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IRS Finalizes 401(k) Regulations on Hardship Distributions

[31991]

October 2, 2019 TO: ICI Members
Pension Committee
Pension Operations Advisory Committee SUBJECTS: Pension RE: IRS Finalizes 401(k) Regulations on Hardship Distributions

The Internal Revenue Service (IRS) recently finalized its amendments to the regulations relating to hardship distributions from 401(k) and 403(b) plans.[1] Like the proposed regulations issued in November 2018,[2] the final rule includes updates to the regulations to address changes made by legislation, including the Bipartisan Budget Act of 2018 (the "Budget Act")[3] and the tax reform bill enacted in December 2017 (the "Tax Reform Act").[4]

To qualify as a hardship distribution, a distribution must be made on account of an immediate and heavy financial need, the amount of the distribution cannot exceed the amount necessary to satisfy that need, and the distribution must be necessary to satisfy the need (i.e., the need cannot be relieved from other resources that are reasonably available to the employee). The regulations include certain safe harbors to help the plan make these determinations.

The final regulations are substantially similar to the proposed regulations, making the following amendments to the existing regulations:

Elimination of the six-month suspension period and requirement to first take a loan. The existing regulatory safe harbor for deeming a distribution necessary to satisfy an immediate and heavy financial need (1) prohibits a participant from making elective deferrals and employee contributions for six months after receiving a hardship distribution and (2) requires a participant to first take any available plan loan before taking a hardship distribution. The Budget Act directed Treasury to remove these two requirements, effective for plan years beginning after December 31, 2018, and the final rule does so. Effective for distributions made on or after January 1, 2020, plans are prohibited from applying a suspension of elective deferrals and employee contributions.[5] For distributions made during the period before January 1, 2020, but within a plan year beginning after December 31, 2018, plans are permitted to continue to apply the six-month suspension. Regarding suspensions that are in effect as of January 1, 2019, the proposal gives plans the option to either terminate the suspension period early (as of January 1, 2019), or to allow it to

continue for the remainder of the scheduled six-month period. In the final rule, the IRS clarifies that this prohibition on suspensions extends to all qualified plans, 403(b) plans, 457(b) plans and 457(e) plans, but it does not apply to nonqualified plans subject to Code section 409A.

New requirement to obtain employee representation. The existing regulations provided that the determination of whether the distribution is necessary to satisfy an immediate and heavy financial need is based on all of the relevant facts and circumstances, and it permitted an employer to rely on an employee representation to this effect. The final regulation simplifies these rules, and for hardship distributions made on or after January 1, 2020, requires an employee representation "that he or she has insufficient cash or other liquid assets reasonably available to satisfy the need."[6] The employee representation must be made in writing, including by electronic medium.[7]

Expanded safe harbor reasons for hardship. The regulations include a safe harbor list of six categories of expenses that are deemed to constitute an immediate and heavy financial need. The final rule, like the proposal, expands this list in three ways.

1. It provides that three of the categories (medical, educational, and funeral expenses) now include expenses incurred by a "primary beneficiary" of the participant under the plan.

2. Regarding the category of expenses for repairing damage to the employee's residence that would qualify for the casualty deduction under Code section 165, the final rule clarifies that the new limitations that the Tax Reform Act added to Code section 165 do not apply for hardship purposes.[8]

3. Finally, the final rule adds a new seventh category to this list: expenses and losses incurred on account of a disaster declared by the Federal Emergency Management Agency (FEMA), if the employee's principal residence or principal place of employment was located in an area designated by FEMA for individual assistance. Until now, the IRS has granted this relief on an ad hoc basis after such disasters.[9] By including this category in the safe harbor, the IRS intends to eliminate the delay and uncertainty that plans often experienced following such disasters. In the preamble, the IRS announces that it expects that the ad hoc disaster-relief announcements will no longer be needed, but that it is "considering separate guidance to address delayed amendment deadlines when the new safe harbor expense or loan provisions are added to a plan at a later date in response to a particular disaster."[10]

A plan may apply any of these changes to distributions made on or after a date as early as January 1, 2018.

Expanded sources for hardship distributions. Under the existing rule, an employee generally could only take a hardship distribution from his total amount of elective deferrals. The Budget Act directed IRS to change the regulation to allow plans to permit hardship distributions of qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), and 401(k) safe harbor employer contributions, in addition to elective contributions, and earnings on all of those amounts, effective for plan years beginning after December 31, 2018. The regulations incorporate this change and make clear that plans can limit the type of contributions it makes available for hardship distributions.

Application to section 403(b) plans. The preamble to the regulations explains that the

changes described above generally also apply to hardship distributions taken from 403(b) plans because the hardship provision in the 403(b) regulations refer to the 401(k) regulatory hardship provision. However, because of the statutory language of 403(b), earnings on elective deferrals to 403(b) plans continue to be ineligible for hardship distribution. Further, the preamble explains that "QNECs and QMACs in a section 403(b) plan that are not in a custodial account may be distributed on account of hardship, but QNECs and QMACs in a section 403(b) plan that are in a custodial account continue to be ineligible for distribution on account of hardship."

The final regulations apply to distributions made on or after January 1, 2020; however, they may be applied to distributions made in plan years beginning after December 31, 2018.

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endnotes

[1] 84 Fed. Reg. 49651 (September 23, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-09-23/pdf/2019-20511.pdf.

[2] For a description of the proposal, *see* ICI Memorandum No. 31486, dated November 16, 2018, *available at* https://www.ici.org/my_ici/memorandum/memo31486.

[3] *See* ICI Memorandum No. 31085, dated February 12, 2018, *available at* https://www.ici.org/my_ici/memorandum/memo31085.

[4] *See* ICI Memorandum No. 30991, dated December 21, 2017, *available at* https://www.ici.org/my_ici/memorandum/memo30991.

[5] In the preamble, IRS cites Congress' concern that a suspension impedes an employee's ability to replace distributed funds as the basis for prohibiting suspensions. Notwithstanding the removal of the loan condition from the safe harbor, the final rule clarifies that a plan may require additional conditions for taking a hardship, including requiring an employee to first obtain all nontaxable loans available under the plan and all other plans maintained by the employer. In the preamble to the final rule, the IRS confirms that additional conditions could include (1) completing a plan's application process, (2) providing required documentation, and (3) providing for a nondiscriminatory, minimum dollar amount for a hardship distribution.

[6] The IRS made a slight change from the proposal, adding the words "reasonably available" to address a commenter's concern that a participant could have cash or other liquid assets on hand that were already earmarked for another use, such as rent.

[7] In response to a comment, the IRS added a reference to the definition of electronic medium in 1.401(a)-21(e)(3), to clarify that a verbal representation via telephone could be used. According to the definition referenced, "the term electronic medium means an electronic method of communication (*e.g.*, Web site, electronic mail, telephonic system, magnetic disk, and CD-ROM)."

[8] The Tax Reform Act narrowed the section 165 deduction by providing that, for taxable years 2018 through 2025, the deduction generally is available only to the extent the loss is attributable to a federally declared disaster. For hardship distributions, expenses in this category continue to be determined without regard to whether the loss exceeds ten percent of adjusted gross income.

[9] For example, *see* ICI Memorandum No. 30936, dated November 6, 2017, available here: https://www.ici.org/my_ici/memorandum/memo30936. Note that, unlike the final rule, IRS's ad hoc guidance typically extends this treatment to former employees, as well as to the employee's or former employee's lineal ascendant or descendant, dependent or spouse who had a principal place of residence or place of employment in one of the designated areas on the applicable date. The IRS acknowledges in the preamble that the regulatory provision is narrower in this regard, noting that this limitation "is consistent with the purposes underlying the Code's hardship distribution provisions and better aligns with the relief given to affected individuals under section 7508A for similar disasters." IRS also notes that unlike its ad hoc guidance, the regulatory provision does not include a specific deadline by which a request for a hardship distribution due to a disaster must be made.

[10] The IRS notes in the preamble that if a plan chooses to wait until a disaster occurs to add this provision, it would need to adopt a plan amendment by the end of the plan year the amendment is first effective.
