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New Retirement Plan Hardship Distribution Rules: What You Need to Know

Legal Alert

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The IRS recently amended the rules applicable to hardship distributions from 401(k) and 403(b) plans. The new hardship distribution regulation relaxes some of the restrictions on the availability of hardship distributions and simplifies the related administrative procedures for processing such distributions beginning on January 1, 2020.

Background. Active participants in 401(k) and 403(b) plans generally are not eligible to receive in-service distributions of elective deferrals prior to attaining age 59½ except for "hardship" distributions, which are defined as distributions that are necessary to meet an "immediate and heavy financial need". Prior to issuance of the new regulation to comply with the Bipartisan Budget Act of 2018, the rules provided for the following:

- In order to alleviate the burden on plan administrators to determine whether the participant has such an immediate and heavy financial need, the existing rules established six "safe harbors" to define circumstances that will be deemed to satisfy this requirement, such as medical expenses and purchase of a principal residence. As a matter of prudence, plans commonly limit hardship distributions to the safe harbor circumstances.
- The regulations also required that the amount of the hardship distribution be only the amount necessary to satisfy the financial need (plus taxes on the distribution). In connection with this requirement, existing regulations required the participant to first borrow any available plan loans to alleviate the need for (or reduce the amount of) the hardship distribution. In addition, future elective deferrals were required to be suspended for six months after receipt of a hardship distribution.
- The funds available to fund a hardship distribution were also generally limited to a participant's aggregate elective deferrals (but not the earnings), which would exclude any qualified non-elective or qualified matching contributions (sometimes referred to as QNECs and QMACs) that may have been made to the plan by the employer in order to satisfy the deferral and contribution percentage tests or to qualify as a safe harbor 401(k) plan.
- Finally, the existing regulations provided that the participant cannot qualify for a hardship distribution if the financial need could be satisfied from other sources and established a procedure whereby the participant could certify that was true, on which the employer was permitted to rely absent actual knowledge to the contrary.

The New Hardship Distribution Regulation. The new regulation effectively makes getting hardship distributions easier for participants of 401(k) and 403(b) retirement plans by loosening restrictions that previously may have prevented such distributions. In order to comply with the new regulation, plan sponsors will need to carefully review their current 401(k) and 403(b) plans and related documents, as well as administrative forms, and to amend them where applicable. The regulation changes the rules in several important ways:

- *Elimination of Six Month Suspension of Elective Deferrals.* For hardship distributions occurring on or after January 1, 2020, the old rule requiring recipients of hardship distributions to suspend elective deferrals for the six months following the distribution has been eliminated and inclusion of a mandatory suspension provision is now prohibited. While this rule is mandatory for hardship distributions beginning in 2020, plan sponsors are permitted to discontinue the deferral suspension requirement in 2019 as well.
- *Plan Loan Suspension Now Optional.* Plans are no longer obligated to require participants to first utilize all available plan loans prior to receiving a hardship distribution, but a plan is permitted to retain this requirement. Some plan sponsors may want to retain the loan requirement if they are concerned about "leakage" of their employees' benefits; *e.*, if they want their employees to maximize the amount of benefits available when they reach retirement age.
- *Expanded Sources of Hardship Distributions.* As noted above, hardship distributions were previously limited to elective deferrals only, without earnings. Hardship distributions from a 401(k) plan may now also include earnings related to elective deferrals, and QNECs and QMACs and related earnings. However, this expansion does not apply fully to 403(b) plans. Specifically, distributions of earnings are never permitted and distributions attributable to QNECs and QMACs are only allowed if the 403(b) funds are held in a "non-custodial account."
- *Disaster Area Limitation on Casualty Loss Hardship Distributions Eliminated.* The availability of the existing safe harbor hardship category for casualty losses was thrown into confusion by an amendment to Section 165 of the Internal Revenue Code (IRC) made by the Tax Cuts and Jobs Act of 2017 (TCJA), which (for the years 2018 through 2025) limits casualty loss deductions to those occurring in federally declared disaster areas. Because the casualty loss description in the existing regulations referred to IRC §165, the TCJA change effectively restricted the casualty loss safe harbor to losses occurring in federal disaster areas. The new regulation revised the casualty loss safe harbor to remove the reference to federally declared disaster areas for hardship distributions on or after January 1, 2020. The change may be implemented retroactively, so it can provide relief for plan administrators that did not impose the federal disaster area limitation on hardship distributions for casualty losses in 2018 or 2019.
- *New Deemed Hardship Distribution for Disaster Areas*. The new regulation provides that distributions to pay expenses and losses (including loss of income) to a participant whose primary residence or place of employment is in an area designated as a disaster area by the Federal Emergency Management Agency (FEMA) will be deemed to be for an "immediate and heavy financial need" if the distribution is for assistance with respect to the FEMA-designated disaster. This amendment is intended to facilitate quick access to plan funds following a federally declared disaster.

- *Replacement of the General "Facts and Circumstances" Test.* Previously, the plan administrator was required to consider "all relevant facts and circumstances" to determine if a hardship distribution was "necessary." The regulation now provides a simplified standard determine whether a distribution is "necessary" to satisfy an immediate and financial need of a participant. Under this new standard, a hardship distribution may be made if the following three requirements are met:
  - The distribution does 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);
  - The participant first obtains all other currently available non-hardship distributions, such as ESOP dividends or deferred compensation payments (but not participant loans) under the plan and all other qualified or nonqualified deferred compensation plans maintained by the employer; and
  - The participant must provide an acceptable representation that he or she has insufficient cash or liquid assets "reasonably available" to satisfy the financial need.

As under the prior rule, the employer may not rely on the certification if it has actual knowledge to the contrary.

Plan Amendment Deadlines. Plans will have to be amended to reflect the hardship distribution rules under the new regulations, which are applicable to hardship distributions made on or after January 1, 2020 (although plans are permitted to implement the new rules for distributions beginning in 2019). The deadlines for amendment vary depending on the type of plan maintained by the employer:

- 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 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.
- Pre-approved 401(k) plans (such as prototype or volume submitter plans) will have to be amended to incorporate the new rules in the next applicable period for the amendment of such plans and approval by IRS. Adopters of pre-approved plans also must adopt interim amendments implementing the changes. The interim amendment deadline is the later of (a) the last day of the plan year ending after January 1, 2020; or (b) the filing deadline (including extensions) for the tax year of the employer in which the January 1, 2020 effective date falls. For example, if both the plan year and the employer's tax year are the calendar year, the interim amendments must be adopted by the tax return filing deadline (including extensions) for the 2020 tax year. The preamble to the new regulation states that even if the plan implemented the new rules in operation for 2019, the required effective date of January 1, 2020 will dictate the amendment deadline.
- 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. In order to ensure compliance with the regulation, plan sponsors should:

- Review hardship distribution procedures and related participant forms and make any necessary changes to conform to the new rules. For example, if the instructions for a hardship distribution request state that a participant must suspend elective deferrals for six months, that provision must be eliminated.
- In the majority of cases, employers using a third-party administrator (TPA) should contact the TPA, which usually provides the plan's administrative forms, to make sure the TPA is implementing the appropriate changes to comply with the new rules.
- Timely adopt amendments to reflect both the required changes and any optional changes that were or will be implemented for the plan. Those employers using a pre-approved plan document should check with the TPA (or other document provider) to confirm that the necessary amendments (including interim amendments) are being prepared to implement the new rules, as well as any optional provisions that the employer wants to adopt.
- For employers maintaining safe harbor 401(k) plans, the safe harbor notice must be updated to reflect the hardship distribution changes. If these forms are provided by the TPA, the safe harbor notice may already have been updated, but if not, a corrected notice should be given.

If you have questions or need more information about the new hardship regulation or about implementing changes to the hardship distribution procedures, please contact Eric Loi, Allen Fineberg, or any member of the Flaster Greenberg Employee Benefits and Executive Compensation Group.

ATTORNEYS MENTIONED

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