Federal Budget Deal—Look Before You Leap Into Withdrawals

By Kelsey Mayo and Toni Tardy

This article discusses changes to hardship rules contained in the Bipartisan Budget Act of 2018.

On February 9, 2018, Congress passed the amended Bipartisan Budget Act of 2018. This Act contains some effects on retirement plans and hardship distributions, in particular.

This two-year budget agreement will make retirement funds more accessible to participants. Effective for plan years beginning after December 31, 2018, the Act will ease rules on hardship distributions by removing (1) the requirement to first exhaust all other options by taking a loan from the plan; (2) the prohibition on withdrawing certain employer contributions and investment earnings; and (3) the requirement to suspend participant contributions for six months after the hardship. For the first time, qualified nonelective contributions (QNECs), matching contributions (QMACs), contributions made to stock bonus plans or profit-sharing plans, safe harbor contributions, plus earnings on all contributions, are now all up for grabs.

While this certainly eases administration, and seemingly is a boon for the financially struggling participant, is it really what is best for a population struggling with retirement security?

The Good

The alleviation of restrictions on hardship distributions can and will be good news for many. Consider the participant facing foreclosure. In that instance, the participant would often need a large amount of money. In fact, there are many instances where one's elective contributions just would not be enough money to satisfy the financial need (particularly when you add taxes and penalties on the hardship distribution to the need). The ability to access earnings and other sources of contributions will be a huge relief for employees in these difficult situations.

In addition, participants will no longer be required to stop contributions to the employer's plans for six months. There are two sides to this. The requirement to suspend contributions (1) may have discouraged hardship distributions; (2) was a built-in method to make more cash from the employee's paycheck available for taxes and penalties due at the end of the year; and (3) in part, reflected an idea that, if you had an immediate and heavy financial need, then you should be meeting the need rather than contributing to the plan. These were all intended benefits of the suspension. Historically, however, the suspension operated more as punitive than beneficial, and has taken severe criticism as worsening the US retirement savings dilemma by unnecessarily preventing savings for little to no benefit. It also assumed that all hardship distributions meant that the participant was in desperate financial straits, when that is not always the case. Often, such as with house purchases and medical expenses, the hardship distribution is needed to meet a one-time, large cash demand that does not affect the participant's ability to contribute on a paycheck-by-paycheck basis. Now that the suspension has been lifted, participants may continue to contribute to the

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plan and not be further penalized for that six-month period.

For administrators, the simplification of these rules may be an enormous relief. Administrators will no longer have to monitor whether there are available loans (sometimes in different plans of the same employer), separately track principal and earnings balances for deferrals, or monitor six-month contribution suspensions. These are certainly welcome simplifications for the industry, but at what cost?

The Bad

It is widely reported that US workers have a hard time saving money for retirement. We acknowledge this every day in the industry as we brainstorm how to enhance plan adoption, increase participation rates, and increase the percentage of employees on track for a secure retirement. But does adopting the Budget Act changes wholesale work against our goal of securing retirement for more US workers?

First, make no mistake that this change is a revenue raiser in the Congressional budget. A hardship distribution, unlike a plan loan, is taxed to the participant and is often subject to a 10 percent early distribution penalty. By allowing easier access to a hardship distribution, the government will collect more tax revenue. And because more of the participant's 401(k) funds may be available, it may be more likely they have sufficient funds to take the full amount needed *plus* the gross-up to pay the taxes related to the distribution. This means that hardship distributions are likely to be higher than they have been historically—increasing the "leakage" for retirement plans in a significant way. Combine this with the IRS's recent relaxation on the hardship documentation that is required, and that "leak" may have just turned into a stream from the plan.

Second, before the change, the plan administrator had to have a conversation with participants about the possibility of a loan when the situation was immediate and dire. Loans are beneficial to participants because (1) they are not immediately taxable to the participant; and (2) they permit participants to return funds to the plan, thereby making their retirement more secure. The loan was not required if it would have exacerbated the financial need, but the plan administrator had to at least inquire if a loan could alleviate the need. Under the new rules, participants may never be counseled that a loan could be more beneficial to them and there will be no requirement that they choose a loan over a hardship distribution when both would meet the need. This will likely result in participants, who are stressed financially, choosing the easier path of a withdrawal, regardless of the short- and long-term financial consequences. This will worsen the issue of retirement security as the absence of a moderate sum (say $10,000) that would have been repaid under the old rules could represent a significant sum to the participant (perhaps $50,000+) that is missing at retirement age.

In addition, aside from those obvious consequences, what about the less obvious? Tax credits target low-to-moderate income earners—those least able to save, more likely to run into a hardship scenario, and least likely to have financial/tax advisors. Increasing access to taxable distributions and decreasing the likelihood of nontaxable loans may have unintended consequences, such as (1) placing the participant in a higher tax bracket; (2) preventing the participant from qualifying for the earned income credit or other tax benefits s/he is used to having (such as higher learning credits and the saver tax credit); and (3) disqualifying the participant from certain subsidies on the health care marketplace.

The Solution

Employers should carefully consider how to adopt these permitted changes, if at all. There are no wrong decisions here—just a matter of culture and philosophy. While an employer may have a strong desire to help secure retirement, the overriding philosophy should be to empower people to make decisions that are right for them and give them tools to make that best decision. Therefore, it may be advisable for an employer to adopt all the changes to ease administration of the plan, but then combining these modifications with a process that assists the employee in making an educated decision. For example, perhaps any participant requesting a hardship could be given (1) information and access to the employer's Employee Assistance Program, if it will provide financial counseling or tax assistance; (2) education on the tax consequences, including loss of other income-based benefits; (3) an illustration of how taxes and penalties on a distribution would work; and (4) an illustration of how a loan versus a distribution could impact the participant. Again, this is not a requirement, but that is just one idea of how to meld the advantages of the new law with the practicalities of the US retirement crisis. ■