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IRS finalizes 401(k) hardship withdrawal rules

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The final rules that provide participants easier access to hardship withdrawals mostly follow those proposed last November, which reflected various legislative updates enacted between 2006 and 2018.

Background

Since the last major overhaul of the 401(k) final regulations in 2004, there were several legislative changes to the hardship distribution rules.

The Pension Protection Act of 2006 (PPA) issued rules that permitted 401(k) plans to treat the participant's designated beneficiary under the plan the same as his or her spouse or dependent under the hardship rules.

PPA also added "qualified reservist distributions" (that allowed military reservists called to active duty to withdraw their 401(k) balances) as a permissible 401(k) distribution event. The Heroes Assistance and Relief Tax Act (the HEART Act) followed in 2008, which allowed participants on active military duty to be treated as if they had terminated employment —allowing them to withdraw their 401(k) accounts but requiring them to stop contributing for six months thereafter —in a manner similar to the existing safe harbor hardship rules.

The Tax Cuts and Jobs Act of 2017 indirectly modified one of the expenses deemed to be a hardship under the 401(k) regulations — for the repair of damage to an employee's principal residence that would qualify for a deduction — by limiting that deduction to damages arising from a federally declared disaster, not, for example, due to a fire unrelated to such a disaster.

Finally, the Bipartisan Budget Act of 2018 permitted 401(k) plans to allow account balances attributable to qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), employer contributions made to satisfy a 401(k) nondiscrimination safe harbors, and earnings on elective employee contributions to be available for hardship distributions. It also eliminated the requirement to take a plan loan before a hardship distribution and directed the secretary of Treasury to revise the 401(k) regulations to remove the six-month suspension on employee 401(k) and after-tax contributions following a hardship distribution.

Proposed regulations were issued in November 2018 to address the above-noted changes. The proposed regulations clarified that a casualty loss to a participant's principal residence would not need to occur within a federally declared disaster area for it to be considered a "safe harbor" hardship eligible expense. They also added expenses incurred as a result of federally declared disasters to the "safe harbor" list of deemed immediate and heavy financial needs. See our November 27, 2018 *FYI*.

Final regulations

Final regulations were issued on September 19 that are substantially similar to the proposed regulations. However, there are several clarifications that are of interest to plan sponsors.

Distribution to meet a need

Instead of the current safe harbor — which includes requiring an elective deferral suspension of at least six months and taking all other distributions, including loans, as conditions to be deemed a hardship — a distribution will now be viewed as necessary to satisfy an immediate and heavy financial need only to the extent the employee has taken all other available distributions from the plan and other deferred compensation plans of the employer *other than loans*. In addition, employees will be required to represent that they do not have any other available cash or liquid assets to satisfy the need.

Though the regulations prohibit 401(k) plans from imposing a suspension from contributing as a condition for granting a hardship, the preamble to the regulations stopped short of prohibiting non-hardship-related contribution suspensions. Thus, the regulations did not remove the six-month suspension from elective deferrals required to be imposed following HEART Act distributions to participants on military leave when called to active duty for more than 30 days. They also do not supersede IRS Revenue Ruling 74-56, which allows plans to suspend employee contributions for at least six months following a *non-hardship* withdrawal of matched after-tax contributions as a means to restrict participants from "manipulating the match" in a prohibited manner (by making after-tax contributions to get a match and then withdrawing the after-tax contributions immediately thereafter).

Must obtain other currently available distributions first

In response to comments requesting that ESOP pass-through dividends be excepted from the requirement, the preamble to the final regulations explains that although no exception can be made for these distributions, in order to be "currently available," they must both (1) have been paid to the plan, and (2) be available for the employee to elect to receive in cash. Thus, if a participant irrevocably elected not to receive a dividend in cash, or the dividend is not payable by the time the immediate and heavy need is incurred, there would be no dividends currently available that would have to be withdrawn before the hardship is granted.

Must represent insufficient cash/liquid assets

The final regulations require the employee to represent only whether the employee has cash or other liquid assets that are "reasonably available" to satisfy the immediate and heavy financial need and not earmarked for other short-term financial needs such as rent payments. While they retain the rule that the plan administrator must disregard an employee's representations if the plan administrator has actual knowledge to the contrary, the new rules say that the plan administrator is not required to inquire about the details of the employee's financial condition if he doesn't already have such knowledge.

Employee representations may be made in writing or via an electronic medium — including over the phone if the call is recorded.

Additional conditions may still be imposed

Despite the increased flexibility, employers can still impose other limitations. These can include, among other things:

- Requiring an application to be filed along with the documentation necessary to substantiate the hardship
- Requiring nontaxable loans to be taken first before receiving a hardship distribution
- Suspending deferrals under nonqualified deferred compensation plans for a specified period following the hardship
- Limiting the amount or number of distributions (provided that nondiscrimination requirements are not violated)
- Continuing to exclude QNECs/QMACs/401(k) safe harbor employer contributions, and/or earnings on elective deferrals from eligibility

The regulations also clarified that a pre-approved plan need not allow hardship distributions for all listed safe harbor expenses described in the regulations.

Disaster relief

Disaster-related expenses that are a result of certain federally declared disasters are now eligible to be treated as safe harbor hardship expenses. In contrast to the special withdrawals available under recent IRS disaster relief pronouncements, only the expenses and losses of employees who lived or worked in the federally declared disaster area will be eligible for this safe harbor hardship — not those of the employee's dependents or relatives. According to the preamble, IRS expects this will alleviate the need for frequent disaster relief announcements, though they can still issue subsequent disaster relief guidance on an ad-hoc basis — such as allowing delayed plan amendment deadlines for adding hardship withdrawal provisions to a plan, or providing relaxed administrative requirements for hardships in response to a particular disaster.

A safe harbor hardship distribution can be made because of damage to the participant's principal residence without requiring that the house be in a federally declared disaster area.

Effect on 403(b) and governmental 457(b) plans

Neither 403(b) accounts nor governmental 457(b) arrangements will be allowed to suspend employees from contributing elective deferrals or after-tax contributions following a hardship withdrawal. Since 457(b) plans do not offer hardship withdrawals, (though they can offer somewhat similar "unforeseeable emergency" distributions) this prohibition for 457(b) plans is aimed at imposing a suspension of 457(b) contributions if a participant also contributes to a 401(k) or 403(b) plan sponsored by the same governmental employer.

Though the 403(b) distribution regulations on hardships reference the 401(k) regulations, the final regulations clarify that pre-1989 earnings on 403(b) elective deferrals still cannot be withdrawn because of hardship. Although hardship withdrawals can include QNECs and QMACs under 403(b) annuity contracts (if the plan and contract terms permit), they still cannot be included in hardship withdrawals from 403(b) mutual fund custodial accounts.

Notice requirements for safe harbor 401(k)/403(b) plans

Because hardship withdrawal provisions must be described in the notice provided to eligible employees, if a description of the new rules was not already addressed in the notice distributed for the plan year in which they go into effect, employees must be provided an updated notice and given a reasonable opportunity to change their cash or deferred election.

Effective date

While the final rules must be applied to distributions made on or after January 1, 2020, plans can apply them earlier to distributions made in plan years beginning after December 31, 2018.

Plans can stop suspending participant contributions because of hardship withdrawals starting with distributions that occur as early as January 1, 2019 or as late as January 1, 2020. As under the proposed regulations, a plan can also remove hardship suspensions applicable to 2018 distributions as early as January 1, 2019 — without waiting for the suspension to expire when originally scheduled. Alternatively, a plan can let suspensions that began before the effective date remain in effect through the end date of the previously scheduled suspension period.

The changes to the list of safe harbor expenses (e.g., for casualty losses or other losses because of a disaster that occurred in 2018) can be applied to distributions made on or after January 1, 2018.

Plan amendments

The deadline for amending an individually designed nongovernmental 401(k) plan to reflect the required changes to the hardship distribution provisions, if included in the IRS' 2019 Required Amendments List, will be December 31, 2021 (as expected). The disaster-related changes (relating to casualty losses; the addition of the new safe harbor expense relating to expenses incurred as a result of certain federally declared disasters; and the extension of the relief under Announcement 2017-15 to victims of Hurricanes Florence and Michael that was provided in the preamble to the proposed regulations) are treated as integrally related to a qualification requirement and therefore may be amended by the same deadline that applies to the required amendments.

The amendment deadline for individually designed nongovernmental plans described above is extended for individually designed governmental 401(k) plans to 90 days after the close of the third regular session of the legislative body with authority to amend the plan that begins on or after the inclusion of the hardship distribution provisions on the Required Amendments List.

For pre-approved 401(k) plans, the deadline for the required amendment will depend on the type of entity sponsoring the plan and the plan year. For example, for calendar year plans, the deadline would be the plan sponsor's 2020 tax-filing deadline with extensions (or its 2020 Form 990 filing deadline with extensions for tax-exempt employers).

The remedial amendment deadline for a section 403(b) plan is March 31, 2020. The Treasury Department and IRS are considering providing for a later deadline for the amendments relating to the final regulations in separate guidance.

In closing

It's likely that plans that complied with the November 2018 proposed rules will satisfy the final regulations. Plan sponsors should take note of the deadlines for safe harbor notices and plan amendments. Sponsors will need to update plan procedures, hardship withdrawal forms, and participant communications (such as Summary Plan Descriptions and Summary of Material Modifications) and eliminate hardship suspensions on their recordkeeping and payroll systems.

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