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Insights

IRS Issues Final Regulations for Hardship Distributions

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The IRS has issued **final regulations** regarding hardship distributions from 401(k) and 403(b) plans. While the final regulations differ little from the proposed regulations (as described in our November 15, 2018 **Employee Benefits ALERT**), there are changes worth noting.

Employee Representation of Financial Need

The **proposed regulations** required that, effective for hardship distributions made on or after January 1, 2020, a participant must provide a representation "in writing, by an electronic medium, or in such other form as may be prescribed by the Commissioner," that he or she has insufficient cash or other liquid assets available to satisfy the financial need. In response to concerns that the participant may have other assets available but has another immediate need for them, the final regulations provide that the representation only relates to whether the participant has cash or other liquid assets that are "reasonably available" to satisfy the financial need. This change allows a participant to represent that he or she does not have sufficient cash to meet a financial need even if he or she does have cash on hand, provided such amount is reserved for a future obligation, such as rent.

The final regulations clarify what constitutes an "electronic medium" by referencing the definition under Treasury Regulation §1.401(a)-21(e)(3) which defines an electronic medium as an electronic method of communication (e.g., Web site, electronic mail, telephonic system, magnetic disk, and CD-ROM).

Suspension of Elective Deferrals

The proposed regulations eliminated the six-month suspension period for making elective deferrals after a participant receives a hardship distribution; however, the types of plans to which this prohibition of suspensions applies were not specified. The final regulations specify that the prohibition applies to qualified plans, 403(b) plans and eligible 457(b) plans but does not apply to unfunded nonqualified deferred compensation plans subject to Section 409A of the Internal Revenue Code.

Effective Date and Plan Amendments

The final regulations apply to all hardship distributions made on or after January 1, 2020; however, plan sponsors who elected to implement optional changes in 2019 will need to amend their plans no later than December 31, 2019 to reflect those changes, if they have not done so already. Plans that complied with the proposed regulations will satisfy the final regulations.

Sponsors of individually designed plans (excluding governmental plans) will be required to amend their plans to reflect the final regulations by the end of the second calendar year that begins after the new regulations are included in the Required Amendments List (RAL) published by the IRS. For example, if the 2019 RAL includes the new hardship rules, the deadline for amending a calendar-year plan will be December 31, 2021.

The amendment deadline for pre-approved and volume submitter plans is the 2020 tax-filing deadline, including extensions, if any.

The amendment deadline for 403(b) plans is March 31, 2020. However, the Treasury Department and IRS have indicated they are considering providing for a later amendment deadline. Any such delay will be issued in separate guidance.

It is important to note that while plan sponsors have time to amend their plans, the elimination of the six-month suspension period for making elective deferrals and the new participant representation of insufficient cost or liquid assets, are both required to be implemented operationally no later than January 1, 2020.

Final Regulations Overview

- Elimination of 6-Month Suspension (Optional for 2019 Plan Year, Mandatory as of 1/1/2020). The six-month suspension of elective deferrals to retirement plans (excluding unfunded nonqualified plans) has been eliminated. This change is **mandatory** for hardship distributions made on or after January 1, 2020; however plan sponsors may choose to eliminate the six-month suspension as early as January 1, 2019 or to continue to enforce the 6-month prohibition through 2019. Plan sponsors may also choose to lift a participant's deferral election suspension due to a prior hardship withdrawal prior to January 1, 2020.
- Facts and Circumstances Test Eliminated (Mandatory as of 1/1/2020). The "facts and circumstances" test as to whether a distribution is needed to satisfy a financial need has been replaced with one general standard for determining if a hardship distribution is necessary. The general standard becomes effective and **mandatory** for hardship distributions on or after January 1, 2020. The multi-part general standard requires that:

    1. The hardship distribution may not exceed the amount of the participant's need (including any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution);
    2. The participant must have obtained other available, non-hardship distributions under the employer's plans, and
    3. The employee must represent in writing or by an electronic medium that he or she has insufficient cash or other liquid assets available to satisfy the financial need. The plan administrator may rely on the representation unless he or she possesses actual knowledge to the contrary.

- Elimination of Requirement to Take Plan Loans First (Optional Beginning with 2019 Plan Year). The requirement that an employee must exhaust plan loans, if available, before receipt of a hardship distribution is now an **optional** provision but requires a plan amendment if the plan sponsor wants to require exhaustion of plan loans.
- Expansion of Funds Eligible for hardship Distribution (Optional Beginning with 2019 Plan Year). In addition to elective deferrals, hardship distributions from a 401(k) plan may now be obtained from qualified non-elective contributions, and qualified matching contributions, as well as the earnings on those contributions, regardless of when contributed or earned. With respect to 403(b) plans and qualified non-elective contributions, qualified matching contributions are available upon hardship only if they are not held in a custodial account (i.e. annuity). Additionally, earnings on elective deferrals under a 403(b) plan remain ineligible for hardship withdrawal. This is an **optional** change.
- New Reasons for Hardship Distributions. The list of expenses for which hardships are deemed to be made on account of immediate and heavy financial need has been expanded as described below.
  - Disaster Event (Optional Beginning with 2019 Plan Year). Expenses and losses (including loss of income) incurred by the participant because of certain natural disasters, as declared by the Federal Emergency Management Agency (FEMA) have been added to the list, provided the employee's principal residence or principal place of employment was located in the area designated by FEMA. This new expense is **optional** but is intended to allow participants in federally declared disaster zones to access funds faster. This new disaster-related expense differs from previous IRS disaster-relief announcements in three respects:

1. Expenses and losses are limited to the participant and not the participant's relatives and dependents;
2. There is no specific deadline by which a request for disaster-related hardship distribution must be made and no specific authority to relax hardship documentation requirements that typically accompany IRS relief announcements; and
3. There is no extended deadline for plan sponsors to add disaster-related distribution provisions to the plan.

  - Casualty Loss Expenses Not Connected with a Disaster (Optional for 2018 and 2019, Mandatory Beginning 1-1-2020). The Tax Cuts and Jobs Act limited when an individual could take a casualty loss deduction under Code Section 165 to losses attributable to a federally declared disaster. The final regulations eliminate this limitation, permitting distributions for repair of damage directly suffered by the employee to his or her principal residence not located in a federally declared disaster area.
  - Primary Beneficiary Expenses. The final regulations reaffirm hardship distributions for a "primary beneficiary under the plan," which is defined as an individual for whom qualifying medical, educational, and funeral expenses may be incurred. This provision is **optional** and has been permitted since the

enactment of the Pension Protection Act.

Action Items

If it has not already done so, now that the final hardship withdrawal regulations have been released, a plan sponsor should:

- Review hardship distribution procedures in plans, distribution procedures, SPD's and forms
- Adopt plan amendments consistent with required changes and any optional changes to be implemented
- Update hardship distribution procedures, SPDs and forms
- If using a pre-approved plan confirm what actions are needed with the plan provider
- If the plan is a safe harbor plan, confirm the safe harbor notice has been updated