



Employee Benefits & Executive Compensation ADVISORY ■

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Final Hardship Distribution Rules Are Here: Does Your 401(k) or 403(b) Plan Comply?

The IRS published [final regulations](#) relating to hardship distributions from 401(k) and 403(b) plans on September 23, 2019. These regulations reflect the changes made by both the Tax Cuts and Jobs Act of 2017 and the Bipartisan Budget Act of 2018. The final regulations are substantially similar to the proposed regulations that were released in 2018 and state that “plans that complied with the proposed regulations will satisfy the final regulations.” However, all plan sponsors should review and, if necessary, amend their 401(k) and 403(b) plans to ensure compliance with the final regulations.

Plan Amendment Timing

Plan sponsors may need to amend their plans to comply with the mandatory provisions of the final regulations, and such amendments must be effective no later than January 1, 2020. Each plan is different, and whether an amendment is required will depend on the terms and operation of the plan. If an amendment is required, the deadline for adopting such an amendment differs depending on the type of plan:

- *Individually designed 401(k) plans* must amend by the end of the second calendar year that begins after the issuance of the Required Amendments List, which will be December 31, 2021, if the final regulations are included in the 2019 Required Amendments List.
- *Preapproved 401(k) plans* must amend by the 2020 tax-filing deadline, inclusive of any extensions.
- *403(b) plans* must amend by March 31, 2020. However, the Treasury Department and IRS are considering providing for a later amendment deadline for these plans that would be issued in separate guidance.

Plan sponsors may also choose to amend their plans to comply with permissible, but non-mandatory provisions of the final regulations. Timing for these permissible changes will depend on when the plan provision is adopted operationally.

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Next Steps for Plan Sponsors

In preparation for the January 1, 2020 effective date of these hardship regulations, plan sponsors and administrators should:

- Determine what provisions will be adopted on what date. Mandatory changes must be effective no later than January 1, 2020. Plan sponsors may also choose whether to adopt an earlier effective date, such as January 1, 2019, for some provisions. If any provisions were adopted operationally in 2019, a January 1, 2019 effective date may be appropriate, and such amendments should be adopted no later than December 31, 2019.
- Update hardship withdrawal provisions on participant communications, including summary plan descriptions and safe harbor notices, if applicable. Keep in mind that safe harbor notices for the 2020 plan year must be provided at least 30 days before the beginning of the plan year. If a safe harbor notice describes hardship withdrawal provisions in detail and if a description of the new hardship withdrawal provisions is not already included in the safe harbor notice, participants must be provided with an updated safe harbor notice reflecting the new hardship withdrawal provisions and must be given a reasonable opportunity to change their cash or deferred election.

Background

Active plan participants are permitted by the Internal Revenue Code to obtain a distribution from their plan account if they are facing a financial hardship. These distributions are commonly known as “hardship distributions.” Many plans have already been administering hardship distributions for several years and are already familiar with the requirements, but in general for a distribution to qualify as a hardship distribution, the distribution must satisfy the following two-pronged test:

Prong 1: The distribution must be made on account of an “immediate and heavy financial need”

While this can be determined on a facts and circumstances basis, the IRS has previously provided a safe harbor list of financial needs that will be deemed to constitute an “immediate and heavy financial need,” including:

- Expenses for medical care for the participant, the participant’s spouse, or dependents.
- Costs directly related to the purchase of a principal residence for the participant (excluding mortgage expenses).
- Post-secondary education expenses, including tuition, related educational fees, and room and board expenses for the next 12 months for the participant or the participant’s spouse, children, or dependents.
- Payments necessary to prevent the eviction of the participant from the participant’s principal residence or foreclosure on the mortgage on that residence.

- Funeral expenses for the participant or the participant's spouse, children, or dependents.
- Expenses for the repair of damage to the participant's principal residence that would qualify for the casualty deduction under Section 165.¹

Prong 2: The amount must be necessary to satisfy the financial need

Again, this can be determined under a facts and circumstances basis or under an IRS safe harbor. If used, the previous IRS safe harbor required that:

- The distribution does not exceed the amount of a participant's need.
- The participant has obtained all other currently available distributions and nontaxable loans under the plan and all other plans maintained by the employer.
- The participant is prohibited from making elective deferrals or contributions to the plan or any other plan maintained by the employer for at least six months after receipt of a hardship distribution.

The new hardship regulations make changes to both of these prongs. Some of the changes are mandatory for plan sponsors to adopt, while other changes are permissible, but not required.

Mandatory Changes

There are no mandatory changes made to Prong 1 of the existing hardship requirements. The only mandatory changes affect Prong 2.

New determination for satisfaction of financial need

The final regulations change Prong 2 to incorporate a single general standard for determining whether a distribution is necessary.

Under this new standard:

- The participant must have obtained all other available distributions from all the employer's plans.
- The participant must represent that he or she has insufficient cash or other liquid assets "reasonably available" to satisfy the need. The "reasonably available" standard can be satisfied even if the participant has cash or other liquid assets on hand, but those assets are earmarked for other purposes (for example, rent).
- The plan administrator must not have actual knowledge to the contrary.

¹ The list of hardships is a general summary and is not intended to outline all the requirements for complying with the IRS hardship safe harbor.

This new certification standard in Prong 2 does not replace or eliminate the substantiation and documentation standards required to show proof of actual expenses incurred found in the safe harbor list of permissible expenses in Prong 1. Plan administrators and recordkeepers should continue to obtain source documents or rely on the summary model as detailed in the Internal Revenue Manual in addition to seeking this new certification from employees.

In addition, plan administrators should consider how to communicate with their recordkeepers to coordinate situations when the plan administrator may have actual knowledge that is contrary to a plan participant's certification.

Six-month suspension of contributions is no longer permissible

Many plans previously suspended participant contributions for six months following a hardship withdrawal. The final regulations no longer allow any automatic suspension for plan years starting January 1, 2020 or later. This prohibition on suspensions applies to qualified plans, 403(b) plans, and eligible 457(b) plans. However, the final regulations clarify that nonqualified deferred compensation plans subject to 409A that provide for a six-month suspension may retain their suspension provisions (or, to the extent consistent with 409A, remove them).

Permissible Changes

Permissible changes affect both prongs of the existing hardship requirements. In addition, plan sponsors may adopt a permissible change affecting the available sources of funds for hardship withdrawals.

Additional permissible hardship withdrawal safe harbor (Prong 1)

The safe harbor list of expenses that are deemed to constitute an "immediate and heavy financial need" is modified and expanded by adding expenses and losses (including loss of income) incurred by a participant on account of a disaster declared by FEMA, provided the participant's principal residence or principal place of employment at the time of the disaster was in the designated disaster area.

Additional permissible recipient of hardship withdrawals (Prong 1)

The new "immediate and heavy financial need" safe harbor provisions state that medical expenses, tuition and educational expenses, and funeral or burial expenses required for a participant's "primary beneficiary" under the plan would also qualify as a hardship withdrawal. Before this change, these withdrawals are limited for the benefit of certain specified relatives or dependents.

The regulations define the term "primary beneficiary" broadly to include any person entitled to receive a portion of the account on the participant's death. A participant could name an unrelated individual as a primary beneficiary for a small percentage of the participant's account and then take a hardship withdrawal to pay the individual's otherwise qualifying tuition, medical expenses, or funeral or burial expenses.

This represents a planning opportunity for participants in plans that permit this change because it significantly expands the universe of people whose needs may now qualify for a hardship distribution.

Amended application of personal casualty loss (Prong 1)

Separate from the new hardship regulations, the Tax Cuts and Jobs Act added a new Section 165(h)(5) to the Code. This new section provides that, for taxable years 2018 through 2025, the deduction for a personal casualty loss is generally only available to the extent the loss is attributable to a federally declared disaster. The final hardship regulations clarify that for purposes of the “immediate and heavy need” safe harbor provisions, Section 165(h)(5) can be ignored. Plans that reference the casualty loss deduction in Section 165 may need to be amended to clarify that Section 165(h)(5) does not apply.

Plan loans are no longer required to demonstrate a financial need (Prong 2)

Participants are no longer required to take out all available plan loans before making a hardship withdrawal to demonstrate a financial need.

Additional permissible sources of hardship withdrawals

The regulations expand the sources of hardship withdrawals to include QNECs, QMACs, safe harbor contributions, and earnings on all these amounts regardless of when contributed or earned. Previously, only participant elective contributions (but not earnings thereon) were eligible for a hardship withdrawal.

QNECs and QMACs in a 403(b) plan that are in a custodial account continue to be ineligible for distribution on account of hardship.

Conclusion

The final regulations provide helpful guidance on both mandatory and permissible changes to hardship withdrawal procedures. Plan sponsors should closely review their hardship withdrawal procedures to determine compliance with mandatory provisions and consider whether to adopt any permissible changes. Please do not hesitate to contact your Alston & Bird attorney if you have any questions about hardship withdrawals or if we can assist you in amending your 401(k) or 403(b) plan.

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