USI Advisors, Inc.

MARKET & LEGAL UPDATE
SEPTEMBER 2019 REVIEW

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"An Eventful Start to Fall"

A number of developments regarding trade, monetary policy, oil supply and the political outlook have dominated the markets during September. After increasing tariffs on each other's goods, the U.S. and China de-escalated tensions at the end of the month. The Federal Reserve cut interest rates for the second time this year but was more divided than before on policy. Additionally, House Democrats opened impeachment proceedings against President Trump. Despite the flurry of negative news, U.S. stocks were relatively stable in September. With the September monthly gains, the S&P 500 Index and the Dow Jones advanced for the third quarter, helping stocks post the biggest year to date gains in more than two decades.

The U.S. and China have been in an escalating trade war for over a year. A new round of trade talks between the world's two largest economies is expected to be held in Washington D.C. on October 10th and 11th. Both sides have recently made a series of small concessions, between China buying more farm products from the U.S. and the U.S. delaying the implementation of some tariffs until December. Stock indices fell at the end September on news that the Trump administration was considering new pressure tactics by limiting U.S. investments in China and the possibility of delisting Chinese companies from U.S. Stock exchanges. However, both sides have previously used aggressive rhetoric ahead of talks in order to gain leverage. During a speech at the United Nations, Trump initially criticized Beijing's trade practices and he later signaled that a trade deal with China could be coming soon, which was received positively by the markets.

Trade war risks and an uncertain global economic outlook led the Federal Reserve to cut interest rates by 25 basis points in September. This move was expected by the markets but division within Fed officials prevented them from delivering a clearer image about future actions. This was the first time since 2016 that three members of the FOMC committee opposed the vote, one of them wanting a bigger cut, and two others favoring to keep rates steady. Interest rate policy for the remainder of 2019 showed a deeper divide, including 7 members expecting another rate cut, but 5 preferring to keep rates steady through the rest of the year.

Market Return Indexes	September 2019	YTD 2019
Dow Jones Industrial Average	2.1%	17.5%
S&P 500	1.9%	20.6%
NASDAQ (price change)	0.5%	20.6%
MSCI Europe Asia Far East (EAFE)	2.9%	12.8%
MSCI Emerging Markets	1.9%	5.9%
Bloomberg Barclays High Yield	0.4%	11.4%
Bloomberg Barclays Aggregate	-0.5%	8.5%
Yield Data	**September 30, 2019**	**August 30, 2019**
U.S. 10-Year Treasury Yield	1.68%	1.50%

Mixed economic data suggests that the trade war is starting to impact U.S. consumers and businesses. The housing market is solid and employment gains remain strong, but consumer spending hardly increased in August and business investment remained subdued. Consumer confidence, as measured by the Conference Board, also fell sharply to 125.1 in September from 134.2 in the previous month. A strong consumer has carried the U.S. economy throughout the year but the trade war with China has put businesses on edge, contributing to a slowdown in hiring, which ultimately could make Americans cut back on spending going forward. The manufacturing sector has also experienced weakness since the start of the trade dispute. The most recent Purchasing Managers' Index (PMI) came in better than expected in September but, despite the slight uptick, IHS Markit reported that the overall growth rate in September remains one of the lowest in the last 3 years.

Eurozone business conditions and economic sentiment were also weak in September. Ahead of the October 31st Brexit deadline, the UK Supreme Court ruled that Prime Minister Boris Johnson's decision to suspend Parliament was illegal. Johnson is now under pressure to resign and the probability of no-Brexit scenario has been reduced while a new delay may be more likely. Another unexpected event internationally was an attack on Saudi Arabian oil production facilities, causing a supply disruption that led to a spike in oil prices. This is the fifth attack this year and if these attacks persist, they could impact political stability, in addition to oil prices.

The most recent development that caused volatility in the markets at the end of September was the impeachment inquiry of President Trump, but it is unlikely to have a big impact on the markets. History shows that presidential impeachment actions usually don't move the markets. During both Watergate and Clinton scandals, economic forces played a much bigger role in driving stock prices than the possibility of an impeachment. Even if impeached by the House of Representatives, the chances of Trump's removal from office are small given that Republicans control the Senate. Overall, markets have navigated the political uncertainty and geopolitical risks well in September and in the third quarter, extending the longest bull market on record.

LEGAL UPDATE | **The IRS Issues Final Regulations on the New Hardship Distribution Rules**

Last November, the IRS issued proposed regulations amending the hardship provisions applicable to 401(k) and 403(b) plans; on September 23rd they issued the final regulations. These regulations reflect the statutory changes that were included in the Bipartisan Budget Act of 2018 and the Tax Cuts and Jobs Act with respect to hardship distributions. While the final regulations make no substantive changes from the proposed regulations, there are some slight differences and clarifications in the final version.

401(k) Plan Hardship Changes under the Final Regulations – like the proposed regulations, the final regulations make the following changes to the current hardship rules:

1. **Mandatory:** Plans must eliminate the requirement that participants suspend their elective deferral contributions for a six-month period after taking a hardship withdrawal. **The final regulations make clear that for distributions on or after January 1, 2020, a plan is not permitted to provide for a suspension of elective contributions as a condition of obtaining a hardship distribution. However, the prohibition on suspensions applies only to qualified plans, section 403(b) plans, and governmental 457(b) plans, but does not apply to unfunded nonqualified plans such as 409A plans. Thus, a nonqualified plan may retain a provision to suspend deferrals following a hardship (or may be amended to remove the suspension provision).**

2. **Optional:** Plans may eliminate the requirement that participants must exhaust any available loans prior to taking a hardship distribution.

3. **Optional:** 401(k) plans may allow hardship withdrawals from previously restricted contribution sources; earnings on elective deferrals, Qualified Nonelective Contributions (QNECs), Qualified Matching Contributions (QMACs), as well as earnings on QNECs, QMACs are now permitted. However, these sources continue to be restricted from 403(b) plans. **The final regulations note that 401(k) safe harbor contributions made to the plan are either considered QNECs and QMACs and may be distributed on account of hardship, including earnings. Additionally, a plan may limit the type of contributions available for hardship distribution and may exclude earnings on those contributions from hardship eligibility.**

4. **Optional:** Plans may expand the safe harbor hardship conditions that are deemed to meet the immediate and heavy financial need by adding a seventh safe harbor condition to the list for expenses and losses incurred following a federally declared disaster that occurs in an area designated by the Federal Emergency Management Agency (FEMA). **The final regulations make the following clarifications to this new safe harbor expense: 1) only disaster-related expenses and losses of an employee who lived or worked in the disaster area qualify, and the expenses and losses of the employee's relatives and dependents do not qualify; 2) unlike previous disaster-relief announcements, there is no specific deadline by which a request for disaster-related hardship distribution must be made; and 3) unlike the disaster-relief announcements, there is no deadline for the plan sponsor to add disaster-related distribution provision to the plan. The IRS expects that no more disaster-relief announcements will be needed.**

5. **Revised Standard for Determining Hardship:** The new regulations add a **"general standard"** for determining whether a participant has experienced an immediate and heavy financial need to justify a hardship distribution. Instead of making the determination based on all the relevant facts and circumstances, the **general standard** would apply to determine whether a distribution is necessary to satisfy a financial need. Effective January 1, 2020, the **general standard** requires plan administrators to:

   (i) Limit the amount of the hardship distribution to the participant's need (including any amounts necessary to pay taxes and penalties on the distribution);
   (ii) Verify the participant has taken all available distributions under the plan (other than loans) as well as other plans maintained by the employer, whether qualified or unqualified; and
   (iii) Obtain a representation from the participant that he/she has insufficient cash or other liquid assets to satisfy the need in writing or by electronic medium (unless the plan administrator has actual knowledge otherwise).

The final regulations clarify that an employee can make a representation that he or she has insufficient cash or other liquid assets reasonably available to satisfy a financial need, even if the employee does have cash or other liquid assets on hand, provided those assets are earmarked to pay an obligation in the near future (for example, rent). The IRS noted that plan sponsors have a broad range of conditions that may be imposed on hardship distribution; for example, a plan can require a minimum amount for hardship distributions, provided the minimum is non-discriminatory. Additionally, the IRS clarified that employees may make verbal representations via telephone as long as the call is electronically recorded.

403(b) Plan Hardship Changes under the Final Regulations – like the proposed regulations, under the **final** regulations, the same hardship changes provided above for 401(k) plans also apply to 403(b) plans with two notable exceptions:

1. Earnings on elective deferrals to 403(b) plans will not be permitted for hardship distribution, as the Bipartisan Budget Act of 2018 did not allow for such.
2. QNECs and QMACs held in a 403(b) plan custodial account are not available for hardship distribution.

The final regulations confirm that these exceptions, as stated in the proposed regulations, continue to apply to 403(b) plans.

Effective Dates – the regulations generally went into effect for plan years beginning after December 31, 2018, and plans had the option of applying the new rules effective January 1, 2019. However, plans must comply with all (non-optional) rules effective January 1, 2020. The new general standard for determining financial need takes effect January 1, 2020. The regulations also clarify that any six-month deferral suspensions could have been eliminated as of January 1, 2019, but no such deferral suspensions will be permitted for distributions on and after January 1, 2020. The seventh safe harbor condition for FEMA declared disasters can be effective with plan years beginning on or after January 1, 2018.

Plan Amendments – the IRS expects that plan sponsors will need to amend their plans for the new hardship rules, and any such amendment must be effective for distributions beginning no later than January 1, 2020.

- **For individually designed plans** - the deadline for amending the plan is the end of the second calendar year that begins after the IRS issues the Required Amendments List (RAL). If the final regulations are included in the 2019 RAL, the deadline will be December 31, 2021.
- **For pre-approved 401(k) plans** - the deadline for amending the plan is the plan sponsor's tax-filing deadline, including extensions for 2020. However, earlier deadlines may apply if the plan sponsor applied the new rules in 2019. More clarification is expected from IRS on the application of any earlier deadlines.
- **For 403(b) plans** – the deadline for amending the plan is March 31, 2020; however, the IRS is considering providing for a later amendment deadline in separate guidance.

Tax Treatment – the tax treatment of hardship distributions remains unchanged. Under current law, hardship distributions are generally taxable and subject to a 10% early withdrawal tax.

If you have any questions regarding these hardship rule changes and the final regulations, please contact your USI Consulting Group representative.

For previous market commentaries please click here.

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