We Are Not Out of the Woods: Some 401(k) Plan Amendments May Be Needed in 2018

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Although the IRS announced on November 28, 2018 that no plan amendments are required in 2018 to 401(k) plan documents in order to maintain their tax-qualified status, this announcement is not the whole story if a plan allows hardship distributions, or a plan sponsor wants to apply forfeitures against qualified non-elective (QNEC) or qualified matching contributions (QMAC).

A 2018 amendment may be needed to use forfeitures to cure discrimination test failures. With respect to forfeitures, regulations finalized on July 20, 2018 permit forfeitures to be used as QNECs or QMACs for plan years ending on or after July 20, 2018. Thus, for plans with the calendar year as the plan year, a plan amendment is needed before year-end if a plan wants to take advantage of this new rule in 2018.

When would a plan need to use this new forfeiture rule? One way a plan can cure the failure of the non-discrimination tests that compare the salary deferral and matching contribution rates of highly compensated employees against those of non-highly compensated employees is to make a fully vested QMAC or QNEC contribution to the appropriate participants. This is often preferable to forcing highly compensated participants to take back part of their elective deferral contributions for the year, which is another common cure for this test failure. If participant forfeitures can be used to fund part or all of the QNEC or QMAC, then the contribution is virtually "free" for the plan sponsor. Thus, a plan sponsor that determines that it is likely to fail these discrimination tests in 2018 may want to amend its plan before year-end to allow the 2018 forfeitures to fund a 2018 QNEC or QMAC.

Another revision in the law involves major changes to the hardship distribution rules effective for plan years beginning in 2019. The regulations are not yet final, so plan amendments will not have to be made until the regulations are finalized, and those amendments will be able to use retroactive effective dates back to the beginning of the plan year. Many of the proposed changes to the hardship rules are discretionary, but the one mandatory change is that, after 2019, plans will no longer be able to impose a mandatory six-month suspension on elective deferral and after-tax contributions once a hardship distribution is made. For plans that would like to eliminate this suspension period earlier (i.e. in the 2019 plan year), either for those who do not take the withdrawal until 2019 or also for those who took a hardship withdrawal in the second half of 2018 and are within their suspension periods at the beginning of 2019, they may do so. Best practices would dictate that an amendment eliminating the suspension period effective on January 1, 2019 be adopted on or before December

31, 2018 so that plan administrators will be able to enforce the plan as written with respect to hardship distributions.

Other changes in the hardship rules allow plan sponsors to ease the restrictions on hardship distributions in a variety of ways. Plan sponsors may eliminate the requirement that participants take all available plan loans before they take the hardship withdrawal. Plans may allow the distributions to be made from QNEC and QMAC accounts as well as from elective deferrals, and may make earnings on all of these accounts also available to fund the withdrawal. The safe harbor reasons to take a hardship withdrawal can be expanded to no longer impose certain casualty law deduction restrictions when determining whether casualty damage to a residence qualifies as a hardship; to allow damage from any FEMA-designated disaster to automatically count as a hardship; and to allow medical, educational, and funeral expenses for primary beneficiaries under the plan to count (if this change had not already been made to a plan). If a plan sponsor wants to make some or all of these changes to broaden the availability of hardship withdrawals to participants in 2019, then an amendment is advisable at the beginning of the plan year so that administrators can apply the plan provisions as written when processing hardship withdrawals.

The proposed hardship withdrawal regulations also ease the documentation requirements for plan administrators. The new rules will require merely that a hardship distribution not exceed the amount of the participant's or beneficiary's need (which includes tax costs arising from the distribution); that the participant must have first taken all other distributions available under the employer's plans (such as age 59 1/2 distributions, if they are permitted); and that the participant must have represented that there are no available liquid assets outside of the plan sufficient to meet the need. More importantly, the new rules provide that a plan administrator may rely on these representations unless the administrator has actual knowledge to the contrary. Under current law (which is reflected by most plan documents), plan administrators have much greater duties to verify that participants did not have other assets that were sufficient to meet their needs without tapping the 401(k) plan. Unfortunately, as appealing as it is to try to adopt these relaxed certification rules effective January 1, 2019, the proposed regulations did not expressly allow plan sponsors to rely on these rules in the interim period until the regulations are finalized. Therefore amendments adopting these new certification rules should not be adopted until then.

If you have questions about whether an amendment for your 401(k) plan is advisable before year-end, please contact the author of this alert or another member of the firm's Labor & Employment Team.

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