

IRS Finalizes Changes in Hardship Distribution Rules

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On September 23, the IRS published final regulations amending the rules governing hardship distributions from 401(k) and 403(b) plans pursuant to changes contained in the Bipartisan Budget Act of 2018 (Act). 84 Fed. Reg. 49651. The final regulations, summarized below, largely mirror the [proposed regulations](#) that the IRS published in November 2018, and include helpful clarifications on the changes and plan amendment timing.

Background

Hardship distributions permit active participants to receive an in-service distribution of elective deferrals (and certain other amounts) from their accounts, prior to reaching age 59½, if they have an immediate and heavy financial need and the distribution is necessary to meet that need. Whether a participant has an immediate and heavy financial need, and whether the distribution is necessary to meet that need, have historically been determined based on all relevant facts and circumstances, including specified “safe harbor” hardship withdrawals that are deemed to be an immediate and heavy financial need (e.g., medical expenses, secondary school expenses, funeral expenses, etc.). The final regulations, generally tracking the proposed regulations, make a number of changes to these rules to expand access to retirement funds when a participant is in need.

Final Regulations

The IRS’ final regulations make the following key changes: (1) requiring plans to eliminate the six-month suspension of contributions following a hardship distribution made on or after January 1, 2020; (2) permitting plans to eliminate the requirement that participants obtain all available plan loans prior to receiving a hardship distribution; (3) expanding the types of contribution sources available for hardship distributions; (4) adding a new type of safe harbor hardship expense for losses relating to a federally-declared disaster; and (5) updating the administrative process required to document that the distribution is necessary to meet the financial need. Below, we describe each of the changes, including certain clarifications provided in the final regulations.

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- Elimination of 6-Month Suspension (Optional for 2019 Plan Year, Mandatory Beginning 1/1/2020).** Consistent with the proposed regulations, under the final regulations, a plan sponsor may (but is not required to) eliminate the 6-month suspension period on employee contributions (401(k), 403(b), after-tax, Roth) for hardships distributions in plan years beginning after December 31, 2018, and may end any current suspension periods as of the first day of the first plan year beginning after December 31, 2018, even if the distribution was made in the prior plan year. However, for hardship distributions made on or after January 1, 2020, no suspension of employee contributions is permitted in connection with a hardship withdrawal from any qualified plan, 403(b) plan, or governmental 457(b) plan.

 - 409A Plan Issues:** The final regulations clarify that the prohibition on suspension is not intended to apply to nonqualified deferred compensation plans subject to Code section 409A, which may eliminate any suspension period provided that it is consistent with Code section 409A and regulations thereunder. The Treasury Regulations under Code section 409A allow an employer discretion to cancel a deferral election under a nonqualified plan due to a hardship distribution; such a provision may or may not be in the nonqualified deferred compensation plan document. Employers should ensure that any changes in the coordination between hardship distributions and Code section 409A deferral elections be consistent with plan documentation and consideration should be given to adopting changes prospectively. Notably, in connection with a hardship distribution, if an employer intends to continue cancelling deferral elections under a Code section 409A plan that has the same third-party administrator as the employer's qualified plan, 403(b) plan or governmental 457(b) plan, the employer should confirm with the third-party administrator that its operating systems can administer different suspension rules.
- Elimination of Requirement to First Take Plan Loans (Optional, Beginning With 2019 Plan Year).** The final regulations preserve the language in the proposed regulations permitting plan sponsors to retain or eliminate the requirement that available plan loans must be taken prior to receiving a hardship distribution, effective for hardship distributions in plan years beginning after December 31, 2018. The plan loan requirement may apply to all plans maintained by the employer.
- Expansion of Amounts Eligible For Hardship Distributions (Optional, Beginning With 2019 Plan Year).** As under the proposed regulations, and consistent with the Act's expansion of available amounts, the final regulations permit (but do not require) a 401(k) plan sponsor to allow hardship distributions from plan accounts holding elective deferrals, QNECs, QMACs, and traditional safe harbor contributions, QACA safe harbor contributions, and all earnings thereon.

 - Special Rules For 403(b) Plans:** Amounts available for distribution due to hardship under 403(b) plans are more limited. First, earnings attributable to section 403(b) elective deferrals continues to be ineligible for a hardship distribution because the Act did not amend Code section 403(b)(11) that prohibits distribution of such earnings. Second, QNECs and QMACs



in a 403(b) plan that are held in a 403(b)(7) custodial account continue to be ineligible for hardship distributions. However, QNECs and QMACs in a non-custodial 403(b) annuity plan (e.g., under Code section 403(b)(1) or 403(b)(9)) are eligible for hardship distribution.

- **Casualty Loss Expenses Not Tied To a Disaster (Optional for 2018 and 2019, Mandatory Beginning 1/1/2020).** The 401(k) plan regulations previously permitted a hardship withdrawal generally for a “casualty loss” as defined under Code section 165 (without regard to certain limitations). The change to the Code section 165 casualty loss provision in the Tax Cuts and Jobs Act of 2017 (the “Tax Act”), requiring that the loss be incurred due to a federally declared disaster, created some uncertainty regarding the impact on hardship withdrawals. Consistent with the proposed regulations, the final regulations clarify that the Tax Act change does not apply to hardship distributions (i.e., a hardship distribution for expenses to repair damage to the participant’s principal residence is not tied to a federally declared disaster). For 2018 and 2019 hardship withdrawals, it is permissible to apply the limitation to such withdrawals, i.e., either approach was acceptable for 2018 and 2019. However, for hardships on or after January 1, 2020, following the new effective date of the regulations, the disaster limitation no longer applies.
- **New Withdrawal Reason – Disaster Event (Optional Beginning With 2019 Plan Year).** Historically, the IRS has announced relief permitting plan withdrawals for expenses or losses incurred by a participant (or the participant’s family) as a result of a federally declared disaster (e.g., Announcement 2017-15 for Hurricane Maria and the California Wildfires). As under the proposed regulations, the final regulations add to the list of distributions deemed to be an immediate and heavy financial need expenses and losses (including loss of income) incurred by the employee on account of a disaster declared by the Federal Emergency Management Agency (FEMA), provided that the employee’s principal residence or principal place of employment at the time of the disaster was located in the area designated by FEMA for individual assistance with respect to the particular disaster. However, the relief in this new hardship withdrawal reason is not as expansive as the hardship relief given in prior disaster guidance, like Announcement 2017-15, for example, it permits hardship distributions only for the participant’s expenses and losses. Regardless, including this new reason is intended to eliminate any delay or uncertainty for participants concerning access to plan funds following a federally declared disaster. Consistent with the proposed regulations, the Preamble to the final regulations states that this provision may be applied to distributions made on or after a date that is as early as January 1, 2018. For example, this provision could have been extended to disasters that occurred in 2018 (such as Hurricane Florence or Hurricane Michael), provided the location requirements were met. While this provision will generally replace future disaster-relief Announcements from the IRS, the Preamble to the final regulations notes that future guidance may be issued to address amendment deadlines where hardship and loan relief provisions are added to a plan in response to a particular disaster.

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- **Catch-all “Facts and Circumstances” Test Eliminated (Optional for 2019 Plan Year, Mandatory Beginning 1/1/2020).** As under the proposed regulations, the final regulations change the provisions for determining whether a distribution is necessary to satisfy a financial need. For hardship distributions made on or after January 1, 2020, the historic, catch-all “relevant facts and circumstances” test is eliminated in determining whether a distribution is necessary to satisfy a financial need and replaced with a single, general, and more objective standard. The determination under the new standard for 401(k) and 403(b) plans requires that:
 - (1) a hardship distribution not exceed the amount of the employee’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 employee first obtain other available distributions (this includes all currently available distributions, such as available ESOP dividends, but not hardship distributions or loans) under the plan and all other plans of deferred compensation maintained by the employer, whether qualified or nonqualified, and
 - (3) the employee represent (in writing or by an electronic medium, including, for example, in an online application or verbally during a telephone conversation that is recorded, or other forms as prescribed by the IRS) that he or she has insufficient cash or liquid assets “reasonably available” to satisfy the financial need. The Preamble to the final regulations clarifies that cash or liquid assets that are earmarked for another expense, such as rent, are not considered reasonably available to the participant. (Note this is a change from the proposed regulations.)

A plan administrator may rely on an employee’s representation unless the plan administrator has actual knowledge to the contrary. The Preamble to the final regulations clarifies that a plan administrator is not required to inquire into a participant’s financial status – actual knowledge applies where the plan administrator already has such information. While not required for hardship withdrawals prior to 2020, the written certification requirement may be implemented for the 2019 plan year. A plan sponsor is also permitted to impose additional conditions to meet this standard, if desired (such as requiring a plan loan to be taken first – but no suspension period; imposing a nondiscriminatory, minimum dollar amount for a hardship distribution; requiring certification that the expense is not reimbursable through insurance or other means and borrowing the necessary amount on reasonably commercial terms is not possible; and requiring documentation substantiating the hardship reason and processing requirements).

Plan Amendments

Plan amendments will be needed to reflect the hardship changes under the final regulations, which provides for an effective date of hardships made on or after January 1, 2020. For non-governmental, individually designed 401(k) plans, the deadline to adopt an amendment for any of these required or optional changes is the end of the second calendar year that begins after the issuance of the Required

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Amendment List that includes these changes. For example, if the hardship regulations are included in the 2019 Required Amendment List, the amendment must be adopted by December 31, 2021.

Sponsors of pre-approved plan programs will also need to adopt interim amendments to address the hardship distribution changes, which for 401(k) plans is the interim amendment deadline for required amendments, which varies depending on the plan year, fiscal year of the plan sponsor, and on a tax filing extension. Specifically, it is the later of the plan sponsor's tax filing deadline (including extensions) for the tax year in which the plan amendment is effective or the last day of the plan year in which the amendment is effective, presumably using a January 1, 2020 effective date for this purpose even if the provisions were adopted early.

For 403(b) plans, the current remedial amendment period is applicable, such that any amendments reflecting the changes in the final regulations are due by March 31, 2020. However, we understand that further guidance extending this deadline is being considered.

Action Steps

Now that the final regulations have been issued, plan sponsors and recordkeepers should:

- promptly review their hardship distribution procedures and forms in light of the final regulations,
- adopt amendments prior to the amendment deadline to reflect the required changes and any optional changes that were or will be implemented in operations,
- if using a pre-approved plan document, check with the plan provider to see what action steps are needed, including any default provisions the plan provider may be implementing, and
- for safe harbor plans, confirm that the safe harbor notice has been updated to reflect the hardship changes (and if not reflected, provide an updated notice and give participants a reasonable opportunity to change their cash or deferral election).

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