distributions are allowed. In addition, plan sponsors may consider checking in with their service providers to see whether there are any limitations on making timely loans or distributions when natural emergencies occur.